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Antitrust Law's Harm to Competition: A New Understanding of Exclusivity

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One of the long-accepted axioms of antitrust law is that the competitive danger posed by exclusivity agreements increases as the market share foreclosed by these arrangements increases. The larger the market share foreclosed by an exclusivity agreement, the less likely the arrangement is to be upheld by courts. And exclusivity arrangements foreclosing extremely large market shares are practically never upheld. The business community has responded by forsaking such arrangements (or concealing them). This Article challenges this very intuitive axiom. It shows that due to an unobserved feature of exclusivity, when extremely large market shares are foreclosed, the competitive danger posed by these arrangements decreases. Exclusivity arrangements foreclosing market shares of 85% and higher should be presumed competitively benign, and therefore legal. Several illustrative examples of industries, in which widespread exclusivity should be allowed in contradiction to the current understanding, are provided. The analysis

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developed in this Article suggests that for decades antitrust law has been decreasing welfare by forcing businesses to steer clear of a welfare-enhancing practice. The Article calls for a change of this paradigm.

INTRODUCTION

In 2018, the Delaware District Court was motioned to summarily dismiss an antitrust claim in *Roxul v. Armstrong*.[1] The plaintiff, a manufacturer of ceiling tiles, alleged that defendant, a competing manufacturer of ceiling tiles, had inhibited the growth of the plaintiff's business by signing exclusivity arrangements with key distributors. Plaintiff explained that distributors were a critical channel in the sale of ceiling tiles.[2] Building constructors, who are the end consumers of tiles, seldom buy tiles from any source other than distributors, because distributors offer a wide range of additional products and services.[3] Manufacturers therefore have no viable alternative to distributors, and tiles are sold almost exclusively through distributors. Plaintiff also claimed that there were very few distributors qualified to distribute ceiling tiles.[4] Defendant had signed exclusivity contracts with the key distributors,[5] thereby retarding the growth of plaintiff's business, as well as that of other tile manufacturers. As a result, defendant was able to charge more than 5% over competitive prices.[6] Taking these allegations to be true (as the court must when summary

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1. Roxul USA, Inc. v. Armstrong World Indus., No. 17-1258, 2018 U.S. Dist. LEXIS 21513, at *3–4 (D. Del. Feb. 9, 2018).

2. *Id.* at *13.

3. Such as logistical planning, same-day delivery, other services, and additional building products. *Id.* at *13–14.

4. *Id.* at *1, *13–14; *see also id.* at *3 ("Due to market forces, regional and national distributors have consolidated resulting in limited numbers of distributors capable of servicing [plaintiff] and [defendant].").

5. *Id.* at *12–13.

6. *Id.* at *4.

dismissal is sought),[7] the court sided with plaintiff.

A year later, in 2019, the court denied defendant's motion to preclude an expert opinion submitted on behalf of the plaintiff.[8] The court again sided with the plaintiff, finding that the assertions made in the expert opinion were sufficient to be brought before a jury. Specifically, the court found that an argument according to which the most efficient (and largest) distributors had been foreclosed to competitors constituted a sufficient allegation of competitive harm.[9]

In line with current antitrust theory and prevailing antitrust law, both decisions were handed down without any attempt to address a question that begs itself under the circumstances: If the foreclosed distributors are indeed indispensable from tile manufacturers' perspectives, be it because they are large, efficient, or for any other reason, why did they agree to participate in a scheme that ultimately resulted in higher prices charged to them? Would they not have been better off turning down defendant's exclusivity offer? Surely, a refusal to grant exclusivity would have left them with the choice of buying from any of several tile manufacturers competing with each other. If the foreclosed distributors can indeed bestow market power on, or withhold market power from manufacturers (otherwise the agreements in question would have been competitively benign), distributors' acquiescence is puzzling. They willingly retarded competition at the manufacturers' level only to find themselves contractually obligated to purchase exclusively from a seller who then charged them higher prices.

An intuitive explanation for distributors' acquiescence would be a straightforward one—payment. The distributors

7. Cedars-Sinai Med. Ctr. v. Nat'l League of Postmasters of U.S., 497 F.3d 972, 975 (9th Cir. 2007).

8. Roxul USA, Inc. v. Armstrong World Indus., No. 17-1258, 2019 U.S. Dist. LEXIS 37925, at *2 (D. Del. Mar. 8, 2019).

9. *Id.* at *11.

may have received consideration from the defendant manufacturer in return for agreeing to the exclusivity clauses.

But despite its intuitive appeal, this explanation is unsatisfactory. The reason is that it requires a collective action problem amongst distributors, which, under the circumstances alleged by plaintiff, would have been extremely unlikely, if not impossible. A detailed explanation of the collective action problem that is a prerequisite for this scenario is provided subsequently.[10] Very briefly, it has long been observed that anti-competitive exclusivity—exclusivity that enhances a contracting party's market power—is, in the context discussed here, a zero-sum game. Any additional dollar of profit that will accrue to one party as a result of its newly-acquired market power will come at the expense of its contractual counterpart. This, as will be explained, holds not only when the agreement is struck between a seller and an end consumer, but also when the parties are a wholesaler and a retailer. Any profits accruing to the manufacturer as a result of anti-competitive exclusivity will necessarily harm the retailer. Importantly, the harm incurred by the retailer will be precisely equal to the manufacturer's gains from anti-competitive exclusivity. A mutually beneficial arrangement whereby the manufacturer is granted market power *and* distributors (as a group) profit from the arrangement is—under this theory of competitive harm—impossible. This understanding is neither novel nor controversial. It dates back many years.[11]

10. *See infra* Section II.B.

11. The understanding is in fact the result of a debate, in which members of the Chicago School initially argued that exclusivity can never produce an anti-competitive outcome. *Compare* RICHARD A. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 203–05 (1976), *and* ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF, 306–07 (1978), *with* Louis Kaplow & Carl Shapiro, *Antitrust*, *in* 2 HANDBOOK OF LAW AND ECONOMICS 1072, at 1204–05 (A. Mitchell Polinsky & Steven Shavell eds., 2007). There are also other anti-competitive explanations for exclusivity, but these are more limited in scope, and more controversial. As Kaplow & Shapiro point out, the presence of multiple

If distributors face a collective action problem, some of them may agree to grant the manufacturer exclusivity, thereby securing the manufacturer's dominant position.[12] But under the circumstances alleged by the plaintiff in *Roxul v. Armstrong*, in which there were only a few key distributors (and apparently two large ones)[13] who could withhold the dominant position from, or bestow it upon, the manufacturer, a collective action problem is unlikely.

As implausible as a collective action problem is under the circumstances alleged by that plaintiff, this is not the key point in the current context. Importantly for current purposes, the court *found no need to address these issues*. In line with the current understanding of exclusivity, the court assumed that exclusivity agreements foreclosing a large market share to competitors were more likely to harm competition.[14] Although the theoretical foundation for the understanding of exclusivity is not new, its practical implications have thus far been overlooked. Courts and commentators continue to assume that exclusivity arrangements foreclosing large market shares are likely to harm competition.

It is this intuitive assumption that the current Article challenges. The challenge launched in this Article does not suggest that exclusivity arrangements never carry any anti-competitive potential. They definitely do. But paradoxically, when extremely large market shares are foreclosed, the

buyers that leads to a free rider problem is "the factor that is probably most important in antitrust challenges to exclusive dealing." Louis Kaplow & Carl Shapiro, *Antitrust*, *in* 2 HANDBOOK OF LAW AND ECONOMICS 1072, at 1204 (A. Mitchell Polinsky & Steven Shavell eds., 2007). For a survey of other explanations, see *id.* at 1205–09 (focusing on the explanation developed in Phillipe Aghion & Patrick Bolton, *Contracts as Barriers to Entry*, 77 AM. ECON. REV. 388 (1987)). Note, however, that many settings in which exclusivity contracts will increase the costs of entry under this explanation will not result in harm to consumers.

12. *See infra* Section II.B.

13. *Roxul*, 2019 U.S. Dist. LEXIS 37925, at *11–12.

14. *Id.* at *9–10, *13–14.

market share foreclosed does not exacerbate the anti-competitive potential, but rather becomes a safeguard against exclusivity's anti-competitive potential. This feature of exclusivity arrangements has, until now, been overlooked. Yet it has important policy implications.

Exclusive dealing agreements are a widespread and long-standing business practice.[15] Such arrangements have mixed welfare effects: On the one hand, they may generate various cost-savings in production and distribution,[16] which in turn result in lower prices and increased output, an undeniably welfare-enhancing effect.[17] On the other hand, they restrict competitors' access to supply sources or distribution outlets. If enough outlets are foreclosed, exclusivity arrangements may exclude competitors from the market altogether. This, in turn, may enhance or entrench the market power of the party being granted exclusivity, thereby enabling that party to elevate prices and restrict output, resulting in the deadweight loss that is the hallmark of market power's exertion.[18]

As exclusivity arrangements have both welfare-enhancing and welfare-reducing (anti-competitive) effects, their legality is subject to the rule of reason analysis,[19] which calls for a balancing of their welfare-enhancing effects against their anti-competitive effects under the specific market circumstances.[20] If the former outweigh the latter,

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15. *See* Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L.J. 311, 314 (2002). For other early cases, see *id.* at 314 n.8. For an early (documented) case, see Gale v. Reed (1806) 103 Eng. Rep. 274 (KB).

16. *See infra* Section II.A.

17. HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION 122 (2d ed. 1998).

18. *See* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 3–15 (5th ed. 2016).

19. Eisai, Inc. v. Sanofi Aventis U.S., LLC, 821 F.3d 394, 403 (3d Cir. 2016).

20. *Standard Oil Company of California v. United States* (*Standard Stations*), 337 U.S. 293 (1949), is regularly cited as the authority under which exclusivity

the arrangement under scrutiny is upheld. If the opposite is the case, the arrangement is struck down.

Within the framework of the rule of reason, the market share of the contracting parties is, and has long been, a key criterion for identifying whether the arrangement at hand is benign or anti-competitive.[21] The importance of the percentage of the market foreclosed is intuitive: the greater the share of the market foreclosed, the less alternatives a competitor (of the party being granted exclusivity) has from whom she can purchase, or to whom she can sell.[22] Consequently, competitors may be driven out of the market.[23] It would thus seem that the competitive danger raised by exclusivity arrangements increases as the percentage of the market foreclosed increases. Factors other

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arrangements are subject to the rule of reason. *See, e.g.*, Recent Developments, *Tying Agreements and Exclusive Dealing Arrangements before the Courts and the FTC*, 55 COLUM. L. REV. 561, 562 n.15 (1955) [hereinafter *Tying and Exclusivity*]. Jacobson, *supra* note 15, at 319, points out that the issue was initially settled almost a quarter of a century earlier in *FTC v. Sinclair Refining Co.*, 261 U.S. 463 (1923). But it should be noted that while the court in *Sinclair* was undoubtedly sympathetic to the contract, the contract at bar had not explicitly prohibited retailers from dealing with competing manufacturers. For an account of the application of the rule of reason in general, see Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981).

21. *See* cases cited *infra* note 25–26.

22. Exclusive dealing arrangements may be exclusive supply agreements, whereby a seller (or sellers) agrees to supply exclusively to a single purchaser, and they may be exclusive purchasing agreements, whereby a buyer (or buyers) agree to purchase exclusively from a single supplier. *See* Commission Regulation 2790/99 of 22 Dec. 1999 on the Application of Article 81(3) of the Treaty to Categories of Vertical Agreements and Concerted Practices, art. 1(c), 1999 O.J. (L 336) 21; Commission Regulation 1984/83 of 22 June 1983 on the Application of Article 85(3) of the Treaty to Categories of Exclusive Purchasing Agreements, 1983 O.J. (L 173) 5. Throughout the remainder of this Article, I normally use the more intuitive example of exclusive purchasing agreements. The argument pressed in this Article is, however, equally valid in the setting of exclusive supply agreements.

23. The focus on the disadvantage at which competitors are placed in comparison to the incumbent as the key element of the analysis follows the understanding of barriers to entry originating in JOE BAIN, BARRIERS TO NEW COMPETITION (1952). For a discussion of the application of this understanding in the context of exclusivity, see sources cited *infra* note 110.

than the percentage of foreclosure, such as the number of barriers to entry, are of course also relevant. But the competitive danger nonetheless largely depends on the percentage of foreclosure.

Current antitrust theory and law view the competitive danger associated with exclusivity agreements as a continuum.[24] At one end are exclusivity commitments granted by firms with trivial market shares, which raise no real competitive concern. At the other extreme are exclusivity commitments granted by firms with significant market shares, which rightly raise concern. This concern may be outweighed by pro-competitive effects, but it definitely exists. And the larger the foreclosed share, the greater the pro-competitive effects that are required to offset the competitive harm if the agreement is to be upheld. Approvals of exclusivity arrangements in which the foreclosed market share is larger than approximately 70% are essentially nonexistent.[25] Courts have emphasized time and again that such large foreclosure almost invariably implicates the agreements as anti-competitive.[26]

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24. *See infra* Part I.

25. *See, e.g.*, Tele Atlas N.V. v. NAVTEQ Corp., 397 F. Supp. 2d 1184, 1190 (N.D. Cal. 2005) (dismissing motion for summary judgment, although nothing but information on the foreclosed market share was alleged to support competitive harm brought about by exclusives); Fisherman's Wharf Bay Cruise Corp. v. Super. Ct. of the City & Cnty. of S.F., 7 Cal. Rptr. 3d 628, 650 (Ct. App. 2003) (making an even more extreme argument, citing authority for the proposition that courts "routinely condemn" foreclosure meeting a 50% threshold); ZF Meritor, L.L.C. v. Eaton Corp., 696 F.3d 254, 263 (3d Cir. 2012) (dismissing motion for summary judgment); Maxon Hyundai Mazda v. Carfax, Inc., No. 13-CV-2680 (AJN), 2014 U.S. Dist. LEXIS 139480, at *269 (S.D.N.Y. Sept. 29, 2014).

