CATEGORY MANAGEMENT: AN INTERVIEW WITH FTC COMMISSIONER THOMAS B. LEARY

"Category management" is a term describing a method of managing retail operations. As defined by the FTC Staff Report on Slotting Allowances, "category management is an organizational approach in which the management of a retail establishment is broken down into categories of like products. Under category management, decisions about product selection, placement, promotion and pricing are made on a category-by-category basis with an eye to maximizing the profit of the category as a whole." Federal Trade Commission Staff Report on Slotting Allowances at 47 (Feb. 2001), *available at* http://www.ftc.gov/bc/slotting/index.htm. Antitrust issues can arise when the retailer designates a particular supplier as a "category captain" with the responsibility to provide advice or even make decisions concerning some or all of these subjects. *See, e.g.*, *Conwood Co. v. U.S. Tobacco*, 290 F.3d 768 (6th Cir. 2002), *cert. denied*, 123 S.Ct. 876 (2003).

To explore the antitrust issues presented by category management, Mary Anne Mason and Paul B. Hewitt, Vice-Chairs of the Sherman Act Section 2 Committee, recently interviewed FTC Commissioner Thomas B. Leary, who has previously stated that "some aspects of category management present high antitrust risks." Thomas B. Leary, A Second Look at Category Management at 2 (May 17, 2004), *available at* http://www.ftc.gov/speeches/leary/040519categorymanagement.pdf. The following is subject to Commissioner Leary's caveat that the opinions he expresses are individual and not necessarily shared by any other Commissioner.

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Section 2 Committee (S2C): As ordinarily discussed in the antitrust world, category management involves a retailer, such as a supermarket, appointing a leading branded manufacturer as a category captain who develops a plan for all products in a particular category, suggesting items that the retailer should stock and recommending how they should be priced, displayed and promoted. Is that a good description of category management?

LEARY: Yes, category management can involve those activities. But my understanding is that the extent to which the category manager actually gets into the details of promoting and pricing varies from retailer to retailer. The way you have articulated it has been represented to me as the most extreme form of category management, but there apparently are levels of advice short of that.

S2C: What's the real basis for antitrust interest here? Haven't suppliers always provided advice to retailers and tried to disparage or disadvantage their competitors' products?

LEARY: I think that there are two differences between traditional supplier jawboning and what we are dealing with here. The first is that the category manager may not just function as another supplier. The category manager is someone to whom considerable discretion may have been delegated by the retailer, as the title suggests. And the second difference is that in my experience suppliers have traditionally provided lots of advice on the pricing and promotion of their own brands, and while they're doing it, they are likely to have disparaged the other guy's brand. However, until category management came along I had never heard of suppliers actually providing advice on how to price and promote a rival brand.

S2C: The FTC Staff Report on Slotting Allowances identified a number of efficiencies that might result from category management. In your view are these efficiencies really significant and do they deserve substantial antitrust solicitude?

LEARY: Well, the efficiencies should not just be evaluated from the retailers' point of view. They are clearly getting a service for nothing that they would otherwise have to buy from a third party or pay their own in-house people for. Whether that is or is not a true efficiency, as you know, is another matter. It may be just a question of whose pocket it comes out of. But I am willing to assume that there can be efficiencies associated with an intelligent management of a particular category. There is some economic learning to the effect that category management can actually expand output. There is some learning that goes in the other direction.

S2C: Do the potential efficiencies just arise from the category manager's activities regarding its own products, or do you see potential efficiencies where the category manager is involved with all suppliers' products in a particular category?

LEARY: I think if the category captain would simply focus on its own products there could obviously be substantial potential efficiencies. And I suppose theoretically there could be efficiencies if the category captain manages everybody's products, but I question whether the down-side consequences aren't more serious. There are efficiencies associated with cartels as well, but we don't permit them because of the more serious down-side consequences. So, there may indeed be efficiencies if one person manages the promotions for an entire industry, but I am not sure why those should be treated any differently than the efficiencies associated with a cartel.

