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Exclusive Dealing

By Gordon Schnell

With the Jan. 4 indictment by New York State Attorney General Eliot Spitzer of James Zimmerman, former head of Federated Department Stores, the retail industry has received a stark wake-up call on the risks associated with exclusive dealing. Zimmerman's indictment on a perjury charge follows on the heels of Spitzer's successful challenge to an exclusive dealing arrangement among Federated (owner of Macy's and Bloomingdale's), May Co. (owner of Lord & Taylor and Filene's), Lenox and Waterford Wedgwood for the sale of Lenox china and Waterford crystal. The parties paid a substantial fine (roughly $3 million) and entered into an antitrust consent decree to settle Spitzer's charges.

While entering into exclusives with key suppliers has been a hallmark of retail trade for generations, merchants may now be wary of relying on the prevalence of this industry practice in negotiating exclusives going forward. And for good reason. Spitzer has made a name for himself by exposing industry practices that while pervasive are questionable in their legality and their ultimate effect on consumers.

Could Spitzer's challenge to the Lenox/Waterford deal, and the spotlight he has placed on Zimmerman, be the opening salvo of Spitzer's next great thing? Probably not. But it should put retailers and their suppliers on notice. There is a right way to deal exclusively and a wrong way. Knowing the difference can save them a lot of trouble.

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Exclusive deals aren't inherently problematic

The potential pitfalls associated with exclusive dealing arrangements principally arise out of § 1 of the Sherman Act, which bars agreements or conspiracies that unreasonably restrain trade. An exclusive deal between a retailer and supplier does not by itself violate this proscription. On the contrary, for more than 80 years the U.S. Supreme Court has recognized as paramount a company's right to choose with whom it wants to deal.

Furthermore, while exclusivity will obviously diminish competition on an intrabrand basis (competing sellers of the same brand), it can actually foster competition on an interbrand basis (competing brands). In particular, exclusivity allows the chosen seller to expend considerable resources on selling the product without fear that competing sellers will free ride on these efforts. Suppliers can greatly benefit from having a limited number of distributors committed to selling their brand. That is why exclusivity deals typically involve promotional obligations on the part of the seller. Exclusivity can also provide the supplier with greater control over how and where the brand is sold.

The area where exclusivity can lead to trouble is when it becomes the centerpiece of a directed effort by a group of retailers or suppliers to suppress competition from one or more of their competitors. That is exactly what happened in the Lenox/Waterford deal. According to Spitzer, Federated and May Co. secured the exclusive deal for the purpose of preventing Bed Bath & Beyond from selling the Lenox/Waterford products. Such a scheme epitomizes the classic group boycott: two or more sellers getting together to persuade or coerce a key supplier to stop dealing with the sellers' competitor to suppress competition from that seller.

But not all group boycotts violate the antitrust laws. And in the context of retail trade, the line that separates those that do from those that don't can be particularly murky. The trick for retailers is to make sure their arrangements fall outside of the purview of per se antitrust review. Under per se review, a court will not engage in any detailed analysis of the competitive effects of or justifications for the group boycott. Anticompetitive harm is presumed.

A plaintiff need only demonstrate the existence of the boycott and of the attributes that make it fall within the per se rubric. There are essentially three: The boycott is horizontal (e.g., encompassing two or more competitors) as opposed to vertical (e.g., covering entities at different levels of the distribution chain); it was designed to suppress price competition; and it involves firms with market power or control over a critical source of supply. If a horizontal

boycott has either of the latter two features, it will almost certainly end up on the wrong side of the per se line.

The antitrust laws treat horizontal agreements and vertical agreements very differently. Whereas vertical arrangements may strengthen competition by allowing the supplier to achieve greater efficiencies in the distribution of its products, horizontal arrangements rarely lead to anything but competitive mischief. For this reason, only horizontal boycotts can qualify for per se review.