26. The court in *Ryko Manufacturing Co. v. Eden Services*, a case upholding exclusives, indicated that it would have been less sympathetic to the exclusives had the market share foreclosed been extreme: "Where the degree of foreclosure caused by the exclusivity provisions is so great that it invariably indicates that the supplier imposing the provisions has substantial market power, we may rely on the foreclosure rate alone to establish the violation." 823 F.2d 1215, 1233 (8th Cir. 1987). Closely related in the context of the focus on market shares (although distinct from an economic perspective) are cases in which the firm being granted exclusivity is a monopoly or holds a significant market share. Such arrangements

This Article challenges the prevailing view. It shows that despite intuition, when exclusivity is granted by a firm or firms with extremely large market shares, economic theory suggests that competitive harm is unlikely, and very often entirely impossible, at least under the main theory of competitive harm. When the percentage of foreclosure is relatively small, its anti-competitive potential indeed increases with the percentage of foreclosure. Foreclosure of 30% is indeed more likely to harm competition than foreclosure of 20%; foreclosure of 40% is more likely to be anti-competitive than foreclosure of 30%, and so on. The anti-competitive impact continues to increase as the market share foreclosed increases, until a threshold of approximately 85% to 90% is reached. But when the percentage of foreclosure exceeds this threshold, the positive correlation between the percentage of foreclosure and the competitive danger no longer exists. In fact, it is reversed. The large percentage becomes a safeguard *against* the use of exclusivity to enhance or entrench market power.[27]

This analysis has paradigm-changing policy implications. Surprisingly, exclusivity arrangements resulting in foreclosure of extremely large market shares should be treated *more leniently* than arrangements

too are regularly struck down. *See* United States v. Greenhut (*In re* Corning), 51 F. 205, 207–08 (N.D. Ohio 1892) (the firm being granted exclusivity was actually a member of a horizontal combination of several defendants, but a combination formed prior to the enactment of the Sherman Act); United Shoe Mach. Corp. v. United States, 258 U.S. 451, 464–65 (1922); Lorain J. Co. v. United States, 342 U.S. 143, 156–57 (1951); FTC v. Motion Pictures Advert. Co., 344 U.S. 392, 392 (1953) (note, however, that the 75% market share was held by four companies, who all had exclusivity arrangements in place); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 239–40 (1st Cir. 1983); Omega Env't, Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1178–79 (9th Cir. 1997). In the landmark *Tampa Elec. Co. v. Nashville Coal Co.*, subsequently discussed, the court ruled that market share alone is insufficient as a conclusive indication of competitive harm. 365 U.S. 320, 328 (1961). Consequently, courts generally refer to additional indicia as well. Nonetheless, despite the rhetoric, the outcome remains the same: courts essentially never uphold exclusivity arrangements foreclosing large market shares.

27. The terms "large" and "small" are quantified *infra* Part 0.

foreclosing significant (but smaller) market shares.

The remainder of this Article is structured as follows. Part I briefly reviews the legal treatment of exclusivity. Part II reviews the potential welfare-enhancing and welfare-reducing effects of exclusivity. Specifically, this Part of the Article offers insight into the key prerequisite for anti-competitive exclusivity under the widely accepted theory of competitive harm—a collective action problem at the link in the chain of production granting exclusivity. Part III develops the concept of "monopoly-over-monopoly status," explaining why exclusivity is unlikely to be anti-competitive when very large market shares are foreclosed. This Part also provides several useful examples of real-life industries in which, contrary to common wisdom, exclusivity should be presumed benign. Part IV derives a practical rule based on empirical data for US industries. A conclusion follows.

I. THE LEGAL TREATMENT OF EXCLUSIVITY

Exclusivity arrangements are dealt with under section 1 of the Sherman Act, which prohibits contracts, combinations, or conspiracies in restraint of trade.[28] Additionally, the Clayton Act,[29] enacted in 1914, contains an explicit provision prohibiting a seller from conditioning sales, prices, discounts or rebates

> on the condition, agreement, or understanding that the lessee or purchaser . . . shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.[30]

The legal treatment of exclusivity agreements has

28. 15 U.S.C. § 1 (1890).

29. 15 U.S.C. §§ 12–27 (1914).

30. 15 U.S.C. § 14 (1914).

undoubtedly changed over the years since the enactment of the Sherman Act and the Clayton Act. Specifically, the numerous welfare-enhancing explanations advanced over the years, which will be surveyed subsequently,[31] have brought about a gradual increase in the minimum threshold for concern. As will be shown, in the earlier years, even foreclosure of trivial market shares through exclusivity arrangements was thought to be concerning. In recent years, even foreclosure of 50% does not trigger immediate condemnation. Another change is associated with other factors of the analysis. Initially, the analysis focused almost solely on the foreclosed market share. Nowadays, courts consider additional factors that may impact the effect exclusivity arrangements have. For example, if barriers to entry are very low, even relatively large exclusivity raises less concern.

However, despite the various changes, the percentage of the market foreclosed to competitors remains a key determinant of the outcome. It is almost always the starting point of the analysis, and is often the end of the analysis as well, specifically when the foreclosed market shares are extreme. As will be shown, when the market share foreclosed by exclusivity agreements is extremely small, the agreements will be upheld almost automatically. When the market shares foreclosed are extremely large, condemnation is all but immediate.

The legal treatment of exclusivity agreements can be roughly divided into three periods—the period between the enactment of the Sherman Act (1890) and the enactment of the Clayton Act (1914), the period between the enactment of the Clayton Act in 1914 and 1961, and the period between 1961 and the present.[32]

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31. *See infra* Section II.A.

32. Jacobson, *supra* note 15, at 314–34, identifies four different periods in the legal treatment of exclusivity agreements. Jacobson divides the third period discussed below into two different periods—1961 to the 1990s, and the 1990s to present. I explain below, *infra* note 76, why I consider these two periods to be

A. *The First Period: 1890 to 1914*

The first period began in 1890, with the enactment of the Sherman Act, and ended in 1914, with the enactment of the Clayton Act. Between 1890 and 1914, courts refrained almost completely from interfering with exclusivity arrangements. With few exceptions, US courts followed the example set by English courts and upheld exclusivity arrangements as 'partial restraints of trade.'[33] The most famous of these cases was the *Pullman* case,[34] in which the court refused to strike down an agreement granting the Pullman Company the exclusive right to furnish sleeping cars for all passenger trains controlled by the Chicago, St. Louis and New Orleans Railroad Company for a period of 15 years.[35] The agreement, which was one of a series of agreements Pullman had with various railroad companies,[36] ultimately enabled Pullman to sustain its monopoly for nearly a half-century.[37] Caselaw throughout this period neither challenged nor adopted the paradigmatic view that larger foreclosure always poses greater competitive danger. Courts had little reason to grapple with the economic complexities of a practice that was, for all practical purposes, per se legal. But this period is important in understanding

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one.

33. Jacobson, *supra* note 15, at 314–16.

34. Chi., St. Louis & New Orleans R.R. Co. v. Pullman S. Car Co., 139 U.S. 79 (1891).

35. *Id.* at 83–84.

36. For some of these agreements, see generally Whitwell v. Cont'l Tobacco Co., 125 F. 454 (8th Cir. 1903); Donovan v. Pennsylvania Co., 199 U.S. 279 (1905); Ohio *ex. rel.* Sheets v. Union Depot Co., 73 N.E. 633 (1905). For a list of additional state cases, see Jacobson, *supra* note 15, at 315 nn.15–16.

37. Pullman's arrangements (the length of which was gradually shortened) continued to occupy the courts for years later. *See, e.g.*, Eugene V. Rostow, *The New Sherman Act: A Positive Instrument of Progress*, 14 U. CHI. L. REV. 567, 588 (1947); William E. Stockhausen, *The Commercial and Anti-Trust Aspects of Term Requirements Contracts*, 23 N.Y.U. L. REV. 412, 414 n.7, 420–21, 423–24 (1948); Jonathan M. Jacobson & Scott A. Sher, *"No Economic Sense" Makes No Sense for Exclusive Dealing*, 73 ANTITRUST L.J. 779, 779 n.1 (2006).

the development of antitrust doctrine as it relates to exclusivity. Naturally, the lack of any in-depth analysis of the economic effects of the practice also meant that there were no cases in which a court was forced to grapple with the possibility that the intuitive view was incorrect. Absent any challenges to the intuitive view according to which the competitive harm always increases as the foreclosed market share increases, this understanding was entrenched.

B. *The Second Period: 1914 to 1961*

The second period began in 1914, with the enactment of the Clayton Act. The Clayton Act was aimed at strengthening antitrust enforcement, which was thought to be lacking under the Sherman Act.[38] Certain practices were therefore explicitly prohibited. Among these was exclusivity, which, as mentioned, Section 3 of the Clayton Act condemned whenever its effect "may be to substantially lessen competition or tend to create a monopoly in any line of commerce."[39]

Courts were quick to follow the explicit Congressional condemnation of exclusivity.[40] Exclusivity agreements were soon struck down regardless of the justification offered for the practice under the specific market settings. The first case in which the Supreme Court found an agreement to violate Section 3 of the Clayton Act was the *Standard Fashion*

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38. For a summary of the legislative history of the Clayton Act, see William B. Lockhart & Howard R. Sacks, *The Relevance of Economic Factors in Determining Whether Exclusive Arrangements Violate Section 3 of the Clayton Act*, 65 HARV. L. REV. 913, 933–35 (1952). *See also* Louis B. Schwartz, *Potential Impairment of Competition: The Impact of* Standard Oil Co. of California v. United States *on the Standard of Legality Under the Clayton Act*, 98 U. PENN. L. REV. 10 (1949); *Tying and Exclusivity*, *supra* note 20, at 562.

39. 15 U.S.C. § 14 (1914).

40. The change in the standard of review was noticed almost immediately. *See* Notes, *The Legality of Contracts of Sale Which Prevent the Purchaser-Retailer from Handling Goods of the Wholesaler's Competitors*, 30 HARV. L. REV. 72, 73 (1916); *see also* Jacobson, *supra* note 15, at 317–23.

case,[41] a ruling subsequently condemned extensively in academic writings.[42] A week later, in *United Shoe*,[43] the Court struck down exclusivity clauses it had upheld twice in the preceding decade under the Sherman Act.[44] In both cases, the Court seemed to apply a rule of per se illegality to the practice, as it conducted no analysis of the effects of the exclusivity commitment on market performance.[45] But shortly thereafter, in *Sinclair*,[46] the Court clarified that the practice was not subject to per se condemnation. Following this clarification, lower courts began focusing on the market shares of the contracting parties, striking down exclusivity clauses that resulted in foreclosure of significant market shares, and upholding exclusivity arrangements signed by firms with insignificant market shares.[47] Once again, the intuitive linkage between the foreclosed market share and the effect on competition was not questioned in any way. The courts subscribed to the same basic logic: the larger the foreclosed market share, the greater the competitive danger.

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41. Standard Fashion Co. v. Magrane Hous. Co., 258 U.S. 346, 357 (1922). The appeal to the Supreme Court was the culmination of lengthy litigation, in the course of which lower courts repeatedly found the arrangement to be in violation of Section 3 of the Clayton Act. *See* Standard Fashion Co. v. Magrane-Hous. Co., 254 F. 493, 500 (D. Mass. 1918); Standard Fashion Co. v. Magrane Hous. Co., 251 F. 559 (1st Cir. 1918); Standard Fashion Co. v. Magrane Hous. Co., 259 F. 793, 795 (1st Cir. 1919).

42. *See, e.g.*, BORK, *supra* note 11, at 305–07; Frank G. Mathewson & Ralph A. Winter, *The Competitive Effects of Vertical Agreements: Comment*, 77 AM. ECON. REV. 1057, 1057 (1987). *But see* Harlan M. Blake & William K. Jones, *Toward a Three-Dimensional Antitrust Policy*, 65 COLUM. L. REV. 422, 441–43 (1965).

43. United Shoe Mach. Corp. v. United States, 258 U.S. 451, 465 (1922).

44. *Cf.* United States v. Winslow, 227 U.S. 202, 217 (1913) (technically considering only the agreement *forming* United Shoe Machinery, not the exclusivity covenant); United States v. United Shoe Mach. Co., 247 U.S. 32, 65 (1918) (which, although decided after the enactment of the Clayton Act, pertained to offenses that had been committed prior to its enactment).

45. *See* Jacobson, *supra* note 15, at 318–19.

46. FTC v. Sinclair Refining Co., 261 U.S. 463, 474–75 (1923).

47. Jacobson, *supra* note 15, at 319–320 & nn.52–54.

Approximately a quarter-century later, the legality of exclusivity arrangements was again questioned, due to a ruling that applied a per se illegality rule to tie-in arrangements.[48] As both tie-ins and exclusivity are governed by Section 3 of the Clayton Act, the ruling finding tie-ins to be per se illegal could have been interpreted to apply to exclusivity as well, or at least could have affected the legal treatment of exclusivity.[49] The Supreme Court was again called upon to decide on the rule applicable to exclusivity. In the landmark *Standard Stations* case, the Court reaffirmed that exclusivity arrangements, as opposed to tying arrangements, were not to be judged under the per se illegality rule.[50] However, complex economic investigations would not be required: exclusivity arrangements foreclosing "a substantial share of the line of commerce affected" would be condemned under Section 3 of the Clayton Act.[51] The term "substantial share" was interpreted to mean any share that was nontrivial. Even foreclosure of relatively small market shares was enough for striking down an agreement.[52]

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48. Int'l Salt Co. v. United States, 332 U.S. 392, 396 (1947) (subsequently limited to a certain extent in Jefferson Parish Hosp. Dist. v. Hyde, 466 U.S. 2, 35 (1984)).

49. *See, e.g.*, *Tying and Exclusivity*, *supra* note 20, at 561–62, 561–62 nn.13–15.

50. Standard Oil Co. v. United States (*Standard Stations*), 337 U.S. 293, 314–15 (1949).

51. *Id.* at 314; *see also* United States v. Richfield Oil Corp., 99 F. Supp. 280, 286–87 (S.D. Cal. 1951), *aff'd*, 343 U.S. 922 (1952) (affirming case with same issues as *Standard Stations*); Fashion Originators Guild v. FTC, 312 U.S. 457, 465 (1941). The Court's reasoning in *International Salt* suggests the same, although the case at bar was one of tie-ins, not of exclusivity. 332 U.S. at 396. For a discussion of the analogy between the legal treatment of both practices, see Schwartz, *supra* note 38, at 11–12.

52. *See, e.g.*, *Standard Stations*, 337 U.S. at 304–05, 314. *See generally Tying and Exclusivity*, *supra* note 20, at 561–62. Although the quote refers directly to tying arrangements, the author clarifies that this account holds relevant to the analysis of exclusivity agreements. But later in the article a more nuanced approach to exclusivity arrangements is identified. *See id.* at 563. A different interpretation of the cases (as conforming to the notion of "workable competition") can be found in Alfred E. Kahn, *The Legal and Economic Appraisal of the "New" Sherman and Clayton Acts*, 63 YALE L.J. 293, 313–15, 319–22 (1954). Kahn

The "substantial foreclosure" test, or the quantitative substantiality test,[53] was subsequently adopted as the test to be applied for scrutiny under the Sherman Act prohibitions as well.[54] Blake and Jones, summarizing the case law at the time, pointed out: "It might be argued that exclusive dealing arrangements have compensating advantages . . . . This is a good basis for upholding exclusive dealing arrangements when they do not threaten to impede entry . . . ."[55]

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acknowledges, however, that although the decisions *can* be explained by the "workable competition" idea, the actual reasoning of the courts suggests that any foreclosure of a "not insubstantial" market share is enough for condemnation. *See id.* at 314–15.

