No. 98-4107

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

TOYS "R" US, INC.,

Petitioner,

v.

FEDERAL TRADE COMMISSION,

Respondent.

On Petition for Review of a Final Order
of the Federal Trade Commission

Opinion of the Commission: Chairman Robert Pitofsky
Initial Decision: Administrative Law Judge James P. Timony

BRIEF FOR THE RESPONDENT

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JURISDICTIONAL STATEMENT

Petitioner's jurisdictional statement is complete and correct.

STATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Whether — in light of an extensive factual showing that competing toy manufacturers adopted parallel policies restricting sales to warehouse clubs, and that they did so only after petitioner Toys "R" Us ("TRU") overcame their initial reluctance by relaying assurances between competing manufacturers that each would adhere to similar policies — substantial evidence supports the Commission's finding that TRU and seven manufacturers entered into a horizontal agreement to boycott the clubs.

2. Whether the Commission properly concluded that the boycott orchestrated by TRU was illegal *per se*, in light of the boycott's purpose to disadvantage the clubs, the dominant positions held by TRU and the participating manufacturers in their respective markets, the clubs' need for the withheld products to compete effectively, and the lack of plausible economic justification.

3. Whether, in light of the foregoing considerations and demonstrated adverse effects on competition, the Commission properly concluded, under the antitrust rule of reason:

(A) that the horizontal boycott agreement engineered by TRU unreasonably restrained trade; and

(B) that, whether or not a horizontal agreement was effectuated, the series of ten vertical agreements TRU entered into with individual manufacturers unreasonably restrained trade.

4. Whether, having found that TRU had engaged in unlawful acts that seriously harmed competition in toy retailing, the Commission acted within its remedial discretion in fashioning its order.

STATEMENT OF THE CASE

In May 1996, the FTC issued an administrative complaint charging that petitioner TRU, the world's largest toy retailer, had violated Section 5 of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. § 45, by entering into agreements with and among competing toy manufacturers to restrict sales of toy products to warehouse club stores. TRU-A42-48.[1] After a 43-day trial, an FTC administrative law judge ("ALJ")

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[1] "TRU-A___" refers to Petitioner's Appendix. "FTC-A___" refers to the Appendix filed herewith. "Op. ___" refers to the Commission's opinion. "ID ___" refers to the ALJ's Initial Decision. "IDF ___" refers to the ALJ's Initial Decision Findings, by paragraph. "CX ___" refers to FTC complaint counsel's exhibits. "RX ___" refers to respondent TRU's exhibits. (Letters or alphanumerics following exhibit numbers — *e.g.*, "CX 686-*B*, CX 1660-*Z48*" — denote specific pages.) "E___" refers to TRU's "Exhibit Volume" filed in this Court.

issued an initial decision concluding that TRU's practices constituted "unfair methods of competition" in violation of Section 5. TRU-A340.

The Commission affirmed. Reviewing the record *de novo*, the Commission found that, in order to reduce the clubs' effectiveness as competitors, TRU entered into vertical agreements with at least ten major toy manufacturers, and orchestrated a horizontal boycott agreement among at least seven of those firms, including industry leaders Mattel and Hasbro. Op. 15-37.[2] The Commission found that these agreements required TRU's suppliers to restrict severely their sales to warehouse clubs and, in particular, to offer the clubs only highly-differentiated products (either unique items or "combo" packages of two or more toys) that would not be sold at TRU. Op. 14-37. The Commission found that toymakers initially resisted entering into such agreements — which deprived them of a promising opportunity to expand sales and reduce their dependence on TRU — and relented only after TRU threatened loss of sales, *and* organized a horizontal agreement in which manufacturers committed to implement substantially the same restrictions. Op. 12, 27-33.

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[2] While the ALJ found that *fourteen* major toymakers had entered into agreements with TRU, the Commission limited its finding of vertical agreements to the ten firms as to which there was "clear and direct evidence." Op. 15 n.17. Although TRU disputed the existence of these vertical agreements in the proceedings before the Commission, it presents no argument on this issue in its brief to this Court, and has accordingly waived it. *See* note 20, *infra*.

