"NO ECONOMIC SENSE" MAKES NO SENSE FOR EXCLUSIVE DEALING

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I. INTRODUCTION

Exclusive dealing is typically output-enhancing. Sellers can pursue exclusive dealing agreements to achieve dedicated distribution, to avoid free riding, or to assure a customer sales base sufficient to achieve economies of scale. Buyers, correspondingly, may seek out exclusive arrangements to encourage competitive bidding among their suppliers, to secure a supply of sufficient quantity, or to ensure receipt of high quality products from a known source. There are numerous other equally valid reasons for exclusives as well. And the benefits to consumer welfare can be significant. Yet, on occasion, exclusive dealing arrangements can also serve to maintain or extend significant market power and, in the process, cause substantial consumer harm.[1] Sound antitrust policy requires care in distinguishing the ordinary, procompetitive arrangements from those that harm consumers.

Exclusive dealing arrangements are among the practices subject to challenge, not just as unreasonable restraints under Section 1 of the Sherman Act and Section 3 of the Clayton Act, but also as exclusionary or anticompetitive conduct under Section 2 of the Sherman Act. In the broader context of what constitutes an unlawful practice under Section 2,

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[1] Consider the Pullman sleeper car monopoly that extended over seven decades. Chicago, St. Louis & New Orleans R.R. Co. v. Pullman S. Car Co., 139 U.S. 79 (1891); United States v. Pullman Co., 50 F. Supp. 123 (E.D. Pa. 1943), or United Shoe's control over shoe-making machinery that lasted for almost as long. United States v. Winslow, 227 U.S. 202 (1913); United States v. United Shoe Mach. Co., 110 F. Supp. 295 (D. Mass. 1953), *aff'd*, 347 U.S. 521 (1954) (per curiam); United States v. United Shoe Mach. Corp., 391 U.S. 244 (1968).

there has been considerable recent academic debate surrounding the appropriate standard by which to determine whether conduct is exclusionary. Some commentators have suggested profitability-focused tests, mainly the "no economic sense" test[2] and the "profit sacrifice" test,[3] as alternatives to the more traditional consumer welfare effects standard.[4] Others have concluded that there is no one-size-fits-all test under Section 2 because different kinds of exclusionary conduct demand different methods of analysis.[5]

Advocates of the no economic sense test would find conduct illegal under Section 2 only if the "conduct likely would [not] have been profitable if the existing competitors were not excluded and monopoly was not created" or if the conduct "likely would [not] have been profitable if the nascent competition flourished and the monopoly was not maintained."[6] Some advocates contend that the test—or its "profit sacrifice" variant—should have near universal application to *all* conduct challenged under Section 2.[7] As applied to exclusive dealing, that would

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[2] *See, e.g.,* Gregory J. Werden, *Identifying Exclusionary Conduct Under Section 2: The "No Economic Sense" Test*, 73 ANTITRUST L.J. 413 (2006).

[3] *See* A. Douglas Melamed, *Exclusive Dealing Agreements and Other Exclusionary Conduct—Are There Unifying Principles?*, 73 ANTITRUST L.J. 375, 389–90 (2006) [hereinafter *Exclusive Dealing*]; A. Douglas Melamed, *Exclusionary Conduct Under the Antitrust Laws: Balancing, Sacrifice, and Refusals to Deal*, 20 BERKELEY TECH. L.J. 1247, 1255 (2005) [hereinafter *Exclusonary Conduct*]; Mark Patterson, *The Sacrifice of Profits in Non-Price Predation*, ANTITRUST, Fall 2003, at 37.

[4] *See* Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 ANTITRUST L.J. 311 (2006); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209, 213 (1986).

[5] *See* Kenneth L. Glazer & Abbott B. Lipsky, Jr., *Unilateral Refusals to Deal Under Section 2 of the Sherman Act*, 63 ANTITRUST L.J. 749 (1995); Mark S. Popofsky, *Defining Exclusionary Conduct: Section 2, the Rule of Reason, and the Unifying Principle Underlying Antitrust Rules*, 73 ANTITRUST L.J. 435, 437 (2006); Andrew I. Gavil, *Exclusionary Distribution Strategies By Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3, 52–66 (2004). The consumer welfare or rule of reason test, as articulated by Professor Salop and endorsed here, has a similar effect—with the analysis varying based on the specific facts of the case at hand to determine whether consumers have been or will be harmed. *See* Part V below.

[6] Werden, *supra* note 2, at 415. The profit sacrifice test is quite similar; it asks whether "the conduct is profitable to the defendant in light of its (incremental) costs [including opportunity costs] and (incremental) benefits . . . [and] (2) . . . whether the conduct enabled the defendant to gain additional market power or a dangerous probability thereof." Melamed, *Exclusive Dealing*, *supra* note 3, at 389–90 (footnotes omitted).

[7] *See* Melamed, *Exclusionary Conduct*, *supra* note 3, at 1255; *cf.* Werden, *supra* note 2, at 420–22 (noting that the no economic sense test does have its limitations). The Department of Justice, in supporting the petition for a writ of certiorari in *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004), encouraged application of the no economic sense test as a general standard for defining exclusionary conduct under Section 2. The government advocated that "[c]onduct is 'exclusionary' or 'predatory' in antitrust jurisprudence if the conduct would not make economic sense for the defendant

make legality turn, not on the net effect on consumer welfare, but on whether the arrangement would have been profitable to (or made economic sense for) the defendant absent the exclusionary impact on rivals.

The no economic sense test is problematic when applied to exclusive dealing. Unlike some other types of conduct subject to challenge under Section 1 or Section 2, exclusive dealing is a practice that almost always is accompanied by some efficiency justification.[8] The presence of efficiencies, coupled with the occasionally minimal costs associated with an exclusive dealing scheme, suggests that an exclusive arrangement will typically make at least *some* "economic sense" to the defendant. But the way in which those efficiencies are achieved, and thus confer economic benefits on the defendant, is precisely through the mechanism of exclusion—the elimination of rivals' competition for the duration of the exclusive arrangement. The application of the no economic sense test to exclusive dealing is therefore unintelligible. In most cases, there is no way to separate the economic benefit to the defendant from the exclusionary impact on rivals. The relevant question for exclusive dealing is not whether it "makes economic sense" (because it so frequently does), but whether, on balance, the specific arrangements at issue are likely to raise prices, reduce output, or otherwise harm consumers. The no economic sense test declines that inquiry.[9]

II. THE NO ECONOMIC SENSE AND PROFIT SACRIFICE TESTS

It is important to understand the purposefully narrow origins of the no economic sense test to help explain why the test has limited applicability beyond the context of predatory pricing and refusals to deal with a horizontal rival.

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but for its elimination or softening of competition." Brief for the United States and FTC as Amici Curiae, at 10, *available at* http://www.usdoj.gov/atr/cases/f200500/200558.pdf. However, in the joint brief filed by the Department and the Federal Trade Commission on the merits of the case, the argument was narrower, urging use of the test in contexts where the defendant was being asked to provide access to its own assets to a rival. Brief for the United States and FTC as Amici Curiae Supporting Petitioner at 15–20, *available at* http://www.usdoj.gov/atr/cases/f201000/201048.pdf.

[8] *See* Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L. J. 311, 357–61 (2002).