53. Jacobson, *supra* note 15, at 320.

54. For examples of cases applying the test to the Sherman Act provisions, see Lorain J. Co. v. United States, 342 U.S. 143, 153–54 (1951) (Sherman Act section 2); FTC v. Brown Shoe Co., 384 U.S. 316, 321 (1966) (Sherman Act section 1); *Richfield Oil Corp.*, 99 F. Supp. 280 at 286–87 (Sherman Act section 1 (but not section 2) and Clayton Act section 3 with respect to the relevance of intent); FTC v. Motion Pictures Advert. Co., 344 U.S. 392, 395, 397–98 (technically discussing the Federal Trade Commission Act section 5, 15 U.S.C. § 45, but stipulating that the contracts were in violation of both the monopolization offenses and the restraint of trade provisions of the Sherman Act); Barry Wright Corp v. ITT Grinnell Corp., 724 F.2d 227, 230, 236 (1st Cir. 1983) (Sherman Act sections 1 and 2 and Clayton Act section 3); Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215, 1233 (8th Cir. 1987) (although the court did suggest that the prohibition in Clayton Act section 3 is broader). This was a change in the understanding of the statutes. They were originally perceived as applying different standards of liability, which, as mentioned, were in fact the *raison d'etre* of the Clayton Act. *See* United Shoe Mach. Corp. v. United States, 258 U.S. 451, 459–60 (1922); William Noel Keyes, *Exclusive Foreign Distributor Agreements—Are They Illegal?*, 41 CAL. L. REV. 439, 443 (1953). For later cases applying a different standard of review, see McElhenney Co. v. Western Auto Supply Co., 269 F.2d 332, 339 (4th Cir. 1959) ("All that the plaintiffs have done is to apply the Sherman law label to the same facts which they charge constituted a Clayton Act transgression."); Am. Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230, 1250 (3d Cir. 1975) (stipulating that analysis under Clayton Act section 3 is more stringent than under the Sherman Act). For a recent account of the *possibility* of different standards under the different applicable sections, see Jacobson & Sher, *supra* note 37, at 779–81.

55. Blake & Jones, *supra* note 42, at 445–46 (emphasis added). Interestingly, the authors claim that this is what the court did in *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961), as well. But subsequent writings view *Tampa Electric* as the cornerstone of the full-blown rule of reason analysis, that calls for a balance of pro- and anti- competitive effects. Although a similar outcome may have been reached under the then-prevailing approach, as market

By the end of the second period, in 1961, it was well established that exclusivity arrangements foreclosing a substantial market share, taken to mean any nontrivial market share, were illegal regardless of whether they were challenged under the Sherman Act or the Clayton Act. Only exclusivity agreements foreclosing insignificant market shares were upheld. Once again, the axiom by which there is a positive correlation between the foreclosed market share and the competitive danger posed by exclusivity was not in any way challenged.

C. *The Third Period: 1961 to Present*

The *Tampa Electric* ruling, delivered in 1961,[56] marks the beginning of the third period.[57] In *Tampa Electric*, the

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shares in *Tampa Electric* were indeed not extremely significant, the case nonetheless marks the advent of a different approach.

56. *Tampa Elec. Co.*, 365 U.S. at 320.

57. Jacobson classifies *Tampa Electric* as part of the second period, and the FTC's decision in *Beltone* as the case marking the beginning of the third period. Jacobson, *supra* note 15, at 322–23 (citing *In re Beltone Elecs. Corp.*, 100 F.T.C. 68 (1982)), rejecting the traditional classification according to which *Tampa Electric* marks the beginning of the full-blown rule of reason analysis. *See, e.g.*, Richard M. Steuer, *Exclusive Dealing in Distribution*, 69 CORNELL L. REV. 101, 107–08 (1983); Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380 (7th Cir. 1984). I prefer the traditional classification to Jacobson's, because cases following *Tampa Electric*, although undoubtedly placing great weight on the substantiality of foreclosure, were generally careful to apply a more comprehensive analysis of the effects of exclusivity even before *Beltone*. *See, e.g.*, Bob Maxfield, Inc. v. Am. Motors Corp., 637 F.2d 1033, 1036 (5th Cir. 1981); *Am. Motor Inns, Inc.*, 521 F.2d at 1252; Magnus Petroleum Co. v. Skelly Oil Co., 599 F.2d 196 (7th Cir. 1979); *see also* cases cited *infra* note 65 (but note that *Barry Wright Corp.* was decided shortly after *Beltone*). And cases of insignificant foreclosure were routinely upheld. See references in Jacobson, *supra* note 15, at 323 n.77. In fact, at least the shift in the Commission's view actually preceded *Tampa Electric*. As early as 1955 it was observed that "the Commission has adopted a less restrictive approach to exclusive dealing arrangements and tie-ins. It vigorously rejects the contention that they are illegal per se, and requires the hearing examiner to hear evidence offered by the defendant that after the agreement was made, the number of competitors and the total volume of their business increased, and that defendant's share of the market decreased. The FTC is thus apparently committed to the theory that proof of dominance or substantial volume is not sufficient to void the agreement if it is shown that there is no deleterious effect

Court emphasized that:

> [t]o determine substantiality in a given case, it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area, and the probable immediate and future effects which preemption of that share of the market might have on effective competition therein. It follows that a mere showing that the contract itself involves a substantial number of dollars is ordinarily of little consequence.[58]

Tampa Electric is a paradigm-changing case. It shifted the analysis from a one-dimensional focus on market shares, to a comprehensive analysis incorporating an account of barriers to entry, competitors' expected responses, the duration of the agreement, and additional factors. However, despite this important shift, the Court in *Tampa Electric* did not stipulate that market share was of no importance. Quite the contrary: The foreclosed market share is explicitly mentioned as a key determinant of the competitive danger associated with exclusivity agreements,[59] and therefore as a factor which must be considered in all cases. And within this element, the Court subscribed to the widespread view that the greater the foreclosed market share,[60] the greater the competitive harm.

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on competition." *Tying and Exclusivity*, *supra* note 20, at 563. For such decisions, see *id.* at 563 n.23. *See also* Aaron Director & Edward H. Levi, *Law and the Future: Trade Regulation*, 51 NW. L. REV. 281, 290 (1956); United States v. Columbia Steel Co., 334 U.S. 495 (1948) (which—although technically analyzing a vertical merger and not an exclusivity arrangement—considered the foreclosing effect in a section 1 and section 2 analysis and was later relied on in *Tampa Electric* itself). Even according to Jacobson, *Tampa Electric*'s reasoning is the foundation of the shift in focus during the third period. *See* Jacobson, *supra* note 15, at 323–27.

58. 365 U.S. at 329 (emphasis added).

59. *See also id.* at 328 (where the foreclosed share of the market is mentioned as part of the three-stage test that must be conducted before competitive harm can be found).

60. In the Court's wording, the "proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area." *Id.* at 329.

Tampa Electric did not result in an immediate shift to a full-blown rule of reason analysis. Courts' focus on market share was not abandoned. *Tampa Electric*'s immediate effect was to alter lower courts' perception of *what* level of foreclosure constituted innocuous foreclosure. The percentage of foreclosure at which exclusivity agreements were condemned was steadily raised, and higher and higher levels of foreclosure were tolerated. When *Tampa Electric* was handed down, even foreclosure of 6% of the relevant market was considered enough for condemnation,[61] and in one extreme case foreclosure of 1.6% of the relevant market resulted in condemnation.[62] Gradually, a 30% to 40% market share became the threshold for condemnation,[63] and some later courts even applied a 45% to 50% threshold.[64]

Tampa Electric's less immediate effect was on the hegemony of market shares in the competitive analysis of exclusivity agreements. Gradually, the myopic focus on market share alone was abandoned. Courts eventually began considering additional factors as well.[65] In *Roland*

61. *See* Standard Oil Co. v. United States (*Standard Stations*), 337 U.S. 293 (1949) (although concern was also expressed with similar practices by other dominant firms).

62. The most extensively criticized of the rulings that condemned foreclosure of small market shares is *Brown Shoe Co. v. United States,* 370 U.S. 294 (1962). While the case was technically a case of a vertical merger, not an exclusivity agreement, the concern was of foreclosure, and the analysis was "consistent with prior precedent." Blake & Jones, *supra* note 42, at 454; *see generally id.* at 453–56. For an account of the different rulings in different contexts see Kahn, *supra* note 52, at 315–322.

63. HOVENKAMP, *supra* note 17, at 435–37; Omega Env't, Inc. v. Gilbarco, Inc., 127 F.3d 1157 (9th Cir. 1997). For an account of the development, see Jacobson, *supra* note 15, at 323–25, 327–28. For a brief account of the state of the law in the early 1990s, when the threshold was between 25% and 40%, see HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 398–99 (1st ed. 1994).

64. *See* United States v. Microsoft Corp., 87 F. Supp. 2d 30 (D.D.C. 2000), *cert. denied*, 122 S. Ct. 350 (2001); *see also infra* note 148.

65. *See, e.g.*, Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983); Jefferson Par. Hosp. Dist. v. Hyde, 466 U.S. 2 (1984); Sulmeyer v. Coca-Cola Co., 515 F.2d 835 (1975) (considering, *inter alia*, the question of de facto

Machinery,[66] the Seventh Circuit upheld an exclusivity arrangement[67] because the plaintiff had not offered proof of a probable anti-competitive effect.[68] In *Ryko*,[69] the Eighth Circuit took note of the level of distribution that was foreclosed and the duration and scope of the agreements, and refused to condemn the arrangement.[70] In *New York News*,[71] a district judge upheld exclusivity agreements which undoubtedly covered a significant market share (although the precise share was not pinpointed, mainly due to plaintiffs' failure to adequately define the market),[72] because, *inter alia*, there had been "no showing that interbrand competition ha[d] been significantly limited or that entrance into the newspaper publishing market ha[d] been foreclosed."[73] In *Paddock Publications,* Judge Easterbrook of the Seventh Circuit emphasized that competition *for* exclusives was in itself a form of competition

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exclusivity and finding the jury's conclusion of no exclusionary effect sustainable); Joyce Beverages v Royal Crown Cola Co., 555 F. Supp. 271 (S.D.N.Y. 1983). For a survey of recent cases and courts' focus on actual effects, see Jacobson & Sher, *supra* note 37, at 793–98. In some cases, indicia other than market share were considered as a substitute for market share, especially when market share had not been proven. But in several cases, additional factors were considered alongside market share.

66. Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380 (7th Cir. 1984).

67. I use the term "arrangement" and not "agreement" intentionally, because the court grappled with the question of whether an actual agreement existed. But the court's conclusion is not based on the distinction. *Id.* at 393 ("Actually, it is not important whether Dresser's antipathy to nonexclusive dealing was secret.").

68. A demonstration of such a probability requires proof of two issues: One is that at least one significant competitor is likely to be kept out of the market due to the exclusives. The other is that the result of this exclusion is likely to be a raise in prices above the competitive level. *Id.* at 394.

69. Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215 (8th Cir. 1987).

70. *See id.* at 1234–35.

71. *See* Bowen v. N.Y. News, Inc., 366 F. Supp. 651 (S.D.N.Y. 1973).

72. *See id.* at 678.

73. *Id.* at 679. This was only one reason for rejecting the argument. The main argument for rejecting the plaintiffs' contention was that they lacked standing to sue. *See id.* at 677–78. As previously noted, the court also pointed out that the plaintiffs had failed to adequately define the market. *See id.* at 678.

to be protected by antitrust laws,[74] even though the end result—a large market share unavailable to competitors due to a series of exclusivity agreements—may seem like a foreclosed market.

In *Omega*,[75] a case in the Ninth Circuit, a dominant producer, Gilbarco, refused to deal with Omega, a distributor who would not deal exclusively with Gilbarco. Gilbarco was the market leader, with a 55% market share, and its policy of refusing to deal with distributors who were not exclusive to its brand foreclosed 38% of the market. The circuit court emphasized the availability of alternative distribution channels, the short duration of the exclusivity contract, and the ease with which the exclusivity contract could be terminated. It consequently refused to strike down the agreement.

At least since *Omega*:

> [C]ourts, for the most part, have demanded rigorous proof of the relevant market in which market power is assessed; have required plaintiffs to distinguish exclusive dealing contracts won through aggressive competition from those that are profitable only because of their negative effect on rivals; and have given extended consideration to proffered efficiency justifications. The focus on true market power in these cases is not attributable to a concern that market power in the abstract, unrelated to the challenged conduct, is harmful (although that is often true). The concern is instead that creating or increasing market power through exclusive dealing is the means by which the defendant is likely to increase prices, restrict output, reduce quality, slow innovation, or otherwise harm consumers.[76]

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74. *See* Paddock Publ'ns, Inc. v. Chi. Trib. Co., 103 F.3d 42, 45 (7th Cir. 1996). However, competition for exclusives may also be anti-competitive, as demonstrated by the Canadian *Nielsen* case. *See* Dir. of Investigation & Rsch. v. D&B Cos. of Can. Ltd. (*Nielsen*) [1995] C.C.T.D. No. 20, 64 C.P.R. (3d) 216 (Can. Ont. C.C.T.D.); *see also* Michal S. Gal, *The Nielsen Case: Was Competition Restored? On the Anti-Competitive Effects of a Partial Enforcement of Competition Laws*, 29 CAN. BUS. L.J. 17, 18 (1998).

75. *See* Omega Env't, Inc. v. Gilbarco, Inc., 127 F.3d 1157 (9th Cir. 1997).

76. Jacobson, *supra* note 15, at 328. Jacobson considers *Omega* to be the inception of a fourth period, in which courts are firmly committed to a full-blown rule of reason analysis. *Id.* I do not challenge Jacobson's point, but as the

The most famous exclusivity case in recent years is the *Microsoft* case,[77] in which the Second Circuit engaged in an elaborate analysis of the effect that a series of arrangements between Microsoft and independent entities had on Netscape's ability to compete effectively in the Internet Browser market. Emphasis was placed not only on the share of the foreclosed distribution outlets, but also on the relative efficacy of these outlets. The circuit court was willing to condemn exclusivity arrangements even when the 40% to 50% foreclosure threshold usually required was not met.[78] Other cases also demonstrate an emphasis on the real effect of the arrangements on market structure and performance.[79]

But despite the shift to a full-blown rule of reason analysis, market share remains the key element of the analysis. As the district court in *Visa* pointed out, "[E]ven after *Tampa Elec.*, the degree to which an agreement forecloses the market remains arguably the most important

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preceding survey shows, the courts' commitment to a rule of reason analysis can be found in quite a few rulings that preceded *Omega* (although the rule of reason was less developed in the early days of this period). As Judge Posner wrote in 1984 in *Roland Machinery*: "Although the Supreme Court has not decided an exclusive-dealing case in many years, it now appears most unlikely that such agreements, whether challenged under section 3 of the Clayton Act or section 1 of the Sherman Act, will be judged by the simple and strict test of *Standard Stations*. They will be judged under the Rule of Reason, and thus condemned only if found to restrain trade unreasonably." Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380, 393 (7th Cir. 1984). *Omega* is thus, for current purposes, one point in the long period beginning in *Tampa Electric*, which resulted in a gradual shift from a technical focus on the substantiality of foreclosure to a full-blown rule of reason.

