The Sedona Conference Journal

Volume 7 2006

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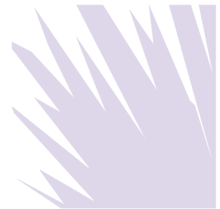

Recommended Citation: J. Thomas Rosch, *Evolution of Exclusive Dealing Law*, 7 SEDONA CONF. J. 51 (2006).

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# EVOLUTION OF EXCLUSIVE DEALING LAW

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## INTRODUCTION

Historically, the legality of exclusive dealing agreements has been litigated primarily under Section 3 of the Clayton Act and Section 1 of the Sherman Act. Section 3 prohibits any lease, sale or contract of sale of commodities, or the pricing of commodities, that is conditioned on the lessee or buyer not dealing with a competitor or competitors, where the effect may be to substantially lessen competition or tend to create a monopoly in any line of commerce. Section 1 prohibits any agreement that unreasonably restrains trade.

The prohibition in Section 3 is in some respects narrower than that in Section 1. For example, it extends only to exclusive dealing agreements respecting commodities, not services. It also does not cover exclusive dealing agreements as to which the exclusivity runs in favor of the buyer rather than the seller. On the other hand, the prohibition in Section 3 is broader than that in Section 1 in that Section 3 is an incipiency statute -- *i.e.*, it applies if the agreement "may" substantially lessen competition or tend to create a monopoly -- whereas Section 1 arguably applies only on a showing that the agreement has actually had that effect. *But see U.S. v. Rockford Memorial Hospital,* 898 F.2d 1278, 1281-83 (7th Cir. 1990) in which Judge Posner conflated Section 1 and Section 7 of the Clayton Act, despite the latter's incipiency language. In any event, the Supreme Court has opined that an exclusive dealing agreement that passes muster under Section 3 is also legal under Section 1. *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961); *see also Barr Labs Inc. v. Abbott Labs.*, 978 F. 2d 98, 110 (3d Cir. 1992).

Recently, the legality of exclusive dealing agreements has been challenged predominantly under Section 2 of the Sherman Act, which prohibits unlawful efforts to monopolize and attempts to monopolize markets. *See LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003); *United States v. Dentsply International Inc.*, 399 F.3d 181 (3d Cir. 2005). By mounting their challenges under Section 2, the plaintiffs in these cases have avoided some of the arguments that have been successfully used to avoiding liability under Section 3 of the Clayton Act and Section 1 of the Sherman Act.

### A. Supreme Court Case Law

More than half a century ago the Supreme Court recognized that exclusive dealing agreements may have procompetitive purposes and effects. In *Standard Oil Co v. United States* (Standard Stations), 337 U.S. 293, 306-07 (1949), the Court said

> "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. They may be useful, moreover, to a seller trying to establish a foothold against the counterattacks of entrenched competitors."

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Given these possible procompetitive purposes and effects, the Court ruled out treating such agreements as per se illegal. *Id.* Instead the Court held that the legality of the agreement should turn on whether "competition has been foreclosed in a substantial share of the commerce affected." *Id.* at 314. Although the particular agreement involved there foreclosed only 6% of the market, the court stressed that in the aggregate such agreements foreclosed 65% of the market, and it held that that was sufficient to make such agreements illegal under Section 3 of the Clayton Act. *Id.* at 309, 314.

In *Tampa Electric*, the Supreme Court jettisoned this "quantitative substantiality" test, which focused exclusively on the percentage of the market foreclosed by the challenged agreement in favor of a "qualitative substantiality" analysis. Under that analysis, while the percentage of the market foreclosed remained a relevant factor, courts could examine other factors such as the duration, purpose and effect of the agreement in assessing its legality. Using that analysis the Court concluded that the agreement at issue did not violate either Section 3 of the Clayton Act or Section 1 of the Sherman Act. *Tampa Electric*, 365 U.S. at 328.

More recently, in *Jefferson Parish Hospital District No 2 v. Hyde*, 466 U.S. 2 (1984), the Court appeared to carve out a safe harbor for exclusive dealing agreements challenged under Section 1. There the challenged agreement did not foreclose more than 30% of the market to competitors, and the Court held that under those circumstances the defendant was entitled to summary judgment.