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S2C: Help us to understand your views on the appropriate antitrust limits on the advice a category captain can give to a retailer. You have commented that such advice can theoretically lead to agreement on market strategies across a group of competing brands or a reduction in competition between the captain's brand and a retailer's private label brand or a market structure that is adverse to maverick firms and disruptive innovation. When is the advice provided by the category captain a real antitrust concern and when is it within the bounds of fair play?

LEARY: At the risk of oversimplification, let me begin with some basic principles. I see a distinct difference between a category captain advising on how to price and promote its own brands versus the brands of its competitors. The *Sylvania* case [*Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977)] and its progeny recognize substantial efficiencies where a manufacturer manages certain aspects of the downstream distribution of its own branded products. The recognized efficiencies include the familiar reduction of the risk of free-riding and the maintenance of the integrity of a particular distribution system for a particular brand. And the Supreme Court has said that the reduction in intra-brand competition that results from that kind of conduct is not as significant or is outweighed by the potential enhancement of inter-brand competition. But to the extent that the category captain is advising on price and promotions for a competitor's brand, you are now talking about inter-brand competition, which is outside the protective rationale of *Sylvania*. And now you are concerned about whether or not there are impacts on inter-brand competition that need to be addressed. There are a number of potential impacts and you could lump them into general legal categories. If you are thinking Section 2, you are thinking risks of exclusion. If you are thinking Section 1, you are thinking risks of collusion of one kind or another. We can amplify on that, but I think it might be helpful to break it down analytically. First of all, break it down between intra-brand and inter-brand consequences, and then, second, break it down between what we think of as Section 2 consequences and Section 1 consequences.

S2C: Concerning Section 1, you have advocated using horizontal rather than vertical antitrust analysis where a category captain makes pricing or other recommendations to a retailer concerning a competitor's products. Could you explain your thinking on this?

LEARY: I guess in the final analysis all competitive effects of antitrust concern are horizontal. There is no such thing as a vertical effect. In "vertical" restraint cases, we are concerned with horizontal effects at the supplier or the dealer level. As I said, it may be more accurate to focus on the distinction between intra-brand restraints and inter-brand restraints. *Sylvania* recognized that a manufacturer has a legitimate interest in the way its product is sold at retail. Consider the automobile business, where I once worked. The name of a General Motors Division is on the door of the dealership. The average customer probably is not too acutely aware of the fact that the dealer is an independent business entity. If the customer gets mad at someone, the customer might be mad at the dealer, but probably mad at General Motors as well, because General Motors's name is on the door and the name is on the car. Therefore, the way those cars are sold, the amount of information that

accompanies their sale, the way that they are serviced, the surroundings in which they are sold, all are matters of concern to the manufacturer. The manufacturer does not lose interest in that vehicle simply because title has passed to a dealer. So, in the larger sense, we recognize that a manufacturer has a legitimate interest in following its product after title has passed and seeing that it is handled properly. And to that degree, I would argue that the manufacturer is participating itself in the retailing of its product, and legitimately so. So it is no longer a purely vertical relationship between the manufacturer and the retailer. The *Sylvania* line of cases allows a manufacturer to manage and to direct some of the retail functions itself. If a manufacturer purports to direct the retailing of another guy's brand, I think it is analytically very, very different from your normal *Sylvania*–protected situation.

S2C: Do you see an important distinction here between price and non-price related conduct? Specifically, if a category manager recommends retail prices for his competitor's products, does that deserve a different sort of antitrust analysis than if the manufacturer is merely saying where to put the competitor's products on the shelf?

LEARY: I agree that this may be an important distinction, although as a matter of fact, as you well know, even advice on how to price your own product is a little bit delicate. That to me does not make a great deal of sense. I think that *Dr. Miles* [*Dr. Miles Med. Co. v. John D. Park & Sons & Co.*, 220 U.S. 373 (1911)] is an anachronism, but it is the law and it has been the law now for 94 years. So, yes, that distinction obviously is important. For example, I can understand a manufacturer saying I am willing to pay you "x" dollars if you give me the eye level shelf, and furthermore, I am willing to pay you "y" dollars if I am the only product that is sold at eye level. This could be analogized to taking out a Yellow Pages ad. If you are the only full page ad in whatever the category happens to be, you may pay more than you would if there are five or six other full page ads in that category. Number one, that's a little different than discussions on how a retailer prices a competitor's product. Number two, I think it's a little bit different when you are engaged as a manufacturer in arm's length bargaining over shelf space, as opposed to the situation where the retailer has said in effect to you, "Listen, I am relying on your expertise, you tell me how to do this." I think there's a difference.