77. *See* United States v. Microsoft Corp., 87 F. Supp. 2d 30 (2d Cir. 2000).

78. *See id.* at 35, 46, 52–53.

79. *See, e.g.*, Avery Dennison Corp. v. Acco Brands, Inc., No. CV99–1877DT(MCX), 2000 WL 986995, at *26 (C.D. Cal. Feb. 22, 2000) (discussing barriers to entry, even though the defendant had a 75% market share, and concluding that there was a likelihood of consumer harm); Louisa Coca-Cola Bottling Co. v. Pepsi-Cola Metro. Bottling Co., 94 F. Supp. 2d 804, 815–16 (E.D. Ky. 1999) (concluding that the harm to the competitor was the result of hard competition, not of harm to competition itself); United States v. Visa U.S.A., Inc., 163 F. Supp. 2d 322 (S.D.N.Y. 2001), *aff'd*, 344 F.3d 229 (2d Cir. 2003).

factor in determining whether the agreement violates § 1."[80] Within the framework of the market share analysis, the idea that the competitive harm is always positively correlated to the foreclosed market share at all levels of foreclosure is still prevalent.

One immediate effect of this paradigm is that despite the courts' rhetoric, exclusivity arrangements foreclosing large market shares are practically never upheld.[81] However, the number of exclusivity agreements actually struck down by courts greatly understates the effect of this paradigm. The prevailing paradigm has a much greater effect than a simple review of the case law may suggest. An extremely important effect of the rule is its effect on those agreements that are *not* reached for fear of condemnation. This is an unobservable effect because by definition it can only be measured by the number of agreements that *are not struck* due to the applicable rule (or that are concealed for fear of condemnation). However, there is good reason to think that this effect is significant. First, it can generally be assumed that business entities, through their officers and legal advisors, are well aware of the prevailing view on exclusivity arrangements and of the state of the law.[82] Second, this is even more likely given that, in this respect, the application

80. Am. Express Travel Related Servs. Co. v. Visa U.S.A., No. 04 Civ.8967(BSJ), 2005 WL 1515399, at *3 (S.D.N.Y. June 23, 2005).

81. This does not change whether the analysis is conducted within the framework of the Clayton Act section 3, or the Sherman Act section 1 and section 2. Although the Clayton Act section 3 was originally intended to apply a stricter standard than the Sherman Act, analysis under the Acts eventually converged. *See* cases cited *supra* note 25 and accompanying text.

82. The idea that through legal advice economic actors conduct themselves with the correct legal outcome in mind is not novel in any way. In fact, even in settings in which we do not expect laypersons to be versed in any way, such as litigation, the assumption is normally that decisions are informed by the expected application of the legal rule. *See, e.g.*, Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982). In the specific context of antitrust law, see CrimA 7829/03 State of Israel v. Ariel Elec. Eng'g Traffic Lights & Control Ltd., 60(2) PD 120 (2005) (Isr.).

of the law has not changed for over a full century, at least since the enactment of the Clayton Act. A business entity considering signing exclusivity arrangements resulting in foreclosure of large market shares would be cautioned by any attorney it consulted that its exclusivity clauses would likely be unenforceable.

Thus, if the paradigm is erroneous—which, as subsequently explained, it is—its effect on competition is difficult to measure, but nonetheless crystal clear. An infinite number of arrangements foreclosing extreme market shares are simply not struck for fear of condemnation. Disallowing perfectly benign exclusivity arrangements is itself a social cost. It is socially undesirable to steer parties away from their preferred (harmless) business arrangement, and force them to settle for the second best alternative, or to conceal the contracts (and risk sanctions). This is certainly the case when it is clear that exclusivity arrangements can achieve a host of welfare-enhancing goals, as will be subsequently shown.

The problem is further exacerbated by the fact that the prohibition on exclusivity encompasses not just exclusivity that takes the form of an explicit contractual commitment not to deal with competitors. Section 3 of the Clayton Act, and sections 1 and 2 of the Sherman Act all apply to agreements that include some kind of financial inducement to exclusivity, even if dealing with competitors is not nominally prohibited.[83] Thus, for example, loyalty discounts and rebate systems that induce de facto exclusivity are also under the purview of the antitrust prohibitions.[84] Similarly, an agreement for the employment of technological measures that will make a competitor's product less accessible may

83. With respect to section 3 of the Clayton Act, this is explicit in the language of the Act itself. *See* Clayton Act, ch. 323, § 3, 38 Stat. 731 (1914) (current version at 15 U.S.C. § 14).

84. *See* Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961); Lockhart & Sacks, *supra* note 38, at 919–20.

also be prohibited by antitrust laws.[85] Each of these may be done for pro-competitive reasons. For example, the employment of technological measures may serve to protect sensitive systems from being compromised.[86] But business entities know that if a side effect of such a system—whether or not intended—is to foreclose a significant portion of the market to competitors, it will not be upheld. They thus have good reason to refrain from introducing such technologies. If firms are steered away from what is otherwise their preferred course of action, the condemnation of large foreclosure has additional grave effects which are not captured by a mere survey of the case law.

Against this backdrop, it is helpful to review the host of welfare-enhancing goals that exclusivity may achieve, so as to understand the scope of what antitrust law may be wrongfully preventing. Subsequently, the anti-competitiveness of exclusivity will be analyzed in detail, in order to understand why anti-competitive foreclosure of extremely large market shares is unlikely, and at times impossible even on a completely theoretical level.

II. THE WELFARE-ENHANCING AND WELFARE-REDUCING EFFECTS OF EXCLUSIVITY

Against the backdrop of the current state of the law that generally condemns exclusivity agreements whenever they foreclose a very large market share to competitors, it is helpful to review the welfare-enhancing and welfare-reducing effects of exclusivity. Subsequently, the prerequisites for anti-competitive exclusivity will be scrutinized in greater detail to show why the intuitive link between large foreclosure and harm to competition must be severed.

85. *See* United States v. Microsoft Corp., 87 F. Supp. 2d 30 (2d Cir. 2000).

86. *See* Ward S. Bowman, Jr., *Tying Agreements and the Leverage Problem*, 67 YALE L.J. 19 (1957) (in the specific context of tying arrangements).

A. *Welfare-Enhancing Effects*

Exclusivity agreements may achieve a host of welfare-enhancing goals.[87]

First, exclusivity reduces the parties' uncertainty. Specifically, parties can use these agreements to insulate themselves from fluctuations in price and quantity. This may be extremely important if there are sunk costs that are specific to the relationship. There are a host of circumstances in which a party to an agreement must make significant relationship-specific investments. Examples may be adapting a plant to produce a product that is compatible with the purchaser's needs, purchasing packing and labeling machinery that conforms to the purchaser's requirements, and so on. If the party required to make these relationship-specific investments is not guaranteed a certain amount of sales for a predetermined price, the investments may be abandoned. Exclusivity arrangements shielding the investing party from fluctuations in price may thus be essential to facilitate the investment in the first place.[88] The

87. *See generally* Race Tires Am., Inc. v. Hoosier Racing Tire Corp., 614 F.3d 57 (3d Cir. 2010).

88. *See, e.g.*, Stockhausen, *supra* note 3737, at 413–15; Blake & Jones, *supra* note 4242, at 440 (discussing full vertical integration, where this advantage is more pronounced); Schwartz, *supra* note 38, at 12 (focusing on a variation of this explanation: "a constant supply of goods at a definite price without the financial burden of a large inventory"); Mark Q Connelly, *Exclusive Dealing and Tied Selling under the Amended Combines Investigation Act*, 14 OSGOODE HALL L.J. 521, 528 (1976) (offering a very close variation of the argument: "[due to a] continuous supply even in times of shortage . . . dealers are relieved of the need to carry large inventories"). An element of this explanation that is sometimes overlooked is the ostensible inadequacy of exclusivity alone to achieve stability. In fact, exclusivity may seem counter-productive in this scenario. If the purchasers' total demand falls for some reason, the seller will not have sold the minimum number of units it needs to sell. On the other hand, if demand increases, the seller will need to increase production so as to meet the increased demand, perhaps to a point at which production is unprofitable. *See generally* DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 35–44 (4th ed. 2005). At times, the seller may even be unable to supply all of the buyers' demand. Ostensibly, therefore, exclusivity is a cumbersome way of reducing volatility. A long-term contract stipulating price and quantity for the

Tampa Electric case previously mentioned[89] demonstrates this neatly. In *Tampa Electric*, a public utility decided to try to use coal instead of oil as boiler fuel in two generating units of a new plant. Naturally, this required significant adaptations of the production process. As per the Court, Tampa Electric, the public utility, expended nearly USD $30 million (in 2020 terms) in excess of what it would have expended on oil-burning units.[90] Similarly, Tampa's contractual counterpart, Nashville Coal, expended approximately USD $70 million (in 2020 terms) in preparing to perform the contract. Any change in the price of coal would have had a dramatic impact on both parties' cost-benefit analysis, making profitability extremely volatile. The exclusivity arrangement, in which Tampa Electric committed to purchase all its coal-requirements for a period of twenty years, assured both parties that their investment would not be in vein. The exclusivity commitment was apparently essential to facilitate deal-specific investments

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duration of the contract is both straightforward and more effective in reducing volatility. *See also* PHILIP AREEDA ET AL., ANTITRUST ANALYSIS: PROBLEMS, TEXT, AND CASES 654–55 (6th ed. 2004) (discussing that the problem of fluctuations in buyers' demand is implicitly dealt with, when the authors describe the setting as one in which users have "fairly stable requirements"; the problem explicitly addressed by the authors is closely related to the one described here); Victor P. Goldberg & John R. Erickson, *Quantity and Price Adjustment in Long-term Contracts: A Case Study of Petroleum Coke*, 30 J.L. & ECON. 369 (1987); Stockhausen, *supra* note 37, at 412 ("[T]he amount remains indefinite and in fact may be zero."). However, in real-life settings, exclusivity may be a workable proxy for specified quantities, although the seller may prefer a firm commitment to specified prices and quantities, and although such agreements are sometimes struck. *See, e.g.*, Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983); Magnus Petroleum Co. v. Skelly Oil Co., 599 F.2d 196 (7th Cir. 1979). Buyers may be reluctant to make such a commitment because they themselves do not know, at the time the contract is struck, the precise quantities they will need. Thus, they may be more inclined to commit to purchasing all of their demand from the seller than to commit to purchasing a fixed number of units, especially when the contract is of greater length. On the seller's side, although this guarantee may be less appealing than a firm commitment, it is nonetheless of value, specifically if buyers' demand is relatively stable. *See* AREEDA ET AL., *supra* note 88, at 654; Stockhausen, *supra* note 37, at 414.

89. *See* Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961).

90. *See id.* at 323.

totaling nearly USD $100,000,000 (in 2020 terms).[91]

A second, closely-related, advantage of exclusivity is that it prevents the "hold up" problem.[92] Even ignoring volatility, and even assuming that investments are initially justified even absent exclusivity, once a party has made deal-specific commitments, its contractual counterpart may try to take advantage of these deal-specific investments to extract a better deal than negotiated. Knowing this ex ante, the party that is supposed to make the investment will refrain from making it. Exclusivity is an "efficient contractual guarantee against the hold-up problem,"[93] without which "the product might not be developed at all, and, at the very least, investment in product-specific assets . . . would be reduced."[94]

Exclusivity also eliminates free riding, which may occur when a manufacturer's competitors can enjoy the benefits of the manufacturer's investments,[95] be they investments in the brand and the like, or the funding of retail-level services.[96] If a manufacturer invests in increasing demand for its own brand, for example through advertising, consumers will be attracted to retailers who carry the brand by virtue of the manufacturer's investment. If these retailers

91. *See also* MICHAEL J. TREBILCOCK ET AL., THE LAW AND ECONOMICS OF CANADIAN COMPETITION POLICY 540 (2002).

92. *See* RICHARD WHISH & DAVID BAILEY, COMPETITION LAW 665–66 (8th ed. 2015).

93. TREBILCOCK ET AL., *supra* note 91, at 628.

94. *Id.*

95. *Id.* at 461; WHISH & BAILEY, *supra* note 92, at 665 ("A free-rider problem can arise where a supplier invests in promotion at a retailer's premises which a competing supplier takes advantage of: a non-compete provision may be justified to prevent this type of free-riding.").

96. For examples of different ways in which the manufacturer may incur the costs of these services, see Martin B. Glauser Dodge Co. v Chrysler Corp., 570 F.2d 72, 76–77 (3d Cir. 1977), *cert. denied*, 436 US 913 (1978); Coleman Motor Co. v. Chrysler Corp., 525 F.2d 1338, 1341–42 (3d Cir. 1975); Mount Lebanon Motors v. Chrysler Corp., 283 F. Supp. 453, 457 (W.D. Pa. 1968); *see also* Russell Stover Candies, Inc., 100 F.T.C. 1, 52 (1982) (Comm'r Miller, dissenting).

also carry competing brands that are sold for a lower price (as they do not need to cover the costs of advertisement), consumers may ultimately purchase these competing brands rather than the brand that they were originally searching for. A retailer may intentionally use the advertised brand to lure consumers and offer them a competing brand for a lower price.[97] This may also simply be a result of the availability of the less-expensive brand. Regardless of the retailer's motivation, this essentially allows competing manufacturers to free ride on the manufacturer's investment. Similarly, a manufacturer may be willing to fund retail-level services, for example by offering training for sale personnel.[98] But if competing manufacturers free ride on these services, manufacturers will be unwilling to fund or provide them.[99] Free riding on services is a real issue. According to a recent inquiry conducted by the European Commission, nearly half of all manufacturers and retailers believe free-riding to be

97. Note that this is different from 'bait and switch selling' prohibited under Section 74.04 of the Canadian Competition Act, R.S.C. 1985, c C-34.

98. A closely related question is why retailers—who accrue the additional profits from the sale of *all* brands—will not spontaneously provide the services, obviating the need for remuneration in the first place. But retailers' profit-margin, or their return on the investment, may be different from the manufacturer's, thus making the investment unprofitable from their perspective. Additionally, retailers face an analogous free-riding problem, known as the *intra-brand* free riding problem. The intra-brand free rider problem may be overcome with the reverse exclusivity provision, namely exclusive supply, whereby the manufacturer commits to selling exclusively to a single (service providing) retailer. Intra-brand free riding can also be overcome by assigning exclusive territories to retailers or—according to traditional antitrust analysis—by imposing a price minimum on retailers. *See* Ward S. Bowman, Jr., *The Prerequisites and Effects of Resale Price Maintenance*, 22 U. CHI. L. REV. 825 (1955); Ward S. Bowman, Jr., *Resale Price Maintenance—A Monopoly Problem*, 25 J. BUS. U. CHI. 141, 151 (1952); Lester G. Telser, *Why Should Manufacturers Want Fair Trade*, 3 J.L. & ECON. 86 (1960); Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007). On the incentive alignment when profit margins are different, see Benjamin Klein & Joshua D. Wright, *The Economics of Slotting Contracts*, 50 J.L. & ECON 421 (2007).