In short, as interpreted by the Supreme Court, neither Section 3 nor Section 1 would condemn exclusive dealing agreements that did not foreclose competitors from more than 30% of the market (i.e., potential customers). And even when the agreements did work a more expansive foreclosure, other factors, such as their duration, purpose and effect might make them legal.

**B. Early Appellate Decisions**

Until recently nearly all of the exclusive dealing agreements that were challenged in the courts of appeals under Section 3 and Section 1 were held to be legal, as a matter of law. For example, in *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983) the First Circuit (then Judge Breyer) stated with respect to requirements contracts:

> "The antitrust problems that courts have found lurking in requirements contracts grow out of their tendency to 'foreclose' other sellers from the market by 'tying up' potential purchases of the buyer. Arguably, under certain circumstances substantial foreclosure might discourage sellers from entering, or seeking to sell in, a market at all, thereby reducing the amount of competition that would otherwise be available."

724 F.2d at 236. The decision suggested that the degree of market foreclosure must be so high that there only not be enough "contestable" customers left to make competition viable.

Similarly, in *Roland Machinery Co. v. Dresser Industries*, 749 F.2d 380 (7th Cir. 1984), the Seventh Circuit (Judge Posner) held that in order to be illegal under Section 3 or Section 1, an exclusive dealing agreement must foreclose access to the market to prevent at least one significant competitor from competing, thereby creating supra-competitive pricing in the market:

> "The objection to excusive-dealing agreements is that They deny outlets to a competitor during the term of the Agreement. … [But] the exclusion of competitors is cause for antitrust concern only if that impairs the health of the competitive process itself. [citation omitted] Hence a plaintiff must prove two things to show that an exclusive dealing agreement is unreasonable. First, he must prove

> that it is likely to keep at least one significant competitor in a relevant market. If there is no exclusion of a significant competitor, the agreement cannot possibly harm competition. Second, he must prove that the probable (not certain) effect of that exclusion will be to raise prices above (and therefore reduce output below) the competition level, or otherwise injure competition…"

749 F.2d at 393, 394.

Subsequently, in *Barr v. Abbott Laboratories*, 978 F.2d 98 (3rd Cir. 1992), the Third Circuit held that the exclusive dealing agreement of a manufacturer with 50% of a highly concentrated market (the top 3 manufacturers accounted for 80% of the market) did not violate Clayton Act Section 3 even though the agreements foreclosed 15% of the market to competitors. The court concluded that that degree of market foreclosure had not eliminated any actual or potential competition:

- [The manufacturer's] market share increased by less than 2% over the relevant time frame.
- The level of concentration in the market increased by less than 1%.
- New manufacturers and products emerged, and prices remained stable."

978 F.2d at 111.

And, in *U.S. Health Care, Inc. v. Healthsource, Inc.*, 986 F.2d 589 (1st Cir. 1993), the First Circuit (Judge Boudin) made it plain that the number of outlets---and indeed even the percentage of the total available outlets---who agree to deal exclusively with a defendant manufacturer is just the starting point in the analysis; the "danger for competition" which controls the legality analysis is whether the arrangements foreclose "so much of the available…outlet capacity that existing competitors or new entrants may be limited or excluded and, under certain circumstances, this may reinforce market power and raise prices for consumers." *Id.* at pp. 595-95 to n. 3. As the First Circuit put it:

> "Although the Supreme Court once said that a 'substantial" percentage foreclosure of suppliers or outlets would violate Section 1, [*Standard Stationers*], the Court's *Tampa* decision effectively replaced any such quantitative test by an open-ended inquiry into competitive impact. What is required under *Tampa* is to determine the probable effect of the [exclusive] contract on the relevant area of competition, taking into account…[various factors including] the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein."

*Id.*

The court refused to disturb the lower court's conclusion that the defendant HMO's exclusive dealing agreements were legal where the evidence showed that 75% of the input capacity remained contestable by competing HMOs and there was no evidence that the agreements had (1) kept any actual or would-be HMO competitor from competing or (2) increased prices. *Id.*

*Roland, Barr* and *U.S. Health Care* all suggest that an important factor in determining whether exclusive dealing agreements violate Clayton Act Section 3 is whether the agreements have actually had the effect of excluding an actual or would-be competitor. This factor, however, was not dispositive. Other factors were considered in determining the likely future effect of the agreements.

