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Antitrust and Exclusive Dealing

By Jeffery M. Cross

An exclusive dealing agreement restricts a distributor or retailer to selling only the products or services of a specific manufacturer or producer. Many of my clients that manufacture or produce goods or services sold through distributors or retailers ask me about the antitrust ramifications of exclusive dealing restraints.

Exclusive dealing is a common restraint in many industries. Franchisees of hamburger chains do not sell the hamburgers of competing chains. Gas stations selling a brand of gasoline do not sell multiple brands. Agreements in these industries contain exclusive-dealing restrictions.

Exclusive dealing can take many forms. One form is a requirements contract where a distributor or retailer agrees to take all of its requirements from a single source. Another form is a market share discount or rebate agreement. A manufacturer agrees to discounts or rebates if a buyer agrees to buy certain percentages of its needs from the manufacturer.

The Rule of Reason applies to vertical exclusive dealing restraints. This is because there are several plausible pro-competitive justifications. From the buyer's side, exclusive dealing assures supply, affords protection against increases in price, enables long-term planning, and obviates the expense and risk of storage in the quantity necessary for a commodity having fluctuating demand.

For the supplier, exclusive dealing restrictions make possible substantial reductions in selling expenses, give the seller protections against price fluctuations, and offer the possibility of a predictable market to a new entrant to whom it is important to know its capital expenses. They can help a seller trying to gain a foothold in a market protect against counterattacks by the incumbent, and protect against free riding on the marketing promotions of the manufacturer.

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Exclusive dealing can have anti-competitive effects. Through exclusive dealing, a manufacturer may be able to prevent a rival manufacturer or new entrant from having access to distributors, and thus access to customers. Even if the limitation on access is not absolute, the arrangement may prevent access to a large enough portion of the market to deprive rivals of the economies of scale necessary to compete. Or the exclusive dealing arrangement could block a rival's access to inputs, distributors, or even customers, so as to raise the rival's costs and make it less able to compete.

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RULE OF REASON

The modern approach in applying the Rule of Reason to exclusive dealing restraints is a step-wise, burden-shifting approach. The plaintiff has the initial burden to show a prima facie case of anti-competitive effect. The plaintiff can do so by direct evidence of an increase in price or decrease in output. Or the plaintiff can do so indirectly by defining a relevant market and showing high market shares and barriers to entry. A high market share infers market power, which in turn infers anti-competitive effects.

If a plaintiff is successful in establishing a prima facie case of anti-competitive effect, the burden shifts to the defendant to proffer plausible pro-competitive justifications.

If the defendant does so, the burden shifts back to the plaintiff to show that the justifications do not fit the facts of the case, or that they are not cognizable under antitrust laws. A plaintiff could also attack the defendant's justifications as not necessary to achieve the pro-competitive purposes, or more restrictive than necessary.

If the defendant's justifications withstand these challenges, the plaintiff has the ultimate burden of persuasion to show that the anti-competitive effects outweigh any pro-competitive benefits.

For an exclusive dealing restraint to have an anti-competitive effect, a rival must be foreclosed from access to distributors, an input or customers. Historically, foreclosure was the critical test of exclusive dealing. The threshold for when foreclosure creates an inference of anti-competitive effect is not well established, however. Some courts and commentators suggest any foreclosure below 40 percent is unlikely to have an anti-competitive effect.

Foreclosure is still important under a modern Rule of Reason approach, but as a "screen" to exonerate an exclusive-dealing restraint.

Use of foreclosure as a screen to exonerate exclusive-dealing agreements generally has three aspects: (1) is the duration of the exclusive dealing restriction limited? (2) is the exclusive dealing agreement easily terminable? and (3) are there alternative methods of distribution? All three aspects of foreclosure suggest that rivals are not really foreclosed from competing.

DURATION IS KEY

Although there is no bright line test regarding the duration of an exclusive dealing arrangement, one prominent antitrust court has held that exclusive dealing contracts terminable in less than a year are presumptively lawful. Of course, the length of time that an exclusive dealing contract will be deemed to raise anti-competitive concerns will vary with the industry.

Similarly, the ease of termination by a distributor or retailer of an exclusive dealing contract is another test of whether foreclosure poses an anti-competitive risk. One oft-cited decision held that an exclusive-dealing contract terminable by distributors on 60-days' notice did not pose an anti-competitive risk. Another court held that an exclusivity clause terminable on 30-days' notice would be close to a de minimus restraint.

The factors of short duration and ease of termination reflect the idea that rivals are free to compete to contract with distributors and retailers. In this regard, courts have held that competition for an exclusive dealing arrangement may constitute a vital form of rivalry that the antitrust laws should encourage and protect.

Finally, another consideration in determining whether an exclusive dealing arrangement poses anti-competitive risks is whether there are alternative methods of distribution. Such alternative routes would eliminate any foreclosure effect. Of course, implicit in this analysis is the question of whether the alternate form of distribution will be sufficient to blunt any efforts by the dominant competitor to exercise market power by raising price or reducing output. ■