[9] The no economic sense test will generate correct results from time to time. *Lorain Journal Co. v. United States,* 342 U.S. 143 (1951), is often cited—correctly—as a case where the defendant's conduct made no economic sense, helped maintain monopoly power, and was properly condemned. But condemnation under that test would have been nothing more than a fortunate accident, attributable to the absence of *any* justification rather than the harm to the market. The facts in *Lorain* would equally have generated prohibition under the consumer welfare effect/rule of reason test, not based on serendipity, but on

The no economic sense test is rooted in the framework first articulated by Professors Areeda and Turner in 1975 for evaluating whether unilateral pricing decisions violate Section 2.[10] Although Areeda and Turner introduced the broad outlines of the test using quite general language—"the classically-feared case of predation has been the deliberate sacrifice of present revenues for the purpose of driving rivals out of the market and then recouping the losses through higher profits earned in the absence of competition"[11]—their articulation of the test was specific to the context of unilateral pricing decisions. This was their thesis in the 1975 article, as well as in their original treatise and its subsequent revisions.[12]

In their description of the predatory pricing test, Areeda and Turner set forth the now familiar architecture that "predatory pricing would make little economic sense to a potential predator unless he had (1) greater financial staying power than his rivals, and (2) a very substantial prospect that the losses he incurs in the predatory campaign will be exceeded by the profits to be earned after his rivals have been destroyed."[13] The then-unique and rigorous marginal cost pricing framework was developed for predatory pricing situations because Professors Areeda and Turner believed that anything less stringent had the potential to result in excessive judicial intervention with price reductions that are almost always procompetitive and essential to competition. Thus, Areeda and Turner prefaced their discussion of predatory pricing by noting how rare the practice is, with a consequent need to take "extreme care" in formulating any rule against it "lest the threat of litigation, particularly by private parties, materially deter legitimate, competitive pricing."[14] The no economic sense test therefore was developed for the specific purpose of judging one type of conduct. Price competition was in a different

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the harm the practice caused. For a useful discussion of *Lorain*, see Glazer & Lipsky, *supra* note 5, at 792–93.

[10] Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975).

[11] *Id.* at 698.

[12] *See, e.g.,* 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ch. 7C-1 (2d ed. 2002).

[13] Areeda & Turner, *supra* note 10, at 698.

[14] *Id.* at 699. In contrast, the extensive discussion of exclusive dealing in the current edition of the treatise characterizes exclusive dealing arrangements as presenting "only limited threats of competitive harm, and then only under carefully defined conditions," 11 PHILIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1820, at 161 (2d ed. 2002), and concludes by suggesting an analysis that looks first at market structure, power, and exclusive dealing coverage to determine whether there is a significant threat to competition, and then at possible efficiency explanations. *Id.* That test is not materially different from the analysis articulated here.

category from other practices, and the test was premised on that distinction.[15]

The Supreme Court eventually adopted the basic structure of the Areeda-Turner rule in a manner faithful to its origins. In *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*,[16] the Court's first modern encounter with predatory pricing, the Court endorsed generally the below-cost pricing requirement advocated by Areeda and Turner in light of the "consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful," and because price cutting is "the very conduct the antitrust laws are designed to protect."[17] The Court's later decisions continued to emphasize the narrow scope of this type of profit sacrifice test, and the limitation of its application to *pricing* practices.[18]

Today, some commentators encourage a wider application for the test, casting aside its narrow theoretical and historical moorings. In its most general formulation, their test makes exclusionary conduct unlawful if it makes sense only because of the prospect of excluding rivals and enhancing market power.[19] This test, its proponents urge, ensures that leading firms retain unimpeded incentives to compete vigorously by condemning conduct only when its anticompetitive objective is wholly unambiguous because the conduct could not have been undertaken "but for" the prospect of obtaining or maintaining market power.[20]

There are a number of forms of unilateral conduct, particularly pricing and refusals to deal, in which an analysis of the short-term profitability or economic sense of the arrangement to the defendant will be of value in assessing the impact on competition.[21] The same is just not true,

[15] Although others have suggested use of a basic Areeda-Turner-like framework for analyzing forms of non-price predation for some time, *see* ROBERT H. BORK, THE ANTITRUST PARADOX 148–60 (1978); Janusz A. Ordover & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 YALE L.J. 8 (1981); *see also* Neumann v. Reinforced Earth Co., 786 F.2d 424, 427 (D.C. Cir. 1986) (Bork, J.), the proposed use of the approach as a test that is nearly universal in evaluating exclusionary conduct is new.

[16] 475 U.S. 574 (1986).

[17] *Id.* at 589, 594.

[18] Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 227 (1993); Cargill, Inc. v. Monfort of Colo., Inc., 479 U.S. 104, 122 n.17 (1986).

[19] Werden, *supra* note 2, at 413–14; Patterson, *supra* note 3, at 37–38; *see also* Melamed, *Exclusionary Conduct*, *supra* note 3, at 1255.

[20] *Id.*

[21] For example, similar to pricing, courts should be reluctant to interfere with a party's decision not to share with rivals assets that it has developed or lawfully acquired. In this context, the no economic sense test works well to determine whether consumers will be harmed—protecting the defendant's incentives to compete and innovate, while condemning refusals to deal where the defendant objectively sacrifices profit in the short term and,

however, for exclusive dealing arrangements. In the exclusive dealing context, the no economic sense test ignores two critical realities. First, the test misses the fact that some harmful practices may be "costless" or require little or no sacrifice in profit.[22] There are many examples in the case law of monopolists using exclusive arrangements that were both nearly costless to the monopolist and, at the same time, marginally more efficient than non-exclusive arrangements. Thus, Microsoft did not have to sacrifice profits by preventing the deletion of Internet Explorer in Windows, or by placing links on the Windows desktop only to those Internet access providers that agreed to carry Internet Explorer to the exclusion of Netscape. Nor, decades earlier, did United Shoe have to sacrifice profits by requiring its customers to use only its machinery to the exclusion of its competitors.[23] These practices harmed consumers because the defendant's market power, in each case, allowed the exclusion of rivals at little or no cost, impairing the constraint on market power the rivals had imposed. Judged only by the profit sacrifice or no economic sense test, however, the practices likely would not have been condemned under Section 2.

Second, the no economic sense test ignores the reality that, in many contexts, it is the (limited) exclusion of competition that itself gives rise to efficiencies and associated consumer benefits. Take the typical agreement requiring a distributor to distribute the defendant supplier's products exclusively. The agreement may enhance the supplier's sales

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in the long term, can recoup that loss after its rivals are marginalized. *See, e.g.,* Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 605 (1985). The *Aspen* variety of refusal to deal with a horizontal rival—dubbed a "horizontal" refusal to deal by Ken Glazer—should be distinguished from "vertical" refusals to deal, i.e., refusals to deal with a vertically related supplier or customer that may weaken the competitiveness of the defendant's rivals. *See* Kenneth Glazer, Three Key Distinctions Under Section 2, Testimony Before the Antitrust Modernization Commission at 3–5 (Sept. 29, 2005), *available at* http://www.amc.gov/commission_hearings/exclusionary_conduct.htm. Vertical refusals to deal are generally analyzed in the Section 2 context in the same manner as exclusive dealing.

[22] Susan A. Creighton et al., *Cheap Exclusion,* 72 ANTITRUST L.J. 975, 980–81 (2005). *See* Rambus, Inc., FTC Docket No. 9302, slip op. at 31 (Aug. 2, 2006) ("[T]he sacrifice test . . . misses conduct that reduces consumer welfare, but happens to be inexpensive to execute, and therefore does not involve profit sacrifice."). Werden, *supra* note 2, at 425–26, dismisses this prospect as a "specter," using an example of burning the rival's plant to the ground, assuming matches are free. The example, however, does not address the more realistic scenario—common in exclusive dealing cases—where the defendant gets a real efficiency gain (such as marginally better distribution) that is swamped by the adverse effects derived from increased market power.