S2C: Do you consider it per se illegal for a category captain to recommend what prices the retailer should charge for competitors' products?

LEARY: You are asking me to use language that we're trying to use very carefully around here. There is a problem with describing something as per se illegal that has never before been declared illegal by the courts. I think by analogy with some cases you might argue this variation is per se illegal, but if I were writing a complaint I'm not sure I would plead it as per se. You might want to say it is inherently suspect or you might want to say that this is something that would require a very, very high level of efficiency justification. I think almost by definition, per se is something where there is some kind of judicial experience and some kind of common agreement on learning. We are dealing here with something on the frontiers. I am not familiar with any judicial decision directly on point, one way or the other, and therefore I think it would be a mistake to go marching into court and saying this is per se illegal. I think before we started bringing cases on a per se theory, we would need to accumulate a little bit of experience and evaluate actual competitive effects over some period of time.

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S2C: In your judgment, should it make a difference in the legal analysis if the supplier pays for the privilege of becoming the category manager?

LEARY: Well, I think that in the first place, even without paying for it, the category manager is providing a rather valuable service for nothing. If category managers go beyond providing the service for nothing, and actually pay for the privilege of doing so, it makes you wonder what they are paying for. You have to assume that the relationship is very worthwhile to the category manager. I would not suggest, however, that it is per se illegal for a category manager to pay for the privilege of being a category manager, because I don't think it should be per se illegal or even necessarily dangerous for

category managers to provide detailed information on how to price and promote their own brands. If they want to give some kind of a payment to the dealer in order to induce the dealer to listen, that may well be benign.

S2C: What are the practical implications of the horizontal and vertical labels as you apply them to category management activities?

LEARY: There is a footnote in the Supreme Court opinion in *Sharp* [*Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 731 n.4 (1988)], which suggests that the formal relationship between the parties to the challenged restraint is outcome determinative. And if you took it out of context you could read the note as saying, well, that's it. But then I don't think that the people who wrote the *Sharp* opinion were focusing on the problem that we've got here today. I think they were using the vertical/horizontal distinction as a shorthand way of distinguishing between inter-brand and intra-brand kinds of effects. *Sharp* involved a situation where a retailer said to a manufacturer, I am not going to buy from you if you continue selling to that discount house. And what the Supreme Court said basically is, that's a vertical thing. It's roughly equivalent to a distributor asking a manufacturer for an exclusive territory, which would be subject to the rule of reason. Well, change the facts in *Sharp* a little bit and now you're the retailer and you go to the manufacturer and you say, listen, I don't want you to cut off my competing retailer, I just want you to make sure that my competing retailer doesn't undersell me. I want you to enter into a resale price maintenance agreement with the competing retailer. That's roughly analogous to a strong version of category management, isn't it? I don't doubt that the *Sharp* Court would accept that as per se illegal. So, I recognize the *Sharp* language is there and I understand that people rely on it, and God knows, I'd rely on it if I were arguing it, but I'm not so sure you can push it too far. Now, there's another issue here that is interesting, and that is whether the *Sylvania* type rationale is limited to those kinds of products where there's a great deal of presale advice and postsale service. I've never thought that the *Sylvania* rationale was so limited. I used to get into arguments with people on that subject years ago, and I used to argue that the classic example of free riding involves a product that's not hi-tech and doesn't involve a lot of service – women's clothing. I heard an ad one time on the radio when I was driving in a car. The ad was addressed to women and it said, shop the boutiques, pick out the styles that you think look the nicest on you and then come to our store and buy them at a great price off the plain pipe racks. That's not hi-tech or post sale service. Go shop in a nice, expensive environment, where it's a more pleasant experience, make your selections, and then come to us. And we'll sell it to you in very unpleasant circumstances, but you won't have to spend much time looking, because you'll know already what you want. All I'm saying is I am willing to accept that *Sylvania* type considerations would justify supplier/retailer consultation on how to market the supplier's dresses. Some would argue that *Sylvania* doesn't even protect that. I disagree, and I want to make clear that my questions about category captains are not inconsistent with my support for broad coverage of *Sylvania*.