99. *Commission Staff Working Document Accompanying the Report from the Commission to the Council and the European Parliament, Final report on the E-commerce Sector Inquiry*, para. 46 n.51, COM (2017) 229 final (May 10, 2017).

common or very common.[100] Manufacturers can eliminate this problem by demanding that retailers who receive these services remain exclusive to them.[101] Exclusivity can thus facilitate investment in product distribution.[102]

A fourth welfare-enhancing function exclusivity may accomplish is the inducement of retail-level selling efforts.[103] Exclusivity agreements link the fates of retailers to that of manufacturers. If a retailer carries several brands, it is relatively indifferent to the success of any specific brand. By contrast, if a retailer's success is contingent on the success of the specific brand, as it is when the retailer carries that brand exclusively, the retailer is motivated to promote the

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100. *Id.* paras. 312–323.

101. *Id.* para. 48. For real-life examples, see Case T–88/92, Groupement d'Achat Édouard Leclerc v. Comm'n, 1996 E.C.R. II-196, ¶¶ 94–96, and Case T–87/92, BVBA Kruidvat v. Comm'n, 1996 ECR II-1931, ¶ 45 (both cases raise this argument with regards to selective distribution contracts of cosmetics); Pictorial Rev. Co. v. Curtis Publ'g Co., 255 F. 206, 206–08 (S.D.N.Y. 1917) (describing the defendant's investment in the distribution system); Perma Life Mufflers, Inc. v. Int'l Parts Corp., 376 F.2d 692, 696 (7th Cir. 1967) (enumerating the benefits the plaintiff got from carrying the brand); *see also* Steuer, *supra* note 57, at 114–16.

102. Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982); Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215 (8th Cir. 1987); Dennis Waelbroeck, *Vertical Agreements: 4 Years of Liberalisation by Regulation n. 2790/99 After 40 Years of Legal (Block) Regulation*, *in* THE EVOLUTION OF EUROPEAN COMPETITION LAW 85, 100–01 (Hanns Ullrich ed., 2006); Stanley I. Ornstein, *Exclusive Dealing and Antitrust*, 34 ANTITRUST BULL. 65, 69–70, 74–76 (1989); *Notice of the EFTA Surveillance Authority on the "Guidelines on Vertical Restraints,"* 2012 O.J. (C 362) 1, paras. 106–08 [hereinafter *EFTA*].

103. *See* A. Douglas Melamed, *Thoughts About Exclusive Dealing*, *in* EUROPEAN COMPETITION LAW ANNUAL: 2007, at 433, 434 (Claus-Dieter Ehlermann & Mel Marquis eds., 2008); Benjamin Klein, *Exclusive Dealing as Competition For Distribution "On The Merits"*, 12 GEO. MASON L. REV. 119, 137–60 (2003); Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L.J. 433 (2008); Lockhart & Sacks, *supra* note 38, at 921–22; Keyes, *supra* note 54, at 441. A prominent real-life example of this use of exclusivity can be found in *Joyce Beverages v. Royal Crown Cola*. 555 F. Supp. 271, 273–74 (S.D.N.Y. 1983);*see also* BORK, *supra* note 11, at 306–307; AREEDA ET AL., *supra* note 88, at 655 (pointing to some concern with the possible divergence between the manufacturer's interest and the social interest, but pointing to two cases in which the pro-competitive benefits of exclusivity seem the strongest).

brand and ensure its success.[104] Theoretically, these services may be contracted for, but perfect contracts are extremely difficult to write, and enforcement is always costly, specifically when the contract seeks to ensure unquantifiable elements, such as zeal, politeness, etc. Exclusivity ties the retailer's fate to that of the manufacturer's, thereby guaranteeing that the retailer will be incentivized to perform retail-level services to the best of its ability. Exclusivity may thus function as an enforcement mechanism that aligns the parties' respective interests in a manner that is less costly than a contract that does the same, even if a contract is a feasible option.[105]

A fifth advantage of exclusivity arrangements is that they may help manufacturers verify that products have originated with them. This may be especially important when manufacturers assume post-sale duties vis-à-vis end consumers, such as warranties, maintenance, or service. Of course, other mechanisms such as barcodes and the like may be useful in verifying the origin of the product, but exclusivity may function as one such mechanism. Any product purchased from the specific retailer is guaranteed to have originated from the manufacturer. Closely related, exclusivity may also serve to ensure *consumers* of the origin of the product. If the manufacturer's brand commands a premium over other brands, consumers may require assurances that they are receiving the manufacturer's brand in return for their additional expenditure. Exclusivity may be a way to ensure consumers that the product they are purchasing originates from the manufacturer.[106]

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104. This commitment is of value even if the manufacturer is not concerned with inter-brand free riding. *See Joyce Beverages*, 555 F. Supp. at 273–76; Sulmeyer v. Coca-Cola Co., 515 F.2d 835, 841, 847 (5th Cir. 1975); Steuer, *supra* note 57, at 124–26; Marvel, *supra* note 102, at 2, 4–5 (arguing that this is not a viable explanation for exclusivity).

105. For a similar analysis of resale price maintenance, see Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON 265 (1988).

106. Steuer, *supra* note 57, at 131–32; Ornstein, *supra* note 102, at 75–76;

Finally, exclusivity can reduce parties' transaction costs. While on-the-spot sales require ongoing negotiations, parties to exclusivity agreements need not renegotiate continuously.[107] Even if market prices remain unchanged for the contract's duration, eliminating volatility and reducing the number of transactions—and, by extension, transaction costs—will reduce the parties' total expenditures.[108]

Connelly, *supra* note 88, at 527. For a variation of this claim, focusing on the quality of the product, see *EFTA*, *supra* note 102, at para. 107(c); *see also* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 55 n.23 (1977); Steuer, *supra* note 57, at 131–32. Note, however, that Steuer cites *Susser v. Carvel Corp.*, *id.* at 132 (citing Susser v. Carvel Corp., 323 F.2d 505, 516 (2d Cir. 1964)), and thus seems to focus more on the way the dealer handles the product (the quality and functioning of which the manufacturer has guaranteed) than on the identification of its origin. There are, of course, additional ways in which the manufacturer can verify the origin of a product, the most obvious of which is by applying a trademark or logo to the product. However, trademark law is aimed at preventing *consumers'*, not producers', confusion as to origin. *See* ROBERT M. MERGES, PETER S. MENELL & MARK A. LEMLEY, INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE 529–34, 621–25 (6th ed. 2012); *see also* AMF, Inc. v. Sleekcraft Boats, 599 F.2d 341 (9th Cir. 1979). Origin-verifiability for the producer is merely a beneficial byproduct of the prevention of consumer confusion, which (along with the more recently recognized goal of dilution-prevention) is the aim of trademark law. Therefore, trademark law may not adequately address the manufacturer's concern (for example, if consumers are entirely indifferent as to the origin of the product or if the brand had become generic). *See* Murphy Door Bed Co. v. Interior Sleep Sys., Inc., 874 F.2d 95 (2d Cir. 1989).

107. BORK, *supra* note 11, at 309; Stockhausen, *supra* note 37, at 414; Ornstein, *supra* note 102, at 77. Areeda, Kaplow, and Edlin question the need for exclusivity to achieve this goal. They point to the fact that a simple pattern of regular repeated purchases from the seller would tend to produce the same savings. AREEDA ET AL., *supra* note 88, at 655. But exclusivity does more than to simply produce these savings. It assures parties, ex ante, that renegotiation will not be required. Repeated transactions may have this ex post effect, but they do not offer parties ex ante confidence that this will be the case.

108. At the same time, when a contract is struck for a longer period of time, the number of contingencies that must be resolved is greater, as is the level of uncertainty. *See* Patrick Bolton & Michael D. Whinston, *Incomplete Contracts, Vertical Integration, and Supply Assurance*, 60 REV. ECON. STUD. 121 (1993) (describing concerns that arise from supply assurances). Similarly, future disagreements on addressing contingencies that arise, which the parties did not fully consider or specify at the time of signing, can be expected to be higher in long-term contracts. The cost-savings associated with long-term contracts are thus more accurately defined as the difference between the savings attributed to the smaller number of negotiations and the added cost of dealing (both ex ante

Importantly for current purposes, each one of exclusivity's numerous advantages may be relevant both when exclusivity is widespread, thereby foreclosing large market shares, and when it is not. Exclusivity arrangements covering 100% of the market are not less likely to achieve any of the welfare-enhancing goals than exclusivity arrangements covering 80% of the market. For example, if retailers are expected to perform services that cannot be contracted for, and exclusivity achieves this by tying their fate to the manufacturer's fate, a manufacturer can be expected to attempt to sign such agreements with all retailers. If the objection to widespread exclusivity is to be justified, the justification can come only from a linkage between foreclosure of large market shares and exclusivity's anti-competitive potential. The balancing act of weighing pro- and anti- competitive effects may yield different results only due to the increased anti-competitive potential of widespread exclusivity. It cannot hinge on a difference in the pro-competitive effects. It is, therefore, necessary to carefully scrutinize exclusivity's potential for anti-competitive effects.

B. *Anti-Competitive Effects*

Notwithstanding its welfare-enhancing functions, exclusivity may also be used anti-competitively. This use is probably the most intuitive use of exclusivity. Exclusivity contracts may exclude a competitor or competitors, thus enhancing or entrenching a firm's market power.[109] For ease

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and ex post) with additional and less certain contingencies.

109. A variation of this explanation is offered in David Gilo, *Retail Competition Percolating Through to Suppliers and the Use of Vertical Integration, Tying, and Vertical Restraints to Stop it*, 20 YALE J. ON REG. 25 (2003). According to the hypothesis developed there, exclusivity may be one means through which an upstream firm with market power overcomes what is referred to as the "commitment paradox." Essentially, through exclusivity the firm is able to assure its downstream buyer that it will not offer a hidden concession to the buyer's competitor. *See id.* at 54–57. However, in contrast to traditional analysis, the motivation for the exclusivity arrangement is not to enhance the downstream buyer's market power, but rather to allow the upstream firm—the firm *granting*

of exposition, we may again think of exclusive purchasing arrangements, whereby retailers commit to purchase exclusively from a manufacturer. By signing exclusivity agreements with retailers, the upstream firm denies its competitors access to distribution outlets. These competitors must consequently either distribute their product through existing outlets that have not committed to exclusive purchasing, or induce independent entry into distribution. If the foreclosed outlets are the more efficient outlets—the ones at the more desirable locations, and so on—the firm granted exclusivity gains an inherent advantage over its competitors. The cost disadvantage of these competitors allows the upstream firm that signed the exclusivity agreements to profitably elevate prices.[110]

Although ostensibly straightforward, the anti-competitive potential of exclusivity is, in fact, more complex than it seems. Early writings of members of the Chicago School argued that exclusivity is unlikely to *ever* be used to forestall competition. The driving force behind this argument is that anti-competitive exclusivity is detrimental to the interests of the party granting exclusivity. First, consider the

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exclusivity—to exploit its market power and charge supra-competitive *wholesale* prices. I do not discuss this function separately because despite the different motivation, the end result is similar for purposes of the present analysis. As mentioned previously, there are also other anti-competitive explanations, but these are more debatable and are contingent on relatively limiting market characteristics. *See supra* note 11 and accompanying text.

110. The analysis of a cost disadvantage as a prerequisite to, and in fact the essence of, anti-competitive exclusivity arrangements follows Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986), which has since become the mainstream view of the competitive concern raised by exclusivity arrangements. *See, e.g.*, A. Douglas Melamed, *Exclusive Dealing Agreements and Other Exclusionary Conduct: Are There Unifying Principles?*, 73 ANTITRUST L.J. 375 (2006). For a view according to which the focus should be shifted, see Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 ANTITRUST L.J. 311 (2006). For earlier analyses of the anti-competitive potential, focusing on the exclusion of competitors, see Director & Levi, *supra* note 57, at 290; Lockhart & Sacks, *supra* note 38, at 923–31. *See generally* RICHARD A. POSNER, ANTITRUST LAW 251 (2d ed. 2001).

setting of a seller who sells to an end consumer. Posner[111] and Bork[112] make the point that in this setting an agreement to exclude competition is highly unlikely. Buyers are adversely affected by the preservation (or establishment) of a monopoly. Once the monopoly has been established, these buyers will be charged higher prices than they would have been charged had competition prevailed. Knowing this, they will be reluctant to participate in a scheme to preserve or establish a monopoly at the seller's level unless they are compensated in full for their prospective losses. At the very least, they will demand to receive *the full value of the monopoly overcharge* (which they will ultimately pay) before they sign exclusivity agreements with the to-be monopolist. This, in turn, implies that the seller's prospective gains from the preservation of the monopoly will all be dissipated in the form of payments to customers, making the scheme unprofitable for the seller. Anti-competitive exclusivity—exclusivity enhancing or entrenching one party's market power—*cannot* be mutually beneficial from the contracting parties' perspective. There is thus a natural check on this use of exclusivity as an anti-competitive device.

This does not, of course, imply that exclusivity is never mutually beneficial. It will be beneficial if it achieves one or more of the welfare-enhancing goals previously discussed. In such settings it has the potential to increase overall—and consequently both parties'—welfare. But anti-competitive exclusivity of the kind discussed by Chicago School theorists cannot achieve this. Anti-competitive exclusivity enhancing one party's market power is a zero-sum game, in which any gain to one of the parties comes at the expense of its contractual counterpart.

Posner concluded that, although it is not impossible that out of ignorance or irrationality a firm will engage in exclusionary practices, "it is unlikely that a rational profit

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111. POSNER, *supra* note 11, at 203–05.

112. BORK, *supra* note 11.

maximizing firm will use exclusive dealing as a method of excluding a competitor."[113] And Bork argued that "[t]he truth appears to be that there has never been a case in which exclusive dealing or requirements contracts were shown to injure competition . . . . [T]here is every reason to believe that exclusive dealing and requirements contracts have no purpose or effect other than the creation of efficiency."[114]

The analysis does not change if the setting is one of a manufacturer and retailers instead of a seller and end consumers. Here too, there is no scope for acquiring additional market power through exclusivity arrangements in a manner that benefits both parties. It may seem that, because retailers can join forces with a manufacturer to elevate prices to end consumers, there is scope for anti-competitive exclusivity. This, however, is not the case. Exclusivity does not, in and of itself, change demand for the product in any way. Therefore, to the extent that it does not achieve one or more of the pro-competitive goals surveyed earlier, it does not allow prices to be elevated profitably beyond their but-for-exclusivity levels. These may be high or low, depending on the (pre-existing) market power of the manufacturer and the retailers. But exclusivity in and of itself will do nothing to change the optimal price that consumers can be charged for the product. Any increase in prices following an (anti-competitive) exclusivity arrangement of the kind discussed by Chicago School scholars will inevitably decrease the total (joint) profits of retailers and the manufacturer, because the effect of lost sales (end consumers who discontinue purchases due to higher prices) will necessarily outweigh any gains from higher prices. Otherwise, retail prices would have already been set higher before the introduction of exclusivity. Consequently, post- and pre- exclusivity prices cannot be

113. POSNER, *supra* note 11, at 205.

114. BORK, *supra* note 11, at 309.

different.[115]

Therefore, if exclusivity confers upon the manufacturer market power that the manufacturer would not have otherwise possessed, resulting in elevated prices and reduced quantities, this will come at the expense of retailers, whose total profits will have declined. Much like the relationship between a seller and buyers who are end consumers, the relationship between a manufacturer and retailers is a zero-sum game in terms of profit. There is a single price at which (joint) profits from sales are maximized. The price-quantity trade-off is maximized at a specific point on the demand curve. This does not change simply because the parties have agreed to exclusivity. Any additional dollar accruing to the manufacturer is a dollar out of retailers' pockets, and vice versa.[116] Consequently, the analysis of the manufacturer-retailer setting is similar to that of the seller-end consumer setting.[117] A mutually beneficial anti-

115. For an early analysis of the phenomenon suggesting that this may be the case, see Kahn, *supra* note 5252, at 317; Stockhausen, *supra* note 3737, at 428–29. *See also* cases cited *supra* note 25.