[23] United States v. Microsoft Corp., 253 F.3d 34, 69–70 (D.C. Cir. 2001) (en banc); United States v. United Shoe Mach. Corp., 247 U.S. 32 (1918); United Shoe Mach. Corp. v. United States, 258 U.S. 451 (1922); *see also* United States v. Dentsply Int'l, Inc., 399 F.3d 181 (3d Cir. 2005), *cert. denied,* 126 S. Ct. 1023 (2006).

and lower its costs, making it an effective interbrand competitor.[24] But it has these beneficial effects because (indeed only because) the agreement excludes rivals from the use of the distributor. In a litigation context, the aggrieved rival could easily trot out the no economic sense test and argue that the exclusive deal made economic sense to the defendant only by virtue of its exclusion of rivals. A court applying the test might even agree.

The leading proponents of the no economic sense and profit sacrifice tests recognize many of these problems and propose adjustments to their tests to mitigate the difficulties. One suggestion, for example, is that, where an exclusive arrangement has both efficiency and market power effects, the factfinder balance the efficiency benefits against the premium paid for exclusivity (or, if easier to determine, the cost incurred by the distributor of not dealing with rival suppliers).[25] Another is to trade off the anticipated benefit from the exclusion against the efficiency gains in determining whether the arrangement at issue is profitable (or economically sensible), subject to some safe harbors for conduct that rarely, if ever, is threatening to competition.[26] Both of these suggestions offer significant improvements. But that is because, in each instance, the adjustments move the test closer to basic consumer welfare effects analysis.

The availability of adjustments to the no economic sense test improves the outcomes in particular cases when correctly applied, but does not counsel in favor of broader use of the test. First, many courts will not, as a practical matter, go beyond the basic contours of the no economic sense and profit sacrifice tests to read and carefully apply the detailed nuances and adjustments that are necessary to the operation of those tests in difficult cases. There will be a tendency, instead, to apply the tests in their basic and unadorned forms, leading to the very problems the proponents now acknowledge. Second, for largely the same reasons, the availability of these adjustments and safe harbors drains the no economic sense test of the primary virtues its proponents proclaim—ease of application, lower costs of judicial administration, and greater certainty for businesses. In fact, if applied correctly, with all of the necessary adjustments, the no economic sense test will be a good deal

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[24] *See, e.g.*, Joyce Beverages, Inc. v. Royal Crown Cola Co., 555 F. Supp. 271, 275–77 (S.D.N.Y. 1983); *see also* Louisa Coca-Cola Bottling Co. v. Pepsi-Cola Metro. Bottling Co., 94 F. Supp. 2d 804 (E.D. Ky. 1999).

[25] Melamed, *Exclusive Dealing*, *supra* note 3, at 410–11.

[26] Werden, *supra* note 2, at 417–20.

more difficult to apply than the consumer welfare standard, with higher administration costs and less business certainty.[27] Third, and most importantly, the no economic sense and profit sacrifice tests still do not ask the correct question—that is, whether the practice is likely to aid consumers or to harm them.

III. EXCLUSIVE DEALING

Exclusive dealing arrangements require a buyer to purchase products or services for a period of time exclusively or predominantly from one supplier.[28] By its nature, exclusive dealing "forecloses" rival suppliers and/or new entrants from marketing their goods to a particular buyer. This does not, nevertheless, mean that an exclusive is suspect. Every sale excludes rivals to some extent. However, competition is enhanced when rivals are forced to compete for their own sales alternatives; and there are many well-recognized economic benefits that flow from exclusive dealing arrangements that, in a typical case, enhance overall competition in the relevant market. From an antitrust perspective, the concern with exclusive dealing is that rivals will be excluded or marginalized to such an extent that they can no longer constrain the defendant's market power—resulting in higher prices, lower output, and diminished quality for consumers.[29]

In decades past, under Section 2, courts analyzed nonprice-related exclusionary conduct simply by inferring competitive harm where a substantial percentage of the market was "foreclosed" to rivals.[30] Today, courts engage in a more sophisticated analysis. Rather than simply calcu-

[27] *See* Salop, *supra* note 4, at 357–67.

[28] An exclusive dealing arrangement can violate Sections 1 and 2 of the Sherman Act, even if not completely exclusive. *United Shoe*, 258 U.S. at 455; Masimo Corp. v. Tyco Health Care Group, L.P., No. CV 02-4770, 2006 WL 1236666, at *10–*12 (C.D. Cal. Mar. 23, 2006); Medtronic AVE, Inc. v. Cordis Corp., No. 2-03-CV-212, slip op. at 9–10 (E.D. Tex. Mar. 22, 2006); Applied Med. Res. Corp. v. Ethicon, Inc., No. SACV 03-1329, 2006 WL 1381697, at *6–*8 (C.D. Cal. Feb. 3, 2006); *cf.* Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1062 (8th Cir. 2000).

[29] Exclusive dealing can violate both Section 1 and Section 2 of the Sherman Act and the analysis under both statutes generally proceeds from the same basic approach. Under Section 2, the issue, again, is whether rivals are impaired to such an extent that the defendant can raise prices or otherwise harm consumers. The greater the market power of the defendant, the less steep are the demands Section 2 places on an antitrust plaintiff, because even a small increase in a dominant firm's market power can cause substantial harm to consumers. Conversely, a plaintiff must demonstrate a greater level of impairment to rivals where the party engaged in exclusive dealing enjoys less market power. *See* United States v. Microsoft Corp., 253 F.3d 34, 54–55 (D.C. Cir. 2001) (en banc); R.J. Reynolds Tobacco Co. v. Philip Morris USA, Inc., 2003-1 Trade Cas. (CCH) ¶ 74,068 (4th Cir. 2003), *aff'g* 199 F. Supp. 2d 362, 394–95 & n.24 (M.D.N.C. 2002).

[30] *See* discussion in Beltone Elecs. Corp., 100 F.T.C. 68, 1982 WL 608293, at *9–*10 (1982).

lating the percentage of the market "foreclosed," courts also examine how the exclusionary conduct affects competitive conditions in the relevant market more generally.[31] This trend toward a more probing analysis of competitive effects is consistent with more developed economic analyses of antitrust issues generally. The focus of the antitrust inquiry has moved from considering whether the conduct foreclosed competition to whether the foreclosure or other aspect of exclusion was imposed in a way designed to lead to an increase in prices or restriction of output in the market as a whole.[32]

A. Potential Harms of Exclusive Dealing

According to Professors Areeda and Hovenkamp, "[t]he most frequently given rationale for condemning exclusive-dealing arrangements is that they limit the access of upstream rivals to downstream firms, thus reducing upstream competition and creating or perpetuating lower output and higher prices."[33] Competition can be harmed when upstream rivals have no access to downstream customers, either through the distribution channels blocked by the firm employing the exclusives, or by other means, and where impaired rivals had operated (or could have operated) as important constraints on the defendant's market power.[34]

The level of the distribution chain at which exclusive dealing arrangements operate may be relevant. Exclusive dealing imposed on end users can have more harmful results than exclusive dealing imposed on intermediaries.[35] Although rival suppliers must reach end users, generally they need not reach them through a particular intermediary or even a particular type of intermediary.[36] The relevant question is not, therefore,

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[31] Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 333–35 (1961); United States v. Dentsply Int'l, Inc., 399 F.3d 181, 193–94 (3d Cir. 2005), *cert. denied*, 126 S. Ct. 1023 (2006); Jacobson, *supra* note 8, at 324–25, 329–34.