The Commission held the TRU-orchestrated boycott unlawful *per se,* after a careful analysis in which it considered various traits identified as indicative of *per se* illegality in *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.,* 472 U.S. 284 (1985). *See* Op. 64-83. The Commission accordingly found that: (1) the boycott's purpose was to disadvantage the clubs (Op. 67); (2) TRU and the participating manufacturers held dominant positions in their respective markets (Op. 67-75); (3) the clubs needed the withheld products in order to compete effectively (Op. 75-76); and (4) the boycott lacked any plausible justification (Op. 76-82). On the latter point, the Commission considered and rejected TRU's contentions that "free-riding" by the clubs justified the restrictions. *Id.*

The Commission further held that the restraints engineered by TRU were unlawful under a full rule of reason analysis, whether they were effected through a horizontal agreement or solely through vertical agreements between TRU and its suppliers. Op. 83-88. The Commission found that the restrictions on club sales engendered serious anticompetitive effects: suppression of a distinct new competitive force in toy retailing; avoidance of price reductions that club competition would have induced; and deprivation of price information that would help consumers to make informed decisions. Op. 83-87. The Commission also held that the restraints produced no countervailing competitive benefits. Op. 76-82, 87.

Having found that TRU violated Section 5, the Commission ordered it to cease and desist from its unlawful activities and to refrain from the threats and similar conduct it had used to effectuate and maintain the restraints.[4] TRU-A346-47.

On December 1, 1998, the Commission issued an order granting TRU a partial stay of its final order. TRU-A447. On December 7, 1998, TRU filed a petition for review (TRU-A454), accompanied by a motion to stay the Commission's order in its entirety. This Court denied that motion on December 31, 1998. TRU-A455.

STATEMENT OF FACTS

A. Toys "R" Us.

TRU is the world's largest toy retailer. The record before the Commission showed TRU's preeminent position, as *buyer* of approximately 30% of the total output of the large, traditional U.S. toy manufacturers, and as *seller* of 20% of all toys in the United States. Op. 5-6. In many major metropolitan areas, TRU's retail share exceeded 30%, ranging from 35% to 49% in 18 metropolitan areas — including Chicago, Los Angeles, and New York — and over 50% in eight other cities and in Puerto Rico. *Id.* Because of TRU's size, geographic coverage, and high local market

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[4] The Commission was unanimous in its determination that TRU had violated Section 5 by entering into a series of anticompetitive vertical agreements. Commissioner Swindle, however, did not agree that TRU also had orchestrated a horizontal conspiracy. TRU-A441-46.

shares, even the largest manufacturers are dependent on TRU to market new toys and to provide the "critical mass" necessary to ensure continued production of older, basic toys. Op. 29; IDF 429, 433-38, 454, TRU-A290-93; Amerman Tr. 3617-19, FTC-A187-89; Shiffman Tr. 2001-02.

TRU rose to this position by offering a broader range of toys at lower prices than department stores and traditional retailers. Op. 5. A TRU store stocks about 11,000 toy items throughout the year — far more than any other retailer. Op. 5. It is "like a warehouse selling toys." IDF 481, TRU-A297. Like other discounters, TRU offers little in the way of presale customer service; customers are presumed to know what they want.[5] Op. 5; IDF 481, TRU-A297; CX 1034-B; CX 1655-Z12; Goldstein Tr. 8242, FTC-A242.

Maintaining a low "price image" among consumers is key to TRU's business strategy. By offering its best prices on top-selling toys, TRU attracts customers who

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[5] Manufacturers compensate TRU for performing functions such as advertising, supporting a full line of products, and stocking inventory in advance of the Christmas selling season. As the Commission explained, such compensation takes a variety of forms: direct advertising credits that make TRU's advertising program "essentially free"; the practice of "dating" on manufacturer billing, which permits TRU to receive inventory early in the year and defer payment until later; and other types of discounts and preferences that compensate TRU for carrying full lines of manufacturers' products, including low-volume items. *See* Op. 41-43; ID 119-20, TRU-A336-37; CX 10, FTC-A1-2; CX 556, FTC-A13; CX 1012, FTC-A39; CX 1730; *see also* CX 686-B, FTC-A19; CX 481, FTC-A5; CX 967-C, FTC-A38.

then also purchase additional, less popular products sold at higher margins. Indeed, TRU makes the most money from sales of the 4,000 moderately popular products in the middle of its vast inventory. Op. 7; CX 1822 ¶ ¶ 19, 20, FTC-A111-12. No other toy outlet has been as successful as TRU in profiting from this strategy. Op. 8.