These decisions identified two additional factors. The first was the duration of the exclusive dealing agreements. The shorter the better from an antitrust standpoint. In *Barry Wright*, the court emphasized that the seller's commitment was only "about two years." 724 F.2d at 237. In Roland, the court went even further, asserting there "[e]xclusive dealing contracts terminable in less than a year are presumptively lawful under section 3." 749 F.2d at 395. In *U.S. Health Care*, the court stated that "[n]ormally an exclusivity clause terminable on 30 days' notice would be close to a de *minimus* constraint…and one year is sometimes taken as the trigger for close scrutiny." *Id.* at 596.

The second additional factor was the existence of a legitimate business justification for the exclusive dealing agreements. In *Barry Wright*, the First Circuit stated that courts "must look both to the severity of the foreclosure…and the strength of the justifications in determining whether the 'size' of the contract to purchase is reasonable." 724 F.2d at 237. In *Roland*, the Seventh Circuit emphasized that "[the calculus of competitive effect must include some consideration of the possible competitive benefits of exclusive dealing…" 749 F.2d at 395. And in *Barr*, the Third Circuit stated that "[t]he existence of legitimate business justifications for the contracts also supports [their] legality…" 978 F.2d at 111.

Conversely, evidence of anti-competitive intent may not, by itself, establish the illegality of an exclusive dealing arrangement under Clayton Act Section 3 or Sherman Act Section 1. Thus, in *U.S. Health Care*, above, the First Circuit shrugged off documentary evidence of exclusionary intent. There were some "meeting notes of [defendant's] staff members which stated that the differential pricing would be 'a deterrent [sic] to joining other HMOs (like [plaintiff])…' The First Circuit stated, however, that

> "Motive can, of course, be a guide to expected effects, but effects are still the central concern of the antitrust laws, and motive is mainly a clue…[*Id.*] under Tampa the ultimate issue in exclusivity cases remains the issue of foreclosure and its consequences. …Absent a compelling showing of foreclosure of substantial dimensions, we think there is no need for us to pursue any inquiry into [defendant's] precise natures for the closure…"

*Id.* at 596.

### C. More Recent Appellate Decisions

These Section 1/Section 3 decisions were followed by the courts in *Omega Environmental, Inc. v. Gilbarco, Inc.*, 127 F3d 1157 (9th Cir. 1997) and *Paddock Publications v. Chicago Tribune*, 103 F. 3d 42, 45 (7th Cir. 1996). In Omega, the defendant had exclusive dealing agreements with 70% of the dealers who were the preferred outlet for products in the market, but, according to the court, there were alternative means of distribution and the dealers accounted for only 38% of the sales in the market. Thus, more than 60% of the market remained contestable. *Id.* at 1162-63. Additionally, the court stressed that the exclusive agreements with the dealers were terminable on relatively short notice so that countermeasure were available to competitors -- i.e., competition for the dealer contracts. *Id.* at 1163. Under these circumstances the court held that the agreements did not violate Section 3 or Section 1, as a matter of law.

In *Paddock* the court (Judge Easterbrook) considered the Chicago Tribune's exclusive dealing agreements with syndicators of a number of popular newspaper features. The court noted that other features were available to the plaintiff and there was no evidence as to the impact of the foreclosure on actual newspaper sales. *Id.* at 47. The court noted that the exclusive dealing agreements were a of relatively short duration, and commented that "[c]ompetition for the contract is a form of competition that the antitrust laws protect rather than proscribe, and it is common." *Id.* at 45.

**D. *LePage's* and *Dentsply***

*LePage's* and *Dentsply*, were Section 2 cases, the former brought by a competitor and the latter by the Justice Department. (The only theory on appeal in *Dentsply* was a Section 2 theory.) In *LePage's* the plaintiff alleged that defendant 3M, maintained its monopoly by offering prices on bundles of products including Scotch tape that were so attractive that customers could not afford to buy tape from any other competitor, including *LePage's*. The practical effect of this bundling strategy, was to create exclusive dealing arrangements with so many customers that LePage's could not compete. LePage's offered no evidence to suggest that the bundled prices were below 3M's cost or that it (LePage's) lacked countermeasures -- *e.g.*, marrying with providers of other products in the bundle and offering competing bundles at more attractive prices. But it did offer evidence that besides the exclusive dealing arrangements, 3M had engaged in a "monopoly broth" of other conduct the totality of which suggested monopolization. On that record, the Third Circuit, in its *en banc* decision, affirmed a Section 2 judgment against 3M.