[32] *See* Jacobson, *supra* note 8, at 328, and cases cited.

[33] 11 Areeda & Hovenkamp, *supra* note 14, ¶ 1802, at 68.

[34] *Id.*; *see also* Krattenmaker & Salop, *supra* note 4, at 234–36.

[35] Omega Envtl., Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1162 (9th Cir. 1997); *see also Dentsply*, 399 F.3d at 194–95; PepsiCo, Inc. v. Coca-Cola Co., 114 F. Supp. 2d 243, 251–52 (S.D.N.Y. 2000), *aff'd*, 315 F.3d 101, 106, 111 (2d Cir. 2002); CDC Techs., Inc. v. IDEXX Labs., Inc., 186 F.3d 74, 81–82 (2d Cir. 1999).

[36] *CDC Techs., Inc.*, 186 F.3d at 81–82; *PepsiCo*, 114 F. Supp. 2d at 251–53. In some cases, the distributors may possess some particularly crucial capabilities that make exclusion at the distribution level itself relevant. In *Visa*, for example, the banks were characterized by the defendants as "mere distributors," but in fact effectively "manufactured" the card products, with varying features, they provided to consumers. The courts had little difficulty in concluding that exclusion of rival networks from access to the banks was unlawful, even though the rivals (American Express and Discover) could easily reach consumers directly through the mail. *See* United States v. Visa U.S.A., Inc., 163 F. Supp. 2d 322, 387–99 (S.D.N.Y. 2001), *aff'd*, 344 F.3d 229 (2d Cir. 2003), *cert. denied*, 543 U.S. 811 (2004).

the percentage of distributors that a manufacturer has locked up, but to the degree to which the exclusive dealing arrangement impairs the competitiveness of rivals by denying them access to the purchasers of the good or service.[37] This distribution level foreclosure can operate to harm competition not only when it serves to exclude competitors from the market completely, but also where it serves to raise their costs so that they can no longer compete effectively against the company using the exclusive dealing arrangements.[38]

A dominant firm may use exclusive arrangements to raise the costs of fringe firms, providing the dominant firm with an umbrella under which it can then raise its own prices. Where such exclusive arrangements tie up existing sales outlets or more efficient avenues of distribution, resulting in rivals' costs being raised because the market for their products has been reduced or because they have been forced either to create new avenues of distribution or to use higher-cost distributors, courts may find harm to competition.[39] Thus, "[r]aising rivals' costs can be a particularly effective method of anticompetitive exclusion. This strategy need not entail sacrificing one's own profits in the short run."[40]

B. Efficiencies Associated with Exclusive Dealing

Exclusive dealing often makes "economic sense" to both parties to the exclusive deal. Customers, in fact, often seek exclusives for their own benefit.[41] As the Supreme Court noted in *Standard Stations* some time ago:

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[37] *Gilbarco,* 127 F.3d at 1162–63.

[38] *See, e.g.,* Nicsand v. 3M, 2006 WL 2252517, at *5–*8 (6th Cir. Aug. 8, 2006); *Visa U.S.A.,* 344 F.3d at 242–43. Exclusive dealing can be an effective method in raising rivals' costs even without complete foreclosure. Einer Elhauge, *Defining Better Monopolization Standards,* 56 STAN. L. REV. 253, 321 (2003) ("[E]xclusionary conditions that produce far less extreme foreclosure can also impair rival efficiency."). As explained by Krattenmaker & Salop, "[u]nder certain conditions, such contracts for exclusionary rights can . . . restrain[] the supply of inputs available to rivals, thereby giving the purchaser power to raise prices in its output market." Krattenmaker & Salop, *supra* note 4, at 224. Such a "strategy need not entail sacrificing one's own profits in the short run. . . . " *Id.* Krattenmaker and Salop provide several compelling examples, including: (1) the "bottleneck," whereby a purchaser enters into exclusive arrangements with all of the lowest-cost suppliers, leaving only higher-cost suppliers for its rivals, *id.* at 234; (2) the "supply squeeze," whereby the purchaser enters into exclusive arrangements with a sufficient number of suppliers, driving up the market price for the remainder, *id.* at 236; and (3) colluding with suppliers to discriminate against rival purchasers, *id.* at 238–39.

[39] Krattenmaker & Salop, *supra* note 4, at 224.

[40] *Id.*

[41] *See* Richard M. Steuer, *Customer-Instigated Exclusive Dealing,* 68 ANTITRUST L.J. 239 (2000); Kenneth L. Glazer & Brian R. Henry, *Coercive vs. Incentivizing Conduct: A Way out of the Section 2 Impasse?* ANTITRUST, Fall 2003, at 45, 48.

> Requirements contracts . . . may well be of economic advantage to buyers as well as to sellers, and thus indirectly of advantage to the consuming public. In the case of the buyer, they may assure supply, afford protection against rises in price, enable long-term planning on the basis of known costs, and obviate the expense and risk of storage in the quantity necessary for a commodity having a fluctuating demand. From the seller's point of view, requirements contracts may make possible the substantial reduction of selling expenses, give protection against price fluctuations, and—of particular advantage to a newcomer to the field to whom it is important to know what capital expenditures are justified—offer the possibility of a predictable market.[42]

Courts properly have considered many significant procompetitive justifications for exclusive arrangements, including the following. Exclusive dealing:

- Induces dealer loyalty: Exclusive dealing encourages dealer or retailer loyalty. If a distributor (or retailer) only carries one brand, that dealer has greater incentive to ensure that the brand succeeds.[43] Likewise, it encourages suppliers to provide dealer-specific investments in training and marketing.[44] And it reduces the likelihood that a distributor will suffer out-of-stocks that would otherwise occur from carrying multiple brands.[45]
- Dampens free-riding: Suppliers have greater incentives to invest in enhancing dealer distribution capabilities when rivals cannot free ride on their efforts.[46]
- Enhances dealer attention to quality assurance: Exclusive dealing ensures a manufacturer that a distributor cannot pass off an inferior product as belonging to the manufacturer because it carries only the manufacturer's brand.[47]
- Ensures volume necessary to achieve scale economies. Exclusive arrangements allow suppliers to be confident that they will have sufficient sales volume to justify what may be costly investments in plant and equipment.[48]

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[42] Standard Oil Co. v. United States, 337 U.S. 293, 306–07 (1949) (footnote omitted); *see also* Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 331–33 (1961).

[43] Joyce Beverages, Inc. v. Royal Crown Cola Co., 555 F. Supp. 271, 276 (S.D.N.Y. 1983).

[44] Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215, 1235–36 (8th Cir. 1987).

[45] FTC v. Sinclair Ref. Co., 261 U.S. 463, 475–76 (1923).

[46] *See* Roland Mach. Co. v. Dresser Indus. Inc., 749 F.2d 380, 395 (7th Cir. 1984); *Ryko*, 823 F.2d at 1235 n.17.

[47] *Sinclair*, 261 U.S. at 473–74; Pick Mfg. Co. v. General Motors Corp., 80 F.2d 641, 643–44 (7th Cir. 1935).

[48] Sewell Plastics, Inc. v. Coca-Cola Co., 720 F. Supp. 1196, 1207–12 (W.D.N.C. 1989), *aff'd on opinion below*, 912 F.2d 463 (4th Cir. 1990).