Therein lies the principal trigger of the per se trap—concerted action by competitors. A boycott that involves concerted, rather than independent, action by competitors is bound to lead to trouble. Under most circumstances, it is permissible for a retailer to threaten to drop a supplier if it deals with a competing retailer. This is generally true even in the context of several retailers making these threats—as long as they are made independently. Where this conduct will often cross the line is when the threats are coordinated in some fashion.

While the existence of a horizontal boycott may alone be enough to qualify for per se scrutiny, typically the courts will look for something more. Designs on price will always suffice. Clearly, that is what prompted Spitzer's recent attack: Federated and May Co. conspiring to boycott Bed Bath & Beyond because of its efforts to sell Lenox and Waterford at lower prices. This kind of group boycott will never fly.

The courts have consistently shown a zero-tolerance policy for restraints that interfere with free and open price competition. After all, the antitrust laws are ultimately about protecting consumers. And nothing hurts consumers more than restricting their ability to obtain the lowest prices possible. So an exclusive deal that involves any agreement on price will rarely pass muster. In the horizontal context, this is true even when there is no explicit agreement on the actual price. The mere suggestion of pricing foul play—e.g., competitors consorting to frustrate discount competition—is likely sufficient to elicit per se review, not to mention the ire of certain regulators.

The final snag of the per se dragnet catches horizontal boycotts involving dominant firms or products. Firms with market power—whether through their high market share or control over an essential product—are always held to a higher antitrust standard because of their ability and likelihood to harm competition through exclusive deals or other competitive restraints. This means that boycotts by an entire industry (such as the one Toys "R" Us orchestrated with the major toy manufacturers against warehouse clubs) or by a group of sellers who together have pricing power over consumers, will likely be subject to the per se squeeze. Firms with market power engaging in exclusive deals—whether vertical or horizontal—may also be subject to Sherman Act § 2 liability for actual or attempted monopolization.

There is a right way to deal exclusively and a wrong way. Knowing the difference can save retailers, suppliers a lot of trouble.

Rule of reason is a more relaxed form of review

When safely outside the confines of per se review, the antitrust risk retailers face from entering into exclusive deals diminishes sharply. Indeed, there is likely little risk at all. That is because the "rule of reason" will apply. Under this more relaxed form of antitrust review, the courts will perform an exhaustive market analysis of the arrangement and the reasons for its formation. A group boycott will fail this test only if it has no business justification other than to harm competition (or there exists an alternative arrangement less restrictive of competition), and it has harmed competition. In the retail setting, the presence of both of these factors is highly unlikely.

There are a number of legitimate, if not procompetitive, reasons for a supplier to limit the number of sellers through which it distributes its products. This is especially so in retailing, where consumer purchases are often based on nothing more than brand image and reputation, and the general customer experience of shopping at a particular store. Any retailer/supplier effort to manage these consumer hot buttons is entirely reasonable and should not be penalized—unless, of course, it is merely a ruse to harm competition.

But harm to competition has a unique meaning in antitrust law. It has nothing to do with harming an individual competitor (who obviously would suffer some injury if left on the outside of an exclusive deal). Rather, it is about harming the competitive process: engaging in restraints that lead to higher prices, reduced output, lower quality or diminished consumer choice.

In the retail environment, it is extremely improbable that a purely vertical arrangement, or one that involves neither price nor dominant parties, could ever lead to such industrywide harm. At most, it will dampen intrabrand competition. Since a single brand will rarely constitute a relevant antitrust market, the existence of competing brands will ensure that industrywide competition remains intact. No harm to competition. No problem with the deal.

So edgy retailers should relax. Spitzer's strike against Zimmerman and the Lenox/Waterford deal is not likely to be the opening round of his next industry purge. But it should give retailers pause the next time they are considering an exclusive deal with their suppliers. They should just remember this: Don't involve competitors or competing suppliers in any exclusive deals; don't talk about pricing; don't target a discounter; and don't deal with dominance. If retailers stay away from these per se flash points, they need not fear the wrath of the angry regulator nor the errant antitrust scuffle. NLJ