116. This analysis is attributable to the well-known double marginalization problem, originally identified developed in the late 1950s and essentially unchallenged since. If retailers possess market power, whether due to an oligopolistic market structure or due to a cartel-like agreement, they have nothing to gain from allowing a monopoly at the manufacturer's level, for reasons similar to those discussed with respect to the manufacturer's incentives. *See* Joseph J. Spengler, *Vertical Integration and Antitrust Policy*, 58 J. POL. ECON. 347, 352 (1950). If transaction costs are not prohibitive, the two successive monopolies can be expected to negotiate a division of the monopoly rents between them, and continue to charge the optimal monopoly price. *See* ROGER D. BLAIR & JEFFREY L. HARRISON, MONOPSONY: ANTITRUST LAW AND ECONOMICS 109–25 (1993). If negotiations over the share of the rents granted to each of the economic agents are prohibitively costly, or otherwise fail, the problem may result in no production at all as in the "tragedy of the anti-commons." *See* Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998) (describing the tragedy of the anti-commons). The tragedy of the anti-commons is in fact an extreme case of the double marginalization problem.

117. Although not identical in all respects. A formal model illustrating the difference is developed in Ittai Paldor, *RPM as an Exclusionary Practice*, 55 ANTITRUST BULL. 309 (2010).

competitive arrangement of the kind discussed by Posner and Bork is impossible.

Another important note is that this analysis is insensitive to the degree of pre-contractual market power each party possesses. It does not change if the manufacturer being granted exclusivity has some market power, significant market power, or even if it is a perfect monopoly. Similarly, it does not change if retailers' market power is significant or insignificant.[118] Ultimately, there is a single optimal price and a single corresponding quantity, both unaffected by (anti-competitive) exclusivity. An economic agent allowing a seller or a buyer to artificially enhance its market power, is in essence transferring some of its share of the supra-competitive rents to its contractual counterpart.[119] Whether it continues to make the same per-unit profit but loses sales due to elevated prices, or continues to make the same number of sales for a smaller per-unit profit, it has lost from the enhancement of a seller's or buyer's market power.[120]

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118. In reality, all economic agents possess *some* market power. No economic agent faces a perfectly elastic demand curve. This is known as "monopolostic competition," a concept originally developed by Chamberlin. *See* EDWARD HASTINGS CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION (8th ed. 1962).

119. For a clear articulation of the importance of this phenomenon in the context of rebates, which for current purposes is similar to the context of exclusivity, see Timothy J. Brennan, *Bundled Rebates as Exclusion Rather than Predation*, 4 J. COMPETITION L. & ECON. 335, 367–68 (2008).

120. Although similar, this argument is different from the argument that a manufacturer cannot profit from monopolizing an additional link in the chain of production. Over the years, several challenges to the so-called "single monopoly profit theory" have been launched. *See* Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397 (2009) (summarizing the challenges to the single profit monopoly theory). These arguments are irrelevant to the current setting. The challenges to the single monopoly profit theory attempt to demonstrate that when *two* markets are involved, a seller may, under certain circumstances, use its power in one market to increase its market power in another market. But this does not challenge the idea that when the link of production for the *same* product is being considered, the vertical relationship between an upstream firm and a downstream firm is a zero-sum game.

Later writings on exclusivity qualified this extreme version of the argument. It has been shown that customers may be induced to participate in a monopoly-creating scheme.[121] But importantly, the key point made by Bork and Posner—that in the regular setting anti-competitive exclusivity harms the entities granting exclusivity—remains uncontested.[122] Specifically, it has been shown that a collective action problem amongst economic agencies at the level in the chain of production granting exclusivity (retailers, in the previous example) may result in anti-competitive exclusivity arrangements being struck. If a seller need not foreclose *all* existing retail outlets in order to preempt entry, a buyers' collective action problem emerges. Although it is in their best interest to withhold their consent to a foreclosure scheme that will result in higher prices charged to them, buyers may ultimately participate in it for a price that fails to compensate them for their future losses.[123] Each buyer faces the dilemma of either committing to exclusivity for a payment or risking ultimately facing a monopolistic seller without having received any compensation at all. Consider, for example, an industry in which recovering the fixed costs of production requires serving at least a quarter of the market.[124] A seller can thus drive out all potential competitors by signing exclusivity contracts with only 75.1% of the buyers. Acting as a group, buyers will undoubtedly turn down the offer, and allow competition between four sellers to drive prices down. But buyers do not decide or act as a group. Each individual buyer realizes that if three-quarters of the buyers grant the seller exclusivity, a monopoly will have been established. Knowing

121. *See* Kaplow & Shapiro, *supra* note 11, at 1204–05.

122. *See supra* note 11 and accompanying text.

123. For a less formal exposition of this result, see Louis Kaplow, *Extension of Monopoly Power Through Leverage*, 85 COLUM. L. REV. 515, 532 (1985).

124. On the concept of fixed costs, see CARLTON & PERLOFF, *supra* note 88, at 29–33. On the concept of "minimum efficient scale" [of production], see *id.* at 41–42.

this, each individual buyer will prefer to sign an exclusivity contract in return for a payment, rather than ultimately pay the monopoly price for no compensation at all. Thus, not only can the seller acquire a monopoly by compensating only slightly more than three-quarters of the buyers for their future losses, it can in fact offer even those buyers less than full compensation. A race to the bottom among buyers will result in enough buyers agreeing to exclusivity, even if they are not fully compensated for their future loss, for fear of facing the same result with no remuneration at all.[125]

The upshot of the qualification to the Chicago School analysis is that in the intuitive case of exclusivity that simply forecloses the market to competitors, exclusivity arrangements carry anti-competitive potential if, and, importantly, *only if*, there is a collective action problem among buyers. Contrary to intuition, anti-competitive exclusivity *does not benefit both parties to these kinds of exclusivity arrangements*. While the seller, or the party being granted (anti-competitive) exclusivity is better off as a result of the exclusives, the parties granting exclusivity are made worse off as a result. It is the collective action problem among buyers that allows this result.[126] As a practical matter, this

125. I use the term "race to the bottom" rather than "competition" to describe buyers' conduct. The reason is that the end result is worse (from the buyers' perspective) than under competition. Under competition, buyers—at least those who ultimately sign exclusivity agreements—will receive their marginal cost, namely their difference between the post- and pre- exclusivity prices multiplied by their respective expected quantity (and capitalized, if the payment takes the form of a lump sum). In the setting described here, buyers may receive a sum *lower* than their marginal cost. *See supra* note 11.

126. This analysis ignores competition among potential sellers to become the monopoly, or "competition for the market." Such competition may counter the collective action problem at the buyers' level, and result in sellers offering larger payments for exclusivity. *See, e.g.*, Paddock Publ'ns, Inc. v. Chi. Trib. Co., 103 F.3d 42 (7th Cir. 1996). *But see* Dir. of Investigation & Rsch. v. D&B Cos. of Can. Ltd. (*Nielsen*) [1995] C.C.T.D. No. 20, 64 C.P.R. (3d) 216 (Can. Ont. C.C.T.D.). At the extreme, sellers may share all of their prospective rents with downstream buyers. But even under such circumstances, only some of the buyers will be compensated for their prospective losses. More importantly, in real-life settings the tension between sellers' competition and buyers' collective action problem

qualification may not seem important, since most industries involve more than a single buyer and a single seller. So, it would seem that there is almost always potential for a collective action problem, and consequently for anti-competitive exclusivity. And indeed, the important practical implications of this specific prerequisite for anti-competitive exclusivity have thus far been overlooked. Although the theoretical understanding of exclusivity is now more than three decades old, this has not impacted the courts' analysis of exclusivity in any meaningful way. However, as I will subsequently show, this has extremely important implications for the analysis.

III. "MONOPOLY OVER MONOPOLY STATUS" – THE NATURAL CHECK ON ANTI-COMPETITIVE EXCLUSIVITY

Against the backdrop of exclusivity's welfare-enhancing potential, it is important to carefully examine the contours of its anti-competitive potential. Specifically, it is important to understand under what circumstances exclusivity has limited or no potential for being anti-competitive. As exclusivity can always achieve pro-competitive goals, the rule of reason analysis must focus on identifying circumstances under which it is likely to be anti-competitive. Antitrust law has already identified certain categories of such circumstances. For example, the rule according to which exclusivity foreclosing extremely *small* market shares will almost automatically be upheld is such a rule. It is based on the uncontested understanding that the anti-competitive potential is largely curbed under such circumstances.[127] Similarly, the idea that if barriers to entry are not high, exclusivity should raise little concern, is again a balancing

may result in some midway equilibrium in which buyers are under-compensated, albeit less so than under no competition among sellers. Finally, one can think of circumstances in which there is no competition, or little competition, among sellers to become the monopoly. For example, if there is only one seller who is capable of serving the whole market.

127. HOVENKAMP, *supra* note 17, at 435–37; *see also infra* note 148.

act within the framework of the rule of reason.[128] If barriers to entry are low, there is no reason to think that exclusivity may inhibit competition. Higher prices will attract entry into the market. Under such circumstances, exclusivity's welfare-enhancing potential far outweighs its anti-competitive potential. In view of the preceding analysis, another such rule should be put in place. Surprisingly, this rule pertains to the setting of extremely large foreclosure.

A. *Industries in which Forestalling Competition Requires Foreclosure of All Outlets*

In view of the preceding analysis, it should be clear by now that industries in which all outlets must be foreclosed in order to forestall competition are industries in which there is limited scope for anti-competitive exclusivity. Anti-competitive exclusivity of the kind discussed here is not even a theoretical option in such industries. The question is only whether such industries are common. As will be shown, they are.

First, consider the extreme case of a single buyer, a monopsony, granting exclusivity to a seller. The share of the market that has been foreclosed is 100%. There is a single buyer, who has committed to purchase all its needs from a specific seller. The sellers' competitors cannot make any sales at all. However, perhaps counter-intuitively, this is a case that should raise no competitive concern. There is no collective action problem, because there is only one economic agent capable of granting exclusivity. Such a monopsony has no concern that its competitors will grant exclusivity and leave it facing a monopolistic seller. If a monopsony grants a seller exclusivity, it cannot be allowing its seller to subsequently raise prices, unless the seller fully compensates the monopsony for its future loss, which would mean that the seller has gained nothing from the agreement.

128. On the balancing act (and skepticism regarding its efficacy), see Posner, *supra* note 20.

The only plausible explanation in this setting is that exclusivity achieves one or more of the welfare-enhancing goals previously discussed, leaving both parties to the transaction (and society as a whole) better off. An anti-competitive explanation is not persuasive. In these settings, Bork's stipulation that "there is every reason to believe that exclusive dealing and requirements contracts have no purpose or effect other than the creation of efficiency"[129] seems convincing with respect to exclusivity agreements designed to foreclose markets.

Next, the analysis can be extended to cases that do not involve a monopoly (or monopsony) granting exclusivity. There are other cases in which there is no collective action problem among the firm or firms granting exclusivity. This is the case, for example, in an industry in which foreclosing the market requires foreclosing *all* existing outlets. Each buyer is then indispensable if the market is to be foreclosed to the seller's competitors, and there is again no collective action problem. An industry in which foreclosure requires the acquiescence of all retailers may seem rare. But in reality, this is probably more common than it would seem. Any industry in which one retailer or more has enough volume to sustain an upstream manufacturer will meet this criterion. Consider the case of an industry with eight retailers of (more or less) equal size, in which an upstream enterprise is viable if it serves 8%, 9%, or even 10% of the market. As each of the retailers' market share is 12.5%, each can sustain an upstream seller. There is no collective action problem. No single retailer faces the risk of ultimately facing a monopoly if it does not grant exclusivity.

Although the specific numeric values presented here are stylized, and designed to illustrate the point, settings in which all outlets are essential for forestalling competition seem extremely common. This may be the case in industries with a handful of large outlets, in industries with quite a few

129. BORK, *supra* note 11, at 309.

medium-size outlets, and in industries in which there are numerous small outlets. Several prominent examples of such settings are provided below. In such settings, each of the retailers is indispensable if the manufacturer wants to foreclose the market to its competitors. Similar to the setting of an industry with a single buyer, there is no collective action problem at the buyers' level. There is no scope for anti-competitive exclusivity of the kind discussed here.

In these settings, each retailer possesses a monopoly over the seller's monopoly status, that is similar to the monopoly the single buyer had in the previous example. Importantly, monopoly over the seller's monopoly status does not require a monopoly in the relevant product or geographic market. The point made here is precisely that a number of retailers may each have this monopoly over the seller's monopoly status, even if none of them can in any way be considered dominant in the product market. Each of them can withhold monopoly status from the seller to whom they grant exclusivity. The consideration each retailer will demand for such exclusivity will fall between that retailer's prospective losses and the full monopoly rents the manufacturer expects to earn. None of the retailers will grant exclusivity for less than its share of the prospective monopoly overcharge (in the numeric example used here, 12.5% of the overcharge). And some may demand up to the full amount of monopoly rents that the seller is expected to extract. If all eight retailers demand the bare minimum—their respective share of the overcharge—nothing will have been gained through anti-competitive exclusivity. Neither the manufacturer nor any of the retailers will be any better off. If any of the retailers demands even trivially more than its prospective share of the monopoly overcharge, the exclusivity program will become detrimental to the manufacturer (who can then, of course, be expected to abandon the whole endeavor). Anti-competitive exclusivity of the kind discussed here is impossible not only when exclusivity is agreed to by a monopsony, but also when it is

granted in an industry in which all retail establishments can sustain an upstream business.

B. *Industries in which Forestalling Competition Requires Foreclosure of Large Market Shares*

The case for allowing exclusivity that forecloses extremely large market shares is, in fact, even stronger than the previous analyses suggest. The analysis can be broadened, and can be applied to settings in which not *all* retailers can withhold the monopoly status from the seller. The more retailers are able to withhold the status from the seller, the less probable anti-competitive exclusivity becomes.