- Induces competitive bidding: Firms often seek out competitive bids by providing the incentive of an exclusive to the victor.[49]

C. The Economic Sense of Exclusive Dealing Arrangements

Exclusive dealing arrangements generally result in *some* efficiencies and often cost very little to impose. Exclusive dealing, therefore, will tend to be profitable, and "make economic sense," even where the associated efficiencies are trivial and the consumer harm significant. And it is equally true that exclusive dealing in many cases will yield efficiencies, and "make economic sense," *only* because of the exclusion of competitors, but to the *benefit* of consumer welfare. Analyzing exclusive dealing only under a no economic sense or profit sacrifice test will therefore result in many false negatives and false positives. Those errors may be significant because neither test is designed to ask the one question antitrust really cares about—whether consumers are likely to suffer harm. Because neither test considers the overall allocative efficiency or consumer impact of a challenged practice, and instead focuses solely on the internal costs and benefits to the company engaged in the practice, the no economic sense and profit sacrifice tests are indifferent to the protection of overall consumer welfare almost by design.

False negatives. A major problem with the no economic sense test as applied to exclusive dealing is the risk that any nontrivial efficiency or cost savings will allow a credible argument that the arrangement makes economic sense for the defendant or, on the same basis, involves no sacrifice of profits. Where the practice, notwithstanding minor efficiency gains, permits the defendant to raise prices significantly, traditional antitrust analysis would counsel that the practice should be condemned. Proponents of the no economic sense test vigorously deny that the test makes any efficiency gain to the defendant a complete defense.[50] As applied by the most careful professionals, that may well be true. But the legerdemain required to demonstrate that an exclusive that yields some efficiencies nevertheless makes *no* economic sense is considerable. And in the hands of busy courts, heavy skepticism is warranted; most will simply conclude that, if the conduct generates some efficiency, it makes enough "sense" to pass.[51]

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[49] *See* Menasha Corp. v. News Am. Mktg. In-Store, Inc., 354 F.3d 661, 663 (7th Cir. 2004); Steuer, *supra* note 41.

[50] *See* Werden, *supra* note 2.

[51] Moreover, as applied by the more sophisticated no economic sense test advocates, their test essentially nets out the expected exclusionary effect (and benefit) against the efficiency gain at the stage of determining whether the conduct "makes economic sense"—while refusing the same inquiry in assessing the net effect on competition. *See supra* text

Questions also arise about the true economic cost to the defendant of implementing exclusive dealing. Does exclusive dealing qualify as "cheap" exclusion often? Rarely? Never? Some proponents of the no economic sense test suggest that exclusive dealing is often costly, requiring direct or indirect compensation to the affected dealers or significant internal costs in articulating, implementing, and monitoring the restraints. When the no economic sense test takes these costs into account, it is said, the arrangement will not escape prohibition and the test will not, as argued here, fail to prevent arrangements that are genuinely harmful.[52]

It is quite correct that exclusive dealing may involve significant costs to the defendant. In fact, the original Chicago School argument for allowing all, or almost all, exclusive dealing was that the defendant would have to reduce its price or offer equivalent value to the customer that equaled, one-for-one, the value of exclusivity such that any welfare losses would be completely offset by welfare gains.[53] But post-Chicago writers long ago debunked that analysis, and it is now common ground that, in many contexts, exclusive dealing can be deployed in a way that is both profitable for the dealer (or other customer) and that allows the defendant to reap gains from the arrangement that far exceed the associated costs.[54]

The greater the monopolist's power, the greater the potential harm of an effective exclusive dealing scheme. Where defendants already have significant market power, the cost associated with implementing an exclusive dealing scheme designed to diminish consumer welfare can be quite small because a dominant firm may be able to make an all or nothing offer that leaves its customers with no real choice but to comply. As a result, a test that focuses only on the internal costs of exclusive dealing to the defendant will tend to underestimate the harm that the practice can impose upon consumers in a relevant market.

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accompanying notes 26–27. The upshot is that the no economic sense test, *correctly* applied, points directionally towards the same outcome as the rule of reason anyway (and is no less complicated in application). Where the proponents of the test fall completely short is in explaining why it is better to engage in balancing and netting in evaluating the profitability of the conduct to the defendant than in evaluating the impact on consumers. Antitrust cares about consumer welfare directly; it cares about profitability and incentives only as means to the consumer welfare end.

[52] *See* Melamed, *Exclusive Dealing*, *supra note* 3, at 409–11.

[53] *See* BORK, *supra note* 15, at 299–309.

[54] *See, e.g.,* Ilya R. Segal & Michael D. Whinston, *Naked Exclusion: Comment*, 90 AM. ECON. REV. 296, 296–97 (2000); Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388 (1987); Jacobson, *supra* note 8, at 345–47 & n.181.

More generally, exclusive dealing often can be profitable to the defendant and its distributors while, at the same time, serving to exclude rivals whose presence would enable downstream price competition. For example, if a monopoly seller ties up key distributors with significant discounts, the seller can offer progressively lower discounts to the later-coming distributors. Although the early distributors may be motivated to sign the exclusives by reason of the discount, creating some net economic benefit for themselves, the effect may be to raise substantial barriers to entry for competing sellers, as all of the most effective distributors will have been signed up by the firm employing the exclusive scheme. After entry is thwarted, the later distributors can be compelled to pay a price at or near the monopoly level, and those higher prices will be passed on to consumers.[55] The arrangement could well be argued to make "economic sense," with seller efficiencies achieved through the exclusives, notwithstanding significant harm to the welfare of consumers.[56] Depending on the sophistication of the antitrust decision maker, application of the no economic sense test in this type of case therefore may fail to identify the most exclusionary arrangements. And even the most careful analyst will have great difficulty in determining the outcome: Does the arrangement make economic sense because of the efficiencies it is generating or "only" because of the exclusionary impact on rivals? The efficiencies and exclusionary effects are often the same.

False positives. Conversely, focusing on the profitability to the defendant also runs the risk of mistaking costly competition for exclusion and thereby condemning exclusive arrangements that result in lower prices and greater output for consumers. The facts of *Louisa Coca-Cola Bottling Co. v. Pepsi-Cola Metropolitan Bottling Co.*[57] illustrate the point. There, a Coca-Cola bottler challenged the locally dominant Pepsi bottler's marketing agreements with area retailers. The marketing agreements provide the Pepsi bottler with additional shelf space and exclusive promotional activities in return for marketing funds and discounts. The plaintiff had the opportunity to compete for the incremental space and promotional activity, but declined to do so. The court applied the rule of reason and dismissed the Coke bottler's case because the limited promotional exclusivity had no net adverse effect on competition.

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[55] *See* Segal & Whinston, *supra* note 54.

[56] Generally accepted antitrust merger analysis, which employs a consumer welfare effect standard to determine the legality of a business combination, specifically discounts seller efficiencies that, when internalized, make sense to the merging parties but ultimately harm consumer welfare. *See* U.S. DEP'T OF JUSTICE & FEDERAL TRADE COMMISSION, Horizontal Merger Guidelines § 4 (1992, revised 1997).

[57] 94 F. Supp. 2d 804 (E.D. Ky. 1999).