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S2C: Does the antitrust analysis change if the category captain makes pricing recommendations concerning a retailer's private label brands?

LEARY: That is an area of major risk. In the private label context the supplier/retailer relationship even as a matter of form is more overtly horizontal. So when you are trying to tell, or advise, a customer how to price its own private label products in competition with your products, I think the dangers are obvious. Even some lawyers who disagree with me on the general approach to inter-brand effects will agree that this is a serious potential issue. The broader question is whether or not you can ever safely give advice on how to price another supplier's product. As I said, I wouldn't go so far as to say I think that's per se illegal, even in the private label situation, because I don't believe that the per se label should be applied to new and widespread forms of business dealings that have been adopted not in a clandestine-like way, but have been adopted presumably in good faith with the advice of experienced counsel. And I just don't believe that we ought to make law that way. So even if we had

the facts developed more fully, I would not favor bringing a per se case at this point. I think we need to have these things aired in some kind of a proceeding and examine competitive effects and possible efficiencies in maybe more than one case before somebody might say, okay, this is either per se or it's so close to per se that it's not worth the candle.

S2C: Now, you said a moment ago that you suspected those who generally disagree with your view of this area would still agree that the risks are higher in the private label area, but there are some people who would take issue with that.

LEARY: I guess there are. I'm just basing that on informal discussions I've had with a number of lawyers representing people who engage in this kind of activity, and they have said well of course, we all understand that there are special problems associated with private label. I'm not so sure that this is a matter of basic economics or whether people are simply captivated by the nomenclature. It is a little bit easier to say that the private label interaction is "horizontal" rather than vertical.

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S2C: The argument that some would make would be that the supplier/retailer relationship should not automatically be treated as horizontal unless the private label product is sold to other retailers.

LEARY: I understand that, and maybe from a fundamental economic point of view there isn't that much difference anyway, but formally it looks a little different.

S2C: Let's turn to Section 2 issues and assume we're talking about a firm that qualifies as a monopolist based on analysis of relevant market and market share. Do you think that the firm could be liable for illegal monopoly maintenance if it systematically over a wide geographic area is appointed the category captain and if it recommends actions that are adopted by the retailer that effectively freeze in place the market shares of competing manufacturers?

LEARY: Yes.

S2C: Would you take that view even if the monopolist only gives advice and recommendation regarding his own products? For example, if this monopolist has an 80 percent market share and if he consistently recommends giving himself 80 percent of the retail shelf space, isn't he just talking about his own products and shouldn't that be considered lawful activity?

LEARY: In theory if all you're talking about is Section 2 it really shouldn't make any difference whether you are consistently advising on your own product or consistently advising on someone else's. That's a very interesting issue, however, and I would like to think about it further before taking a position. I hadn't thought of that frankly because, for whatever comfort it may give to your readers, I don't think of category management as primarily likely to be a Section 2 problem. A case like *Conwood* where the category captain destroyed its rival's in-store displays is likely to be very unusual. In general I think even the most naïve retailer would probably be able to sniff out a Section 2 type problem. And probably would be resistant to it. In my experience the last thing in the world that even the most naïve buyer wants to do is to find itself dealing with a monopoly or a near monopoly. Buyers tend to be very sensitive about that, so I really don't think of Section 2 as the primary problem.

S2C: You brought up the concept of naïve retailers. Do you see any potential for liability on the part of a retailer who may simply decide to appoint a category captain as a way of cutting costs?

LEARY: Well, let's take the polar extreme where I think the retailer would be really in deep trouble. That is if the retailer sits down with the category captain and says listen, I know that you are giving advice to my competitors in this marketplace as well, and I want you to know that I am not interested in butting heads with them, and I hope that you are coordinating the advice that you give to me with the advice that you give to them so that we are not getting in each other's way – so that we are not engaged in intensive price competition, so that our price promotions are separated in time, etcetera etcetera. This is what I am looking for you to do. And I will evaluate your performance as my category manager based on how successful you

are in keeping this market stable. That is the typical hub and spoke conspiracy if there ever was one. That's the most extreme situation.