To see why, let us begin with a theoretical possibility. If not all buyers have a monopoly over monopoly status, anti-competitive exclusivity is reintroduced as a theoretical construct. The reason is that those retailers who cannot withhold the status from the seller may be exploited. A retailer's acquiescence to anti-competitive exclusivity creates a negative externality on other retailers. And this negative externality can be harnessed to benefit both the seller and the acquiescing buyer or buyers. Consider an industry with ten buyers, eight of whom are essential for blocking competitors. The previous analysis will hold with respect to these retailers. None of them can be taken advantage of. But as some of the monopoly overcharge is charged to the two other buyers, it may be possible to compensate all eight buyers for their prospective losses, and nonetheless profit from charging the two other retailers monopoly prices.

Therefore, theoretically, anti-competitive exclusivity may still be possible as long as not all buyers possess monopoly over monopoly status. But because it is only the non-essential retailers that can be exploited, and because the profits derived from exploiting these retailers must be shared with all essential retailers (as well as the manufacturer), there is a practical limit on the viability of anti-competitive exclusivity. Specifically, the more buyers

are able to withhold the status from the seller, the less likely anti-competitive exclusivity becomes. There are several reasons for this. First, there is an inherent tension between the viability of the anti-competitive scheme and its profitability. The *viability* of the scheme is largely contingent on the non-exclusive buyers' total market share being small. If their market share is not small, they will be able to sustain the competitors' business, and are therefore essential for exclusivity. At the same time, the *profitability* of the scheme depends on the non-exclusive buyers jointly holding a large market share. Otherwise, given that the exclusive buyers need to be fully compensated, the scheme will not be profitable.

In the scenario described here of eight buyers agreeing to exclusivity, the market share of the two remaining competitors must be small enough that they cannot sustain the manufacturer's competitors. Otherwise, foreclosing the eight retailers will not exclude a competitor. The ability to sustain the business of a competing manufacturer depends chiefly on these two buyers' total volume of sales. So, in order for the exclusivity plan to achieve its anti-competitive goal, the joint market share of these two retailers must be relatively small. But the profitability of anti-competitive exclusivity depends mostly on these retailers' market share being large enough so that their exploitation—the marginal increase in the price they are charged as a result of the establishment of a monopoly—generates enough profit to share between the artificially-created monopoly and the other eight retailers. In other words, in order for the scheme to be *possible,* the exploited retailers' share must be small. But in order for the scheme to be *profitable*, the exploited retailers' market share must be large. The tension between the viability of the scheme and its profitability thus makes anti-competitive exclusivity far less likely.

A second reason for why anti-competitive exclusivity becomes less likely as the market share required for forestalling competition increases has to do with a problem

that is well known in closely related contexts—the double marginalization problem.[130] As the number of retailers that are essential for blocking competitors increases, so does the likelihood that at least some of them will demand a share of the supra-competitive rents that makes the whole endeavor unprofitable from the manufacturer's perspective. Even if some of them demand only trivially more than their respective loss, the aggregate may make the whole scheme unprofitable.[131] Once again, in the example of the ten-retailer industry described here, if each of the eight retailers demand a seventh of the monopoly overcharge, the scheme will not be profitable.[132]

Finally, transaction costs must be accounted for. Agreeing to anti-competitive exclusivity can be expected to be extremely costly. Each economic agent granting exclusivity must accurately assess its share of the expected overcharge, as must the party being granted exclusivity. This entails both assessing the expected monopolistic overcharge and addressing potential future fluctuations in each of the exclusive retailers' market shares. If any of the exclusive retailers' market share changes during the duration of the exclusivity commitment, its share of the overcharge will change, as will the share of the competing retailer or retailers whose market share has decreased or increased. Accounting for these contingencies seems extremely costly. And the more retailers there are that can withhold monopoly status from the manufacturer, the more costly exclusivity becomes, because an exclusivity agreement must be struck

130. Double marginalization regularly occurs in product markets in which each of two successive monopolies in the chain of production disregards the effect their pricing has on the other, resulting in prices that are above the optimal level, to the detriment of both monopolies. *See* Spengler, *supra* note 116.

131. The uniqueness of the current setting is that the two (or, more likely, the several) monopolies are in fact competitors in the product market. They are successive monopolies only with respect to their monopoly over the seller's monopoly status.

132. Because if monopoly rents are *X*, the manufacturer will have to pay $\frac{8x}{7}$, or 14% more than it can afford to.

with each retailer.

Thus, although anti-competitive exclusivity of the kind discussed by Chicago School theorists is theoretically possible if competition can be forestalled without the acquiescence of *all* retailers, it becomes extremely unlikely as the market share required to forestall competition reaches very large market shares. The extremely small profits derived from the non-exclusive share of the market will have to be divided among a large number of participants; any one of a large number of retailers attempting to extract even trivially more than the precise amount of its expected overcharge will jeopardize the profitability of the scheme; and the contingencies that will have to be addressed with precision will, at the very least, largely increase transaction costs.

The implications of this analysis can be demonstrated in several prominent billion-dollar industries in which current theory and doctrine suggest that exclusivity may be problematic. As will be shown, large-scale exclusivity is unlikely to be anti-competitive in these industries, and should in fact be presumed benign.

C. *Exclusivity in the Real World*

Several prominent real-life industries demonstrate how the current (mis)understanding of exclusivity disallows parties to reach welfare-enhancing agreements, resulting in a social loss. Specifically, these industries demonstrate that while foreclosure of a 60% to 70% market share may indeed be designed to forestall competition, foreclosure of 85% to 90% is unlikely to be anti-competitive.

1. Exclusivity in E-Commerce

Exclusivity arrangements signed with large e-retailers such as Amazon have recently come under attack worldwide. Although the welfare-enhancing potential of these arrangements is not contested, the concern is that they may

inhibit competition and ultimately raise prices to consumers.[133] Some antitrust authorities have even banned certain kinds of exclusivity arrangements in the e-commerce sector altogether.[134] A closer look at the sector shows that the competitive concerns are misplaced.

According to a July 2018 report by eMarketer, the ten largest US online retailers account for 70.1% of this over-$525 billion industry. The four largest retailers account for approximately 63% of sales.[135] Exclusivity arrangements foreclosing a 60% to 70% market share may indeed be anti-competitive. At least with respect to some products, for which fixed costs (such as R&D, marketing, and logistical costs) are significant, it stands to reason that a wholesaler must have presence in at least one of the four largest retailers in order for its business to be viable. Thus, a wholesaler that signs exclusivity agreements with these four retailers, may thereby block its competitors' access to the market. The four retailers' acquiescence to this anti-competitive scheme is also plausible. They may have agreed to anti-competitive exclusivity and received remuneration for their share of the expected overcharge. The higher prices to be charged to the remaining 40% of the market provide a revenue stream that would allow both the wholesaler and the four large retailers to benefit from the elimination of competition.

But let us now consider a wholesaler who, due to the cost structure in its industry, must foreclose significantly larger market shares, say 90%, in order to block its competitors'

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133. *See, e.g.*, *Report From The Commission To The Council And The European Parliament: Final Report on the E-commerce Sector Inquiry*, para. 26, COM (2017) 229 final (May 10, 2017). Note, that the analysis focuses on selective distribution systems, which are the practical equivalent of an exclusivity commitment. *See id.* paras. 9–22.

134. *See, e.g.*, Aftab Ahmed & Sankalp Phartiyal, *India Tightens E-commerce Rules, Likely to Hit Amazon, Flipkart*, REUTERS (Dec. 26, 2018, 1:11 PM), https://www.reuters.com/article/us-india-ecommerce-idUSKCN1OP14M.

135. Corey McNair, *Top 10 US Ecommerce Companies in 2018*, EMARKETER (Sept. 17, 2018), https://www.emarketer.com/content/top-10-us-ecommerce-companies-in-2018.

access to the market. As mentioned, the ten largest retailers account for 70.1% of the market, out of which the four largest retailers account for 63%. The six retailers that are next in line in terms of size thus account for a total of approximately 7% of the market, or slightly more than 1% on average. And a large number of retailers who do not rank among the top ten retailers in terms of size obviously hold market shares of less than 1% (or $5.25 billion in dollar terms) on average.[136] Foreclosing the market to the wholesaler's competitors would require the acquiescence of tens, if not hundreds, of retailers. If that is the case, anti-competitive exclusivity becomes practically impossible. There would be tens, or hundreds, of "monopolists" (with power over the seller's market power) that would need to be brought on board, each making its own demand (and possibly overcharging the wholesaler). The costs of foreclosure would be unimaginable. Reaching an agreement with numerous retailers and compensating each of them for their future share of the overcharge would require assessing each retailer's expected share of the overcharge, and agreeing on compensation. Importantly, it would require bargaining ex ante with numerous retailers for the calibration of compensation in case of fluctuations in sales' volume. Even very small changes in market shares in this dynamic industry would require major changes in compensation. Compensation paid to a retailer whose market share increased from 0.5% to 0.6%, a change that is unlikely to be significant from the wholesaler's perspective, would have to be recalibrated. Otherwise, that retailer would be paying an (uncompensated) monopoly overcharge for twenty percent of its purchases. This recalibration would, in turn, require recalibration of the compensation paid to a competitor whose market share had shrunk. If the latter were not recalibrated, the wholesaler would be overpaying for exclusivity. And the changes to compensation in each of these contingencies

136. *See id.*

would have to be bargained for ex ante. This seems almost imaginary. And even if it were somehow accomplished, the market share that would remain for exploitation would be extremely small. Presumably, only a handful of retailers whose market shares are trivial could not sustain a competing enterprise. And it is only these retailers that could be exploited.

Ultimately, anti-competitive exclusivity foreclosing 60% to 70% of the market seems plausible. Anti-competitive exclusivity foreclosing 90% to 95% of the market is virtually impossible.[137] If exclusivity arrangements foreclosing 90% of the market are observed, the reason is likely some welfare-enhancing goal that these arrangements achieve. Surprisingly, foreclosure of very large market shares provides a safeguard against anti-competitive exclusivity, not a factor worsening the competitive situation.

2. The Food-Retail Industry in Canada

The Canadian food-retail industry is also illuminating in this respect. According to a report published in 2017, this $85 billion industry is dominated by three firms—Loblaw, Metro, and Sobeys—whose combined market share is estimated to be approximately 60%.[138] The Canadian Competition Act would make exclusivity arrangements signed by any of these major suppliers actionable.[139] But independent retailers hold a stable market share of approximately 40%, amounting to

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137. Of course, foreclosure of smaller magnitude may prevent some competitors from entering, but this will not change the analysis. The rents will be smaller, and the seller will be willing to pay less for exclusivity. Additionally, coordination problems among the sellers that were not excluded would emerge.

138. USDA FOREIGN AGRIC. SERV., RETAIL FOODS: THE RETAIL LANDSCAPE OF CANADA 5 (Feb. 21, 2017), https://gain.fas.usda.gov/Recent%20GAIN%20Publications/Retail%20Foods_Ottawa_Canada_2-15-2017.pdf; QUEEN'S UNIV. INV. COUNS., CANADIAN GROCERY MARKET REPORT: A FRESH LOOK AT SOME APPETIZING INVESTMENTS 3 (Jan. 16, 2017), http://www.quiconline.com/wp-content/uploads/2016/09/CH-Canadian-Grocery-Report-01.16.17.pdf.

139. Competition Act, R.S.C. 1985, c C-34 § 77 (Can.).

$31 billion of sales in 2017.[140] Among these independent retailers are many mom-and-pop type stores that have no affiliation with a wholesaler.[141] And chain discount retailers such as Costco and Walmart have also significantly increased their market share in recent years.[142] If exclusivity is signed with the "Big Three" and perhaps with Costco and Walmart, resulting in foreclosure of 60% to 75%, one might believe that the market was anti-competitively foreclosed. Again, the industry may be such that a seller must serve at least one of these five large retailers for its business to be sustainable. Foreclosing all of these outlets may prevent competition, and allow the contracting parties to share the profits by exploiting the remaining retailers. But if independent retailers are sufficient to sustain a competitor, foreclosure of 90% and higher becomes a pre-requisite for anti-competitive exclusivity. The idea that hundreds or thousands of arrangements are being signed for the benefit of exploiting several retailers with trivial market shares seems uncompelling, at the very least. Once again, foreclosure of 70% may be anti-competitive. Foreclosure of 90% provides comfort that exclusivity is not anti-competitive.

3. The UK Food and Grocery Industry

Finally, the UK food and grocery retail industry provides another illustrative example. The UK Competition Act prohibits agreements preventing, restricting or distorting competition.[143] This prohibition is interpreted to apply, *inter alia*, to exclusivity agreements, and legal experts explicitly caution against any exclusivity arrangement foreclosing

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140. George Condon, *The 2017 Annual Market Survey*, CANADIAN GROCER (Mar. 22, 2018), http://www.canadiangrocer.com/research/the-2017-annual-market-survey-79472.

141. *Id.*

142. *Id.*; QUEEN'S UNIV. INV. COUNS., *supra* note 138, at 3.

143. Competition Act 1998, c. 41 § 2 (UK), https://www.legislation.gov.uk/ukpga/1998/41/contents.

market shares of over 30%.[144]

But a look at the food and grocery retail industry suggests that widespread exclusivity in this industry should raise very little concern. Each of the ten major competitors—Tesco, Sainsbury's, Asda, Morrisons, Aldi, Co-Op, Lidl, Waitrose, Iceland, and Ocado[145]—is indispensable if an exclusivity scheme is to exclude a producer's competitors. These competitors account for a total of over 96% of this £180 billion industry, and even the smallest of these major retailers holds a market share of 1.4%,[146] accounting for approximately £2.5 billion in sales. It is hard to see how anti-competitive exclusivity can be accomplished. All ten chains would have to agree to charging essentially nothing more than their expected losses (which would require pinpointing the expected overcharge with precision, making transactions far more costly), all for the benefit of overcharging the remaining 3.5% of retailers. If exclusivity is struck with all ten chains, it seems far more likely that a welfare-enhancing goal has been achieved.

IV. FORECLOSURE OF LARGE MARKET SHARES – A PRACTICAL RULE

The preceding analysis suggests that there is an upper boundary on exclusivity's anti-competitive potential. In some industries, specifically when exclusivity is granted by a monopoly or monopsony, foreclosure of extremely large

144. Kathryn Rogers, *Distribution Agreements and UK/EC Competition Law*, CRIPPS PEMBERTON GREENISH (June 13, 2017), https://www.crippspg.co.uk/distribution-agreements-competition-law-2/.

145. *See Lidl tops Waitrose to become UK's seventh biggest grocer*, BBC NEWS (Aug. 22, 2017), https://www.bbc.com/news/business-41011259. With the exception of the change in Lidl's positioning, the 2016 data are not very different. *See* RETAIL ECONOMICS, UK FOOD AND GROCERY SECTOR REPORT 15 (2016), https://www.retaileconomics.co.uk/download/Sample%20-%20UK%20Food%20and%20Grocery%20Sector.pdf.