The marketing funds and discounts in *Louisa* were quite costly to the Pepsi bottler. They made "economic sense" if, and only if, the promotional activity was exclusive. If the retailers could promote the Coke bottler's products at the same time, consumers walking into the store would see a Coke display rather than a Pepsi display and purchase Coke products rather than Pepsi; the Pepsi bottler would not receive the same level of sales benefit, and its incentives to provide the discounts would have been diminished. The discounts thus made economic sense to the Pepsi bottler *only* because of their effect in limiting competition from rivals. But, as the court concluded, the discounts also generated lower prices that were passed on to consumers, and they were beneficial to consumers and not harmful to competition. If the no economic sense test had been applied, however, the court easily might have reached the opposite result—condemning the Pepsi bottler's competitive activities on the basis that they made economic sense only because of their effect in excluding competition from rivals.[58]

IV. MAJOR CASES

Prominent exclusive dealing cases demonstrate the concern with importing the no economic sense test from its predatory pricing origins to non-pricing Section 2 cases. In each of *Microsoft, United Shoe,* and most recently *Dentsply,* it appears clear that the monopolists charged with violations of Section 2 engaged in conduct that cost little, created marginal efficiencies greater than cost, and yet managed to harm consumer welfare.[59] If each of these cases had been viewed from the lens of the no economic sense test, it appears far less likely that the conduct in each would have been judged illegal under Section 2, even though the harm to consumer welfare in each case was evident. Conversely, application of the no economic sense could result in condemnation of exclusive arrangements that are utterly benign. The *Joyce Beverages* case provides a useful example.[60]

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[58] A result of just that type was in fact reached in *Coca-Cola Co. v. Harmar Bottling Co.*, 111 S.W.3d 287 (Tex. App. 2003), *petition for review granted*, (Tex. 2004) (argued Nov. 9, 2004). The appeals court upheld the judgment holding Coca-Cola's marketing practices illegal in large part because their efficacy depended on the agreements' ability to "restrict what retailers can do with regard to the competitors' products." *Id.* at 304–06, 314. (Author Jonathan Jacobson argued the Texas Supreme Court appeal in *Harmar* on behalf of Coca-Cola.)

[59] United States v. Microsoft Corp., 253 F.3d 34, 76–77 (D.C. Cir. 2001) (en banc); United Shoe Mach. Corp. v. United States, 258 U.S. 451, 456 (1922); United States v. Dentsply Int'l, Inc., 399 F.3d 181, 192–93 (3d Cir. 2005), *cert. denied*, 125 S. Ct. 1023 (2006).

[60] Joyce Beverages of N.Y., Inc. v. Royal Crown Cola Co., 555 F. Supp. 271 (S.D.N.Y. 1983).

A. *MICROSOFT*

In *Microsoft*, the plaintiffs alleged that by closing to rivals a substantial percentage of the available opportunities for browser distribution, Microsoft managed to preserve its monopoly in the market for operating systems (OS).[61] According to the D.C. Circuit, "[b]y ensuring that the majority of all [Internet Access Provider (IAP)] subscribers are offered IE either as the default browser or as the only browser, Microsoft's deals with the IAPs clearly have a significant effect in preserving its monopoly; they help keep usage of Navigator below the critical level necessary for Navigator or any other rival to pose a real threat to Microsoft's monopoly."[62]

Microsoft had a monopoly in the OS market. Netscape's Navigator, at the time, was thought to pose a risk to the Microsoft OS monopoly. To preserve its position in the market, Microsoft engaged in a number of allegedly anticompetitive practices. Among Microsoft's tactics were (1) agreements with various OEMs requiring them to place Microsoft's IE on the desktop, to the exclusion of other browsers; (2) developing the IE access kit, which permitted IAPs to create a distinctive identity for their service, but only if it employed IE; (3) other agreements with IAPs that provided additional support and access in exchange for their favoring of IE over Netscape;[63] (4) omitting IE from the Add/Remove applet in Control Panel; and (5) placing IAPs in a folder on the Windows desktop if, but only if, the IAP used IE, rather than Netscape, as its browser. Each of these tactics "required the other party to promote and distribute Internet Explorer to the partial or complete exclusion of Navigator. In exchange, Microsoft offered, to some or all of these parties, promotional patronage, substantial financial subsidies, technical support, and other valuable consideration."[64]

These efforts by Microsoft to protect its Windows monopoly cost little, at least in comparison with the additional distribution it gained through the OEMs and IAPs. The extraordinary power of the OS monopoly made it difficult for these third parties to say no to the terms Microsoft offered. Microsoft's exclusive dealing tactics (one of many strategies, to be sure) were successful—Netscape was marginalized, and ultimately was unable to compete effectively in the market. Yet, under a strict application of the no economic sense and profit sacrifice tests, most would conclude

[61] *Microsoft*, 253 F.3d at 70.

[62] *Id.* at 71 (internal quotations and citations omitted).

[63] *Id.* at 70–71.

[64] United States v. Microsoft Corp., 87 F. Supp. 2d 30, 51 (D.D.C. 2000), *aff'd in part and rev'd in part*, 253 F.3d 34 (D.C. Cir. 2001).

that Microsoft's conduct was not illegal—there was no "sacrifice" of profitability because the restrictive clauses were both profitable and exclusionary at the same time. As Professor Gavil explained:

> [I]n the *Microsoft* case, Microsoft did not appear to sacrifice any profits when it imposed various exclusionary licensing and contractual restrictions on its various classes of customers, or when it integrated its various programs into its operating system. . . . In fact, these acts were facilitated by its market power. Ironically, it is that very market power which, especially in extreme cases, can permit a dominant firm to exclude at no or little cost.[65]

Defenders of the no economic sense deny that the test would give Microsoft a pass. They say that there was a "cost" to Microsoft in that it had to explain to OEMs what it was doing. Even if this were true, it ignores some tactics that were truly costless, such as preventing the deletion of IE or including in the desktop online services folders only those IAPs that agreed to use IE exclusively. But much more importantly, the entire debate highlights the fundamental problem with the no economic sense test. Liability should not turn on whether it was very costly, somewhat costly, or entirely costless for Microsoft to argue with OEMs. Liability should turn on whether consumers were, or likely would be, harmed.[66]

B. *United Shoe*

United Shoe was a notorious monopoly for decades and, indeed, its practices were cited prominently in the hearings that led to the passage of Section 3 of the Clayton Act.[67] The company controlled a substantial portion of the market for providing shoe-making machinery to shoe manufacturers in the United States.[68] The government sued, alleging that United Shoe violated the Sherman Act through illegal exclusive dealing arrangements. One provision of the challenged lease agreements required exclusive use of United Shoe's machines; once a lessee used the machine of one of United Shoe's competitors, United Shoe had the right to cancel the lease at any time. Although the lease provisions did not require exclusive usage—specifically, they did "not contain specific agreements not to use the machinery of a competitor of the lessor, the practical effect of these drastic provisions [wa]s to prevent such use."[69]

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[65] Gavil, *supra* note 5, at 56–57.

[66] *See, e.g.,* Omega Envtl., Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1161 (9th Cir. 1997).

[67] *See* H.R. REP. NO. 627, 63d Cong., 2d Sess. (1914); S. REP. No. 698, 63d Cong., 2d Sess. (1914).

[68] United Shoe Mach. Corp. v. United States, 258 U.S. 451, 455 (1922).

[69] *Id.* at 457.

Although the exclusive provisions were of short duration, the harms associated with these provisions were significant.[70] The quasi-exclusive nature of the contract created a substantial burden on lessees. If the lessee decided to use the equipment of a competitor, United Shoe could cancel its lease, imposing upon the lessee the substantial burden of having to purchase additional equipment from competitor manufacturers, which would be both expensive and time-consuming.[71]

Because of its dominant position in the market, United Shoe was able to impose this de facto exclusive term on its lessees without reducing its lease prices significantly. Lessees trapped by the high cost of switching out United Shoe's equipment for that of a competitor were not in a position to negotiate better terms in exchange for exclusivity. The tactic made perfect economic sense for United Shoe—it did not entail a short-term sacrifice of profits as the quasi-exclusive nature of the contracts imposed no additional cost upon the company, and at the same time served to exclude rivals from the market by foreclosing their distribution opportunities. Yet under the no economic sense and profit sacrifice tests, United Shoe's conduct—which allowed it to maintain a substantial monopoly over many decades—might well be found not to violate Section 2.

