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PROFESSIONAL CORPORATION

# ***A General Test for Exclusionary Conduct? The Case of Exclusive Dealing Agreements***

**Hearings Before the Department of Justice and  
the Federal Trade Commission on Exclusionary Conduct**

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# Exclusionary Conduct

- ▶ There are countless practices that can be challenged as potentially exclusionary, and they come in all shapes and sizes.
- ▶ Many of these practices can cause serious competitive harm. Ripping competitors' displays out of stores or sabotaging a rival's plant come to mind. Others, like price cutting, are rarely harmful. And many can yield significant consumer benefits.
- ▶ Exclusive dealing presents a challenge in antitrust enforcement because what makes it potentially harmful is the very same mechanism that may make the arrangement efficient and lead to lower prices to consumers.

# Exclusionary Conduct

- ▶ Exclusive dealing can provide major consumer benefits.
- ▶ The typical exclusivity arrangement with a distributor makes the supplier a more effective competitor.
  - The distributor focuses solely on the supplier's wares and has an incentive to compete more effectively against other brands.
  - The supplier has an incentive to provide the distributor with information, displays, and the like without concern about free riding.

# Exclusionary Conduct

- ▶ The benefits of exclusive dealing are considerable, but they are possible only because the arrangement is exclusive, denying rivals access to the distributor's capabilities.
- ▶ That same exclusivity also can have the effect of increasing rivals' costs and rendering them less effective competitors, less effective constraints on the supplier's market power.
- ▶ The question, then, is how do we evaluate exclusive arrangements in light of these simultaneous benefits and harms?

# Exclusionary Conduct

- ▶ Today, there is little dispute about the overall goals Section 2 enforcement should achieve; specifically, exclusionary conduct should be defined in a way that:
  - Prevents the creation, enhancement, or extended maintenance of significant market power;
  - Avoids deterring procompetitive conduct;
  - Provides rules or at least a method of analysis that business can understand and apply; and
  - Allows the courts and enforcers reasonably to distinguish the lawful from the unlawful.
- ▶ For exclusive dealing, we have achieved these goals effectively for over 40 years by applying the traditional rule of reason.
  - The plaintiff must show that the effect of the conduct, net of efficiency gains, is to raise prices, reduce output, or otherwise harm consumers.

# Exclusionary Conduct

- ▶ The recent debate – largely among the enforcers and academics, not the courts – is whether there is a general test for all exclusionary conduct that we can apply to exclusive dealing.
  - The search for a universal test to determine whether single-firm conduct is unlawfully exclusionary has been going on ever since the Hand decision in *Alcoa*.
  - But finding a one-size-fits-all approach that can be applied equally to diverse practices such as tying, predatory pricing, and refusals to deal has proven to be elusive.
- ▶ The main area of disagreement is whether we need extraordinary screens to ensure that procompetitive conduct is not deterred – screens of the sort that are rarely seen in areas of law outside antitrust.

# The “No Economic Sense” Test

- ▶ The “no economic sense” test, or its “profit sacrifice” variant, has gained the most attention.
  - Under the NES test, a practice is not exclusionary for purposes of Section 2, nor anticompetitive (if vertical) under Section 1, unless “it would make no economic sense for the defendant but for the tendency to eliminate or lessen competition.”
    - Some advocates of NES apply it to all single-firm and vertical conduct.
- ▶ Test has been urged by DOJ in *Trinko*, *Dentsply*, *American Airlines*, and many policy speeches.

# The “No Economic Sense” Test

- ▶ NES is derived from the test originally proposed for predatory pricing by Areeda and Turner (1975), and later adopted by the Supreme Court in *Matsushita* (1986) and *Brooke* (1993).
  - Pricing below incremental cost makes no economic sense but for the recoupment made possible if the pricing succeeds in eliminating or lessening competition.
- ▶ This was acknowledged to be an extraordinary test, extremely difficult to satisfy, because price cutting is the essence of the normal competitive process and almost never harmful to competition and consumers.
- ▶ But why should we apply this purposefully extraordinary test to all types of exclusionary conduct?