146. *See Lidl tops Waitrose to become UK's seventh biggest grocer*, *supra* note 145.

market shares cannot be anti-competitive in the manner discussed here, even on a theoretical basis. In most industries, exclusivity foreclosing large market shares is unlikely to be anti-competitive. Industries with several retailers of equal size, none of whom holds a market share that is significantly larger than other retailers' share, are industries in which there is no real potential for anti-competitive exclusivity.

The current paradigm must be changed. For small and medium market shares, the competitive danger posed by exclusivity agreements raises as the foreclosed market share increases. But for relatively large market shares, the danger is reduced as the foreclosed market share increases. Just as exclusivity arrangements foreclosing small market shares are considered presumptively benign, so should exclusivity agreements foreclosing extreme market shares. Foreclosure of 100% should, paradoxically, raise less concern than foreclosure of 90%. The prevalent (and very intuitive) view according to which the competitive danger always increases as the foreclosed market share increases,[147] is simply wrong.

The precise percentage from which exclusivity is unlikely to produce any anti-competitive outcome depends on specific case-by-case factors.[148] There is no single percentage of foreclosure beyond which exclusivity will never be anti-competitive. Suggesting a single percentage applicable to all industries under all settings would thus be a gross

147. *Commission Notice: Guidelines on Vertical Restraints*, 2000 O.J. (C 291/01) paras. 21–25; RICHARD WHISH, COMPETITION LAW 594–98 (5th ed. 2003); BARRY J. RODGER & AGNUS MACCULLOCH, COMPETITION LAW AND POLICY IN THE EUROPEAN COMMUNITY AND THE UNITED KINGDOM 189–95 (2d ed. 2002); CDC Techs., Inc. v. IDEXX Labs., Inc., 186 F.3d 74, 77 (2d Cir. 1999) (finding no competitive danger *despite* the large market share foreclosed).

148. Such as the industry cost-structure (of both the link in the chain of production granting exclusivity and the link in the chain of production being granted exclusivity). On other barriers to entry (regulation, industry-specific sunk costs, etc.), see CARLTON & PERLOFF, *supra* note 8888, at 29, 73–82. On profit-margins, the length of the exclusivity covenant, and the ease of termination of the contract, see Omega Env't, Inc. v. Gilbarco, Inc., 127 F.3d 1157 (9th Cir. 1997).

oversimplification. Nonetheless, as in many other areas of antitrust law, for practical purposes it is helpful to propose a rule of thumb—a tentative upper boundary, beyond which exclusivity arrangements should enjoy a refutable presumption of legality.

This percentage can be informed by the experience gained over the years with the opposite end of the scale—foreclosure of insignificant market shares. As will be shown, anecdotal empirical analyses covering a large number of industries in the United States bolsters the conclusion derived from this comparison.

Antitrust law has long grappled with the lower threshold, *below* which exclusivity arrangements are presumed benign. Antitrust theory and law assume, in line with traditional analysis of exclusivity arrangements (and with the analysis advanced in this Article), that exclusivity arrangements foreclosing insignificant market shares raise no real competitive concern. Antitrust theory has not provided a hard and fast number below which exclusivity should be presumed benign, or a framework for producing such a number. Nonetheless, antitrust law has provided a ballpark figure. Courts almost automatically uphold exclusivity arrangements foreclosing market shares of 15% to 30%.[149] Block Exemptions in the European Union

149. *See, e.g.*, Am. Express Travel Related Servs. Co. v. Visa U.S.A., No. 04 Civ.8967(BSJ), 2005 WL 1515399, at *11 (S.D.N.Y. June 23, 2005) ("Generally speaking, cases construing *Jefferson Parish* have held that an agreement must foreclose at least 30 percent to 40 percent of the market to support a § 1 violation, and one treatise advises that there thus exists a 'virtual safe harbor . . . for market foreclosure of 20 percent or less.'"); ZF Meritor, L.L.C. v. Eaton Corp., 696 F.3d 254, 326 (3d Cir. 2012); Kentucky v. Marathon Petroleum Co., 191 F. Supp. 3d 694, 702 (W.D. Ky. 2016); McWane, Inc. v. FTC, 783 F.3d 814, 837 (11th Cir. 2015) ("Traditionally a foreclosure percentage of at least 40% has been a threshold for liability in exclusive dealing cases."); Omega Env't, Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1162 (9th Cir. 1997). Even courts willing to set the threshold at a lower percentage have normally relied on aggravating factors, and have not generally struck down exclusivity arrangements foreclosing less than 20%. *See* Masimo Corp. v. Tyco Health Care Grp. L.P., No. OV 02-4770 MRP, 2006 U.S. Dist. LEXIS 29977, at *10 (C.D. Cal. Dec. 15, 2004) (relying on Twin City Sportservice, Inc. v. Charles O. Finely & Co., 676 F.2d 1291, 1298 (9th Cir. 1982)

specifically mention 30% as a threshold under which exclusivity arrangements are presumed benign.[150] This may be mirrored in the context of extreme foreclosure. Of course, caution must be taken when instating a new rule of thumb, so that it is not overly inclusive. As a conservative measure, it seems appropriate to use the lower end of the 15% to 30% range. Just as foreclosure of market shares of 15% or less enjoy a 'safe harbor,' foreclosure of 85% and higher should presumptively be considered benign.

The 85% threshold is supported by a study covering a wide range of industries. In an article published in March of 2014, *The Economist* divided the US economy into 893 sectors, covered by America's five-year economic census. *The Economist* found that the weighted average share of the four largest firms in each sector was 32%.[151] The average market share *of a large firm* is thus 8%. This, in turn, implies that normally, when a market share of 85% and higher has been foreclosed, only one large firm in the industry will not have committed to exclusivity. If all large firms but one, as well as a large number of smaller firms, have committed to exclusivity, the analysis developed in this Article suggests that the probability that exclusivity is anti-competitive is extremely small. Thus, exclusivity foreclosing an 85% market share and higher should be considered competitively benign.

This presumption of pro-competitiveness must be refutable. This is so for three main reasons: First, further empirical research is called for. Although the survey on

(striking down arrangements foreclosing a 24% market share)).

150. Commission Regulation 330/2010 of Apr. 20, 2010 on the Application of Article 101(3) of the Treaty on the Functioning of the European Union to Categories of Vertical Agreements and Concerted Practices, 2010 O.J. (L 102) 1; Commission Regulation 2790/99, *supra* note 22, at 3; *see also* Israel's *Block Exemption Rule For Vertical Non-Price Agreements*, 25/07/2013 (Publication Num. 500434).

151. *Too Much of a Good Thing*, THE ECONOMIST (Mar. 26, 2016), http://www.economist.com/news/briefing/21695385-profits-are-too-high-america-needs-giant-dose-competition-too-much-good-thing.

which the analysis is based is a comprehensive one, covering nearly nine hundred industries, it is nonetheless a single survey. Future systematic research may call for a change of the specific percentage.

Second, even if the findings of this survey are confirmed by future research, the survey suggests an *average* figure. The precise percentage from which large foreclosure provides a safeguard will change from industry to industry based on each industry's characteristics.

One obvious factor that would change the specific percentage in different industries is the number of competitors in the industry.[152] The smaller the number of firms in the market, the larger the average size of these firms. This implies that for a given foreclosure rate necessary for the elimination of competition, the smaller the number of firms in the market, the smaller the probability of anti-competitive exclusivity. This is so because there is more likely to be more than one firm that has a monopoly over monopoly status. For example, in an industry in which forestalling competition requires foreclosure of 75.1% of the market, anti-competitive foreclosure is possible if there are one hundred retailers with equal market shares (because foreclosure can be achieved even if as many as twenty-four retailers decline the exclusivity offer). It is less likely to occur

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152. I do not use the term "concentration ratio," as in the present context it is important to decouple two elements of concentration—the *number* of firms, and the *distribution* of size among these firms. In the most commonly used index, the Herfindahl-Hirschman Index, concentration rises the larger the average size of the firms (measured in terms of market share) *and* the greater the differentiation between the firms in terms of size. In the four-firm concentration ratio (*CR4*), which is one instance of the general *CRK* test ($CRK = \sum_{I=1}^{K} Si$), the distribution of size positively impacts concentration indirectly, because the total size of the largest firms can be expected to be greater the greater the inequality in distribution. *See generally* B. Curry & K. D. George, *Industrial Concentration: A Survey*, 31 J. INDUST. ECON. 203, 204–10 (1983). As Curry & George note, values of three to eight are usually employed. *Id.* For a less formal description of the two most common indices and a discussion of their shortcomings and relative advantages, see HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY 456–63 (2d ed. 1999).

if there are six, seven, or eight retailers of equal size (because only one retailer is expendable if a manufacturer attempts to foreclose the market). And it is *impossible* if there are four retailers or less.

Another factor affecting the likelihood of anti-competitive exclusivity, closely related to the previous one, focuses not on the number of firms in the market, but rather on the distribution of size among these firms. This is important because for any given number of firms, the more uniform the distribution of market shares among the larger firms in the industry, the less likely anti-competitive exclusivity becomes. As explained, when market shares are relatively similar, all entities are likely to be essential for forestalling competition. By contrast, when there is a single dominant firm whose market share is large but not extreme, and other smaller firms, anti-competitive exclusivity is more likely. The smaller firms may be exploited. In an industry with four competitors of equal size, anti-competitive exclusivity is unlikely. In an industry with four competitors, three of whom have a 10% market share and one of whom holds 70% of the market, anti-competitive exclusivity is plausible.

Due to the fact that the precise percentage is based on a single study, and given the potential differences between industries, the 85% threshold advocated here should not be irrefutable. Plaintiffs should be allowed to produce evidence rebutting this presumption under specific market circumstances.

Nonetheless, the fact that the 85% figure is not engraved in stone should not dissuade policy makers from adopting such a figure as a default rule. The use of workable rule-of-thumb values is in no way foreign to antitrust analysis, and is in fact the norm in antitrust enforcement. Similar rule-of-thumb values that are not precise in the same sense are used in various contexts of antitrust law. For example, in the context of product market definition, the test adopted by the Department of Justice and Federal Trade Commission is the

'hypothetical monopoly test,' which seeks to determine the profitability of a "small but significant non-transitory increase in price" (SSNIP). The "small but significant" element of this test is generally translated to mean a 5% increase in price.[153] This figure is also inaccurate in the same sense.[154] "Small but significant" could have been translated to mean 2.5% or 15%. Similarly, the Herfindahl-Hirschman Index (HHI) is used to assess the probable effects of horizontal mergers on market concentration. Within the framework of the HHI, the government sets general standards: it considers markets in which the post-merger HHI is less than 1500 to be unconcentrated, markets in which the post-merger HHIs are between 1500 and 2500 to be moderately concentrated, and markets in which post-merger HHIs are above 2500 to be highly concentrated.[155] These values are not based on any precise analysis. Again, one could just as easily have supported a stipulation of 2000 HHI-points as the upper boundary of moderately concentrated markets. The government also considers a 100 HHI-point increase in a moderately concentrated market and a 200 HHI-point increase in a highly concentrated market to potentially raise significant competitive concerns (in the former case) or be likely to enhance market power (in the latter case). This precise quantification is imprecise, if not arbitrary. Different market shares are also used in attempted monopolization and in illegal monopolization cases under section 2 of the Sherman Act. Finally, in the present context of exclusivity arrangements, the 40% threshold for condemnation is not inherently more

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153. U.S. DEP'T JUST. & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 4.1.2 (1997), https://www.justice.gov/atr/horizontal-merger-guidelines-08192010.

154. And indeed, the FTC and DOJ reserve the right to use a different figure: "However, what constitutes a 'small but significant and nontransitory' increase in price, commensurate with a significant loss of competition caused by the merger, depends upon the nature of the industry and the merging firms' positions in it, and the Agencies may accordingly use a price increase that is larger or smaller than five percent." *Id.*

155. *Id.* at 5.3.

compelling than a 35% one.

Thus, the setting of an 85% threshold is not itself objectionable. But as it is imprecise, the presumption of legality for foreclosure exceeding this threshold must be refutable.[156] Industries may exist in which a collective action problem is prevalent even when the foreclosed market share reaches levels of 90% and higher.[157]

A final reason for why the presumption should not be irrefutable is that actual foreclosure levels are not necessarily indicative of the foreclosure levels that are required for the elimination of competition. Consider, for example, an industry in which foreclosure of 92% is observed. The industry may theoretically be one in which the elimination of competition requires the foreclosure of only 65%. And if this is the case, the industry is one in which the presumption of pro-competitiveness should not be invoked. It is of course unclear why exclusivity arrangements would be struck with 92% of the market if 65% are enough to foreclose the market. But theoretically, the additional agreements, while redundant in terms of forestalling competition, may have been signed in order to invoke the presumption of legality and conceal the fact that 65% of the market were sufficient to forestall competition.[158]

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156. Melamed, *supra* note 110, at 376, points to the inflexibility that has resulted from the focus on the lower threshold in the present context: "…[A]lthough rules of thumb like a specified percent foreclosure test are not unrelated to the competition issues raised by exclusive dealing agreements, they are often too wooden and inflexible to provide a sound basis for decision."

157. Of course, there may be cases in which collective action problems exist even when the elimination of competition requires foreclosure of 99%. Theoretically, if each of 100 retailers holds a 1% market share, the collective action problem will prevail even if the elimination of competition requires foreclosure of 99%. But as a practical matter this seems like an unrealistic qualification: if any of the retailers holds a market share that is even marginally greater (say, 1.01%), the collective action problem will be spontaneously eliminated and there will be a natural check on anti-competitive exclusivity. Additionally, hold-out problems and transaction costs make it far more difficult to achieve foreclosure under these circumstances.

158. Once the monopoly has been secured by virtue of the 65% foreclosure,

Notwithstanding its proposed refutability, exclusivity arrangements foreclosing market shares in excess of 85% should, counter-intuitively, enjoy a presumption of pro-competitiveness. At extremely large foreclosed market shares, the probability that exclusivity arrangements are being used to an anti-competitive end decreases dramatically, and it becomes far more likely that their intended and actual effects are welfare enhancing.

V. CONCLUSION

Contemporary antitrust doctrine routinely, and in fact almost automatically, condemns exclusivity arrangements foreclosing extremely large market shares.[159] Antitrust doctrine is, in this respect, in line with antitrust theory which has surprisingly overlooked a key upshot of the understanding that anti-competitive exclusivity can normally be achieved only if a collective action problem exists among the entities granting exclusivity.

The argument pressed in this Article is that within the framework of the rule of reason, courts should be mindful of the fact that exclusion of competitors through exclusivity agreements is unlikely not only when the foreclosed market share is relatively small, but also when the foreclosed market share is extremely large. Contemporary antitrust law wrongly condemns such arrangements. An immeasurable number of welfare-enhancing business arrangements are nipped in the bud.

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additional outlets seem to have little reason to resist an offer to sign exclusivity agreements, at least in terms of enhancement of monopoly power.

159. *See supra* note 8 and accompanying text.