C. *Dentsply*

Dentsply was the leading manufacturer of prefabricated artificial teeth, accounting for 75–80 percent of sales.[72] The company sold its artificial teeth through independent dental dealers (i.e., distributors). The dealers in turn distributed the teeth to dental laboratories for use in the creation of dentures. Notwithstanding the absence of written contracts requiring dealers to purchase Dentsply teeth exclusively, Dentsply prohibited its dealers from carrying the teeth of competitors. Dentsply's dealers were at liberty, however, to end their relationship with Dentsply at any time, for any reason, and without penalty.[73] In the more than ten years that Dentsply had maintained the exclusive dealing criteria prior to the DOJ challenge, no dealer dropped the Dentsply product line in favor of competing brands of artificial teeth.[74]

[70] *Id.* at 457–58.

[71] *See id.* at 455.

[72] United States v. Dentsply Int'l, Inc., 399 F.3d 181 (3d Cir. 2005), *cert. denied*, 126 S. Ct. 1023 (2006).

[73] *Id.* at 185.

[74] *Id.* at 193–94.

The Department of Justice contended that Dentsply's dealer program amounted to illegal exclusive dealing under the no economic sense test. The district court, however, found for the defendant, concluding that Dentsply's arrangements did not foreclose a sufficient portion of the market from competitors and that Dentsply's competition had the opportunity to sell artificial teeth direct, or could instead attempt to "flip" Dentsply's distributors by offering higher quality teeth or better prices.[75]

The Third Circuit reversed, concluding that Dentsply's exclusive arrangements harmed competition by limiting consumer choice and slowing the decline of prices of artificial teeth.[76] According to the Third Circuit, because rivals could not access the market through the relatively more efficient distributors that were locked-up by Dentsply, their costs to compete effectively were substantially higher, making them less competitive in the market. Dentsply's use of exclusive dealing, in effect, served as a defensive mechanism to maintain its monopoly in the market.[77]

Although the Third Circuit did not expressly balance the exclusive dealing arrangements' procompetitive justifications against their competitive harm, the court implicitly recognized that there were some efficiency justifications for the arrangements, saying: "Dealers also provide benefits to manufacturers . . . . [D]ealers provide manufacturers more marketplace exposure and sales representative coverage than manufacturers are able to generate on their own. Increased exposure and sales coverage traditionally lead to greater sales."[78]

Notwithstanding the Justice Department's arguments, Dentsply's conduct easily could have been shielded under the no economic sense or profit sacrifice tests from Section 2 liability because—under the circuit court's analysis—adding more dealers would provide some economic benefits to Dentsply at little cost. The use of exclusive dealers provides dealer focus and prevents free riding, and does not cost much to achieve. Had the no economic sense test been employed, Dentsply's arrangements—which allowed it to maintain higher prices and impeded competitive entry and expansion—could have been upheld. The court of appeals, applying a broader rule of reason analysis, correctly held otherwise.[79]

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[75] The district court also concluded that there was *no* efficiency explanation for Dentsply's exclusive arrangements. United States v. Dentsply Int'l, Inc., 277 F. Supp. 2d 387, 419 (D. Del. 2003), *rev'd*, 399 F.3d 181 (3d Cir. 2005), *cert. denied*, 126 S. Ct. 1023 (2006). *See infra* note 79.

[76] *Dentsply*, 399 F.3d at 194–96.

[77] *Id.*

[78] *Id.* at 192–93.

[79] Proponents of the no economic sense test often cite *Dentsply* as an exclusive dealing case where the defendant's conduct—signing up all the major artificial teeth distributors—

D. *JOYCE BEVERAGES*

Royal Crown distributed its cola products in New York through Joyce Beverages, a bottler whose product line also included 7-Up. RC's agreement with Joyce, and with each of its other bottlers, provided that the bottler would distribute no other brands of cola. 7-Up's owners, however, came up with a new cola product, "Like," and sought to distribute it in New York through Joyce. Joyce thought this was just fine—after all, it was adding a new product—but RC cried foul and enforced the exclusivity clause in its agreement, saying that Joyce would be terminated if it took on "Like." Joyce sued, but the district court had no trouble in denying relief and upholding the exclusive dealing arrangement. The court recognized that exclusivity eliminated conflicting incentives and motivated Joyce to ensure that RC was a more effective competitor.[80]

What if the court had been asked to invoke the no economic sense test? Joyce could have argued, with some force, that exclusivity made sense for RC only because of its effect in eliminating competition for Joyce's business by rival cola suppliers. RC, of course, would have advanced contrary arguments. But the no economic sense argument by the plaintiff in this instance would have had at least a superficial appeal, and could, if accepted, have resulted in an alarming false positive.[81]

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made no economic sense. *See, e.g.,* Werden, *supra* note 2, at 414. Indeed, the district court found that "the sole purpose of the policy was to exclude Dentsply's competitors from the dealers." *Dentsply,* 277 F. Supp. 2d at 419. And, on appeal, the Justice Department's opening brief argued that the defendant's conduct was unlawful under the no economic sense test. Brief for the United States, United States v. Dentsply Int'l, Inc., No. 03-4097, 2004 WL 255652, at *13 (3d Cir. Jan. 16, 2004). If the district court's finding was correct, then *Dentsply* was a truly exceptional case. Although some exclusive dealing arrangements may make no economic sense, and may be employed solely in order to exclude competitors, the number of instances where the arrangements will not have some net positive effect on the defendant's distribution capabilities will be quite small. In *Dentsply*, there is reason to suspect that the district court's finding may have been erroneous, as suggested by the text of the circuit court's opinion, 399 F.3d at 192–93, quoted above. Adding additional distributors generally enhances the supplier's distribution capabilities, and doing so exclusively likely created for Dentsply some marginal measure of efficiency by reducing monitoring costs, ensuring a source of supply for the artificial teeth distributors and diminishing the company's transaction costs. The point here is that simply looking to whether the scheme made economic sense to the defendant creates a high risk of missing the effect of the practice on consumer welfare.

[80] Joyce Beverages of N.Y., Inc. v. Royal Crown Cola Co., 555 F. Supp. 271, 276–77 (S.D.N.Y. 1983). *See also* U.S. Healthcare, Inc. v. Healthsource, Inc., 986 F.2d 589, 596 (1st Cir. 1993) (holding that exclusive dealing cannot be illegal unless it harms some dimension of consumer welfare).