# The “No Economic Sense” Test

- ▶ As applied to exclusive dealing, the NES test is unintelligible:
  - Exclusives “make economic sense” precisely because they lessen competition by rivals for the affected business.
    - That tells us nothing about whether the arrangement is procompetitive or anticompetitive.
- ▶ Exclusives usually are associated with real efficiencies, and often cost little to implement; so they almost always make “economic sense” to the defendant.
- ▶ Yet the way in which the efficiencies are achieved is precisely through the mechanism of exclusion, the elimination of rivals’ competition for the duration of the exclusive arrangement.
- ▶ And there need be no period in which profits are sacrificed and then recouped; exclusive dealing can be profitable as it is occurring.

# The “No Economic Sense” Test

- ▶ *Harmar v. Coca-Cola* (Tex. Oct. 20, 2006) (5-4 decision)
  - Exclusive promotional agreements with retailers
    - For the period of the promotion, retailers had to give Coke (1) a reduced price – which in a few instances was required to be the lowest in the store, (2) the most prominent displays, and (3) the exclusive ads.
    - In return, Coke provided significant promotional payments and deeply-discounted wholesale prices.
  - Resulted in lower prices for Coke products, and soft drinks overall, but reduced visibility for competing brands.
  - The exclusivity “made economic sense” precisely because it made things more difficult for rivals.
    - Coke would not pay big money for a promotion if a customer could walk into the store and see a big display of two-liter Pepsi at \$0.89.
  - Exclusivity here could fail an incautious application of the NES test.
  - But was upheld under the rule of reason because there was no evidence of an adverse overall effect on competition in the market as a whole.

# The “No Economic Sense” Test

## ▶ *Microsoft* (D.C. Cir. 2001)

- Microsoft:
  - Left IE out of “add/remove programs.”
  - Banned OEM modifications to the Windows Desktop.
  - Included ISPs in Desktop “Online Services” Folder only if their default browser was IE.
- D.C. Circuit condemned under rule of reason because competitive harm outweighed any competitive benefit.
- But MS easily could have passed the NES test, since each of these tactics involved essentially no cost and, at least arguably, made sense with or without harm to rivals.
  - NES proponents say “No; MS would fail the NES test,” reasoning that the cost of explaining the restrictions to Dell, HP, and other OEMs makes the overall exercise unprofitable but for the exclusion of Netscape.
  - Perhaps that is so. But should legality turn on whether it is very costly, somewhat costly, or not costly at all to explain your restrictions to a customer?
    - If NES became law, the key piece of evidence might be the defendant’s phone bill.

# The “No Economic Sense” Test

- ▶ The test is both underinclusive and over inclusive, and extremely difficult for non-expert judges to apply.
  - Some courts may bless truly harmful arrangements by saying that any efficiency justification proves that the exclusive arrangement makes economic sense whether or not it eliminates competition – and is therefore lawful;
  - Other courts will take efficient arrangements and say they make economic sense only because they eliminate competition from rivals – and are therefore unlawful.
    - E.g., *Harmar* dissent.

# Why not apply the rule of reason?

- ▶ Why not continue to apply the rule of reason and analyze exclusive agreements on the basis of whether the specific arrangements at issue are likely to raise prices, reduce output, or otherwise harm consumers?
  - That's what we care about.
  - It is functionally the same analysis we apply every day in analyzing mergers, joint ventures, and other agreements under Sherman 1.
  - Has worked well for over 40 years, and NES proponents have not identified cases where application of the rule of reason has generated inappropriate outcomes.
  - Avoids false positives because, in the absence of proof of market power, and likely consequential harm, exclusive arrangements will be seen as benign and will be upheld.

# Why not apply the rule of reason?

- ▶ The rule of reason is complex, but not too complex.
  - Business people understand you when you say the test is whether it is likely to increase market prices.
  - And application of NES test is in fact a good deal more complicated.
    - Ascertaining whether an arrangement is or is not intrinsically profitable is itself difficult – and analyzing whether the profitability depends on the adverse effect on rivals even more so.

# Why not apply the rule of reason?

- ▶ The courts seem to agree.
  - Courts applied rule of reason analysis in *Microsoft* and *Dentsply* notwithstanding DOJ arguments.
  - NES has never been endorsed by a court in the context of exclusive dealing.
  - NES was also rejected by FTC in *Rambus*.