S2C: Do you see potential antitrust misconduct by retailers as a cause for major concern?

LEARY: My guess is that a few years ago when this category management thing first became prevalent, retailers probably went into this a little bit more naïvely. I don't think that the retailers necessarily saw category management as an antitrust issue to the same degree as they might today. I'm willing to bet my bottom dollar that the grocery manufacturers were the ones who were really getting in-depth antitrust counsel on issues like this. However, I think the retailers now are a little bit more enlightened on that extreme case, and maybe on the private label issue. I wouldn't see the retailer as a likely prime candidate for antitrust liability. A Section 1 case requires two parties, and one may be more culpable and one may be more passive, but I would see the retailers as being more passive.

S2C: You mentioned that retailers might easily be able to detect and stop unlawful Section 2 conduct by suppliers. Wouldn't that also be true for conduct that might constitute a supplier cartel in violation of Section 1? Why would a retailer ever accept any advice from a category captain if it might ultimately result in reduced supplier competition and higher prices to the retailer?

LEARY: I understand. This is the argument you get from the people defending category management who say well why would any retailer in its right mind want to facilitate any cartel-like behavior among its suppliers? But the answer to that would be that if the retailer thought that somehow or other through orderly marketing it would be able to increase its own prices, it would get a cut of this increase. For example, the retailer might theoretically want to eliminate price disruptive promotions which may create expectations in consumers. You can hypothesize that that might happen and that retailers are not the perfect proxy for the consumer interest. They may have many interests that are diverse from those of consumers. This is an area that is complex and would require a great deal of factual development. I recognize that any given retailer is presumably in competition with other retailers and before going along with some kinds of cartel-like behavior the retailer would need some confidence that the other stores in the same market were playing the same game.

S2C: What do you see in the future for the FTC regarding category management?

LEARY: One of the things I am thinking about is that the best way to move forward on something like this is not necessarily to bring lawsuits. It may be that what we need most is more information: How pervasive is category management? Who are the category captains and for which retailers? What functions do these category captains actually perform? To what degree do competing stores in the same market use the same captain? How much actual coordination does that result in? And so on. Those are all areas that we really don't know much about.

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S2C: As an institution, how do you think that the FTC would best go about exploring the issues – through an individual investigation, or perhaps through some additional hearings?

LEARY: Well, I'm not sure the hearings would do it. One possibility I suppose would be to use 6(b) questionnaires. [15 U.S.C. § 46(b).] You could have a market-wide investigation and try to develop information that way. I don't want to convey the impression to your readers that just because I am interested in this that there are other people who are necessarily going to go down that road. I can't represent that that will happen, but just thinking aloud, that might be another way to do it. To just find out the extent to which category captains are offering advice on other people's products. Some people say that they never do it, and they advise their clients not to do it. Other people say they advise their clients to do it and don't see anything wrong with it, and so we would want to know how

pervasive it really is. My overall impression, by the way – and I have no idea whether this is really true or not – is that people may be becoming a little bit more careful, and that the retailers may be learning a little bit more, and that their level of dependence on suppliers to manage their product categories is becoming less pronounced.

S2C: Would you see a potential here for the FTC to use its Section 5 unfair methods of competition authority to go beyond the Sherman Act in attacking any aspects of category management?

LEARY: I am not a big fan of using Section 5 beyond the Sherman Act, quite frankly. I think the proper occasions for that are really kind of limited.

S2C: On behalf of the Section 2 Committee we thank you for speaking with us today. Your past public statements on category management have certainly raised awareness of antitrust risks, and your comments today will help push all of us further in our thinking.

LEARY: Well, I think this is part of what the agency was created to do. We weren't created primarily to bring lawsuits at all. If you read the legislative history of the FTC Act, it says to the agency, in effect, you're not supposed to be just another prosecutor, you're supposed to be informing people as to what you think the parameters of acceptable conduct are.

S2C: Thank you very much.

LEARY: You're very welcome.