[81] A fair response to this point on the specific facts of *Joyce* is that RC, with its small share, clearly lacked market power and would, therefore, escape condemnation under most applications of the profit sacrifice test. *See, e.g.,* Melamed, *Exclusive Dealing*, *supra* note 3, at 390 (likelihood of market power gain an essential element of profit sacrifice

V. THE RULE OF REASON

No radical reformation of Section 2 jurisprudence is required for exclusive dealing arrangements. The appropriate test is the basic rule of reason—an examination of the exclusive dealing arrangement's effect on consumer welfare. It is the same test used to examine other vertical and horizontal restraints, and essentially the test employed in analyzing mergers.[82]

A first step in every case is for the plaintiff to make out a prima facie case of competitive harm. A prima facie case will typically have three components: (a) To begin with, there must be proof of market power (or a probability that market power will be acquired) in a relevant market. As the D.C. Circuit explained in *Microsoft*, when "an exclusive deal is challenged, it is clear that in all cases the plaintiff must" demonstrate that a defendant has market power in a relevant market.[83] Without market power, and the ability to harm consumer welfare, conduct cannot violate Section 2.[84] (b) The plaintiff must show that the exclusive dealing impairs rivals and, as a result, lessens the constraints on the defendant's market power. The relevant inquiry in this respect is whether, as a result of the impairment, the defendant has an enhanced ability to raise prices or limit choice or quality.[85] As recent cases hold, proof of "foreclosure" alone is not enough.[86] (c) The plaintiff must also show that the exclusivity itself is not the product of the competitive process. Where a customer puts its business up for bid to secure a lower price, "competition for the contract" necessarily results.[87] If that is all there is, there is no showing of consumer harm. Where, however, there has been an impairment of

test). But the *Joyce* facts could easily be repeated in cases involving firms with actual or potential market power, and the points made in the text would all be applicable.

[82] Scott A. Sher & Scott D. Russell, *Adding Bite to Exclusive Dealing?: An Analysis of the Third Circuit's* Dentsply *Decision*, ANTITRUST SOURCE, May 2005, at 7–8, http://www.abanet.org/antitrust/source/05-05/may05-fullsource.pdf.

[83] United States v. Microsoft Corp., 253 F.3d 34, 69 (D.C. Cir. 2001) (en banc); *see also* Heerwagen v. Clear Channel Communications, 435 F.3d 219, 227–29 (2d Cir. 2006) (Sherman Act § 2); United States v. Visa U.S.A., Inc., 344 F.3d 229, 238 (2d Cir. 2003) (Sherman Act § 1), *cert. denied*, 543 U.S. 811 (2004).

[84] *E.g.*, Spectrum Sports v. McQuillan, 506 U.S. 447, 458–59 (1993).

[85] Krattenmaker & Salop, *supra* note 4, at 236–38.

[86] Omega Envtl., Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1162–63 (9th Cir. 1997).

[87] Paddock Publ'ns, Inc. v. Chicago Tribune Co., 103 F.3d 42, 45 (7th Cir. 1996); *see also* Louisa Coca-Cola Bottling Co. v. Pepsi-Cola Metro. Bottling Co., 94 F. Supp. 2d 804 (E.D. Ky. 1999). With respect to this inquiry, the no economic sense test may have some relevance. It may be difficult, in some cases, to distinguish exclusivity that impairs competition from exclusivity that is the product of competition. One way, of course, is to assess the customer's reaction. *See* Steuer, *supra* note 41, at 239. When customer views are ambiguous, however, application of the no economic sense test may be useful as one input into the analysis. *See* Jacobson, *supra* note 8, at 350.

rivals sufficient to harm consumers that is not a necessary outcome of the competitive process, a prima facie case has been established.

Once a prima facie case has been established, the burden of going forward shifts to the defense to provide business justifications for the challenged practice. The types of efficiencies that are cognizable in this context are those that offer the prospect of lower prices, greater output, and other benefits to consumers. The types of efficiencies summarized above are illustrative.

Once the defendant has met its burden of production, the burden shifts back to the plaintiff to provide evidence in rebuttal. That evidence may include proof that the claimed efficiencies do not exist; are pretextual; or that the same or similar benefits could easily be achieved by significantly less restrictive means.

Most cases will have been resolved by this point. The plaintiff may fail to present a prima facie case. The defendant may not be able to demonstrate cognizable, non-pretextual efficiencies. Or the plaintiff will be unable to demonstrate that the same efficiencies could have been achieved in a much less restrictive way. However, truly rare cases arise in which the final step—an assessment of magnitudes and corresponding balancing—becomes necessary. In those rare instances, the question will be whether the net effect or competition is substantially adverse. Only where the net effect, taking efficiencies into account, is to create a likelihood of increased prices, lower output, or reduced quality, should exclusive dealing be found unlawful.[88] Because exclusive dealing offers substantial benefits—including decreased cost of distribution, elimination of free-riding, enhanced interbrand competition, and secure source of supply—it will be a relatively rare case when an exclusive arrangement will violation Section 1 or Section 2. But when that case is found, condemnation should follow.

The analysis articulated here is not unusual, or new, or different. It is the same analysis courts have applied for years in rule of reason cases under both Section 1 and Section 2.[89] It is fundamentally the same test

[88] *See* Jacobson, *supra* note 8, at 365–69.

[89] *See* United States v. Microsoft Corp., 253 F.3d 34, 58–59 (D.C. Cir. 2001) (en banc) (Section 2); ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 60 (5th ed. 2002) (Section 1). As the Second Circuit said in *K.M.B. Warehouse Distribs. v. Walker Mfg. Co.,* 61 F.3d 123, 127 (2d Cir. 1995) (citations omitted):

> Establishing a violation of the rule of reason involves three steps. "[P]laintiff bears the initial burden of showing that the challenged action has had an *actual* adverse effect on competition as a whole in the relevant market. . . . " If the plaintiff succeeds, the burden shifts to the defendant to establish the "procompetitive 'redeeming virtues'" of the action. Should the defendant carry this

that the courts and agencies apply almost every day in determining whether a merger violates Section 7 of the Clayton Act, a process that necessarily involves a determination whether the net effect of the transaction is to raise prices or not.[90]

Proponents of the no economic sense test criticize the rule of reason as too complicated. In fact, given the difficulties encountered in applying the no economic sense test to exclusive dealing, a fair response would be that application of traditional rule of reason analysis is a good deal *less* complicated.[91] But even if that were not the case, the complexity objection is meritless. The objective of antitrust policy is to protect consumers, and the analysis necessary to achieve that result may, in unusual cases, be difficult. The associated cost, if there is any, is well worth bearing. Perceived complexity was the basis for the huge expansion of per se analysis from the 1940s through the early 1970s.[92] In hindsight, we can safely characterize that approach as misguided.[93] Ousting the rule of reason was erroneous then. It is no less a mistake in the exclusive dealing context now.

burden, the plaintiff must then show that the same pro-competitive effect could be achieved through an alternative means that is less restrictive of competition.

[90] *See, e.g.,* FTC v. Swedish Match, 131 F. Supp. 2d 151 (D.D.C. 2000); Merger Guidelines, *supra* note 56, § 4.

[91] The no economic sense test requires essentially the same balancing in determining profitability of the practice to the defendant that its proponents attack as too complicated when applied in determining the impact on consumers under the rule of reason. *See supra* text accompanying notes 25–27. The degree of complexity in applying the rule of reason can easily be overstated, for the rule of reason can often—perhaps usually—be applied "in the twinkling of an eye." 7 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1508a (2d ed. 2003); *see also* NCAA v. Board of Regents, 468 U.S. 85, 109–10 n.39 (1984) (quoting Areeda). For some of the complexities in applying the no economic sense test, see Salop, *supra* note 4, at 357–67.

[92] *See* United States v. Topco Assocs., Inc., 405 U.S. 596 (1972); Int'l Salt Co. v. United States, 332 U.S. 392 (1947).

[93] *E.g.*, Illinois Tool Works Inc. v. Independent Ink, Inc., 126 S. Ct. 1281 (2006); State Oil Co. v. Khan, 522 U.S. 3 (1997).