In *Dentsply*, the defendant allegedly had monopoly power in the manufacture and sale of artificial teeth. It also had exclusive dealing agreements with 23 out of hundreds of dealers, and the government challenged those agreements as a Section 2 violation. It charged that even though competitors had hundreds of dealers as well as direct distribution as alternatives, the 23 dealers were the "key" ones, and it brushed off Dentsply's contention that those agreements were terminable at will on the ground that in fact the right of termination was historically exercised only rarely, if at all. The government pointed out that during the period that the exclusive dealing agreements were in force, there was evidence that Dentsply's prices, margins and market share were all extraordinarily high and that there was also evidence that Dentsply was determined to maintain its monopoly position. On that record, the Third Circuit, reversed the District Court's rejection of the government's Section 1 claim.

**E. Open Questions**

In some respects, these two Third Circuit decisions are unremarkable. For example, though some have questioned whether *LePage's* was really an exclusive dealing case at all because few, if any, of 3M's agreements required exclusive dealing, there was prior authority that exclusive dealing arrangements can be de facto as well as de jure, and that package pricing for which there are no countermeasures may constitute de facto exclusive dealing. *See e.g., U.S. Healthcare*, 986 F.2d 595-96; *Virtual Maintenance v. Prime Computer*, 11 F.3d 660 (6th Cir 1993). On the other hand, there are some aspects of these decisions that raise some eyebrows.

First, the lack of evidence in *LePage's* that countermeasures were impossible is troubling. The notion of one competitor marrying others to combat package pricing is not new. *See Ways & Means Inc. v. IVAC Corp*., 506 F.Supp. 697 (N.D.Cal. 1979), *aff'd*, 638 F.2d 143 (9th Cir. 1981). The Third Circuit could (and arguably should) have demanded proof that that was not possible. Indeed, the notion that 3M was handcuffed from engaging in package pricing because it alone had the attractive components of the package is troubling. As the Seventh Circuit said in *MCI Communications Corp., v. AT&T*, 708 F.2d 1081, 1131 (7th Cir. 1983), "MCI's competitive disadvantage…stems from the fact that it entered the market only on a limited geographic scale, and does not reflect unlawful predation by AT&T." *See also Northeastern Tel.Co. v. AT&T*, 651 F.2d 76, 90 (2d Cir. 1981) (antitrust laws do not favor 'interests of single-market competitors over those of consumers.'). Indeed, one can question whether the decision is consistent with the admonition in *Verizon Communications, Inc. v. Law Off. of Curtis Trinko*, 124 S.Ct. 872 (2004) that even one with monopoly power cannot generally be compelled to share the source of its advantages with competitors. *Id.* at 879.

Second, the decision in *Dentsply*, like the government, brushed off the evidence that competitors had numerous alternative methods of distribution available to them and that the agreements that *Dentsply* did have with dealers were terminable at will. These were factors that were dispositive in prior Section 3 and Section 1 cases like *Omega* and *Triangle Publications*. It is arguable

that they are as important in a Section 2 case as they are in Section 3 and Section 1 cases - *i.e.*, one can question whether the Third Circuit sufficiently linked the undeniable evidence of *Dentsply's* monopoly position to the challenged exclusive dealing agreements, especially where those "holes" in the agreements existed.

In the end, it can be argued that the most important evidence in these cases was the evidence of the defendants' market positions and of their determination to maintain those market positions. The monopoly broth evidence in *LePage's* and the internal communications in *Dentsply* have to be considered extremely valuable in trying to persuade any trier of fact -- especially a lay jury -- that monopolization (or an attempt to monopolize) has occurred, and the Third Circuit decisions demonstrate that that kind of evidence is also important on appeal. That being so, one can probably expect challenges to exclusive dealing agreements to be increasingly tried under Section 2.