B. The Warehouse Clubs.

In the late 1980s, an innovative concept in retailing — the warehouse club store — increasingly threatened TRU's price image and profits. IDF 38-40, TRU-A226-27; CX 1545, FTC-A40-46. Clubs offer the lowest prices on toys of any retailer, selling at even lower margins — 9% to 14% — than Wal-Mart and other general merchandise discounters. Op. 7; IDF 38, TRU-A226.[6] "Almost invariably [the clubs'] presence in the community [has] a tendency to drive prices down." IDF 38, TRU-A226 (quoting Sinegal Tr. 200, FTC-A344). In 1992, there were five warehouse club chains: Sam's Club, a division of Wal-Mart; Pace, a division of Kmart; Price Club; Costco; and BJ's Wholesale. Op. 8.

Clubs achieve exceptionally low prices by using innovative techniques to minimize operating costs and maximize inventory turnover. Op. 8-9; IDF 20-30, TRU-

[6] TRU's average retail margins are close to 30% above cost, significantly higher than Wal-Mart and other general merchandise discounters, whose markup is about 22%. Op. 7; *see also* IDF 43-44, TRU-A227.

A223-25. Costco, for example, largely avoids the capital costs of carrying inventory, by turning over inventory an extraordinary 13 times a year and funding the majority of inventory by vendor accounts payable. Sinegal Tr. 159, FTC-A337. Clubs also sell goods directly from shipping pallets, eliminating the labor costs and delay associated with unpacking, marking, and displaying goods on traditional racks and shelves. Op. 9; IDF 28, 38, TRU-A224, 226.[7]

The clubs focus on popular name-brand items, which are most likely to be recognized as a value and generate the highest turnover. Op. 9; IDF 23-24, TRU-A224.[8] The clubs also maximize turnover by making frequent changes to the mix of products they offer.[9] Moreover, the clubs sell only to members, enabling them to target

[7] This method of handling merchandise limits the number of stock keeping units ("SKUs") the clubs can offer (Sinegal Tr. 161-62, FTC-A339-40), but the more limited range of SKUs simplifies ordering and reduces the clubs' exposure to "carry over inventory." IDF 23, TRU-A224; Sinegal Tr. 161, FTC-A339.

[8] Wal-Mart adopted a somewhat different strategy for Sam's Club, targeting higher-income customers with products often different from those available through other discounters and with larger quantities and combination packs. The record shows, however, that half of the toy offerings at Sam's were regular-line products, and — despite TRU's contrary assertion (Br. 11) — they included items also carried by Wal-Mart. Op. 10; IDF 410-11, TRU-A288; Jette Tr. 1010. Indeed, Sam's expressed serious dissatisfaction at manufacturer limitations on the availability of popular regular-line items. *See* CX 210, FTC-A4.

[9] Contrary to TRU's assertion (Br. 10), it is not possible for clubs to "'cherry-pick' only the 'hottest selling' toys" because it is often not known which toys will be "hot" at the time the clubs place their orders. Clubs order far in advance of the

customers who find their low-cost, low-service approach desirable. And, by charging an annual fee, the clubs give members an incentive to shop at the clubs consistently, again increasing turnover. IDF 30, TRU-A225. All of these innovations result in significant savings, yielding a ratio of expenses to sales of under 9% for the clubs — as compared to 17% for TRU. IDF 49, TRU-A228.

C. Toy Manufacturer Distribution Policies.

The record demonstrates that TRU's conspiratorial activities — not the unilateral business decisions of toy manufacturers — placed severe restrictions on sales to the clubs. Before TRU commenced its campaign against the clubs, leading manufacturers aggressively pursued club business and, with few exceptions, allowed the clubs to select regular-line products offered to all classes of retailers. Op. 10; IDF 34, TRU-A225.[10] In 1989, 80% to 90% of Pace's toy purchases and 90% of Costco's purchases from Mattel were regular-line items. IDF 377, TRU-A283. As TRU's marketing expert conceded, although some manufacturers restricted the availability of certain

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year-end holiday selling season, just as other retailers do. Op. 10; IDF 33, TRU-A225; Hilson Tr. 4424, FTC-A265.

[10] *See* IDF 118-20, TRU-A242-43 (Mattel); IDF 170, TRU-A252 (Hasbro's Playskool division); IDF 217-18, TRU-A258 (Fisher Price); IDF 235-241, TRU-A260-61 (Tyco); IDF 285-86, TRU-A269 (Today's Kids); IDF 301, TRU-A271 (Tiger Electronics); IDF 314, TRU-A274 (Vtech); IDF 322-24, TRU-A275 (Binney & Smith); IDF 342, TRU-A277 (Sega).

brands to clubs, those brands typically were not distributed to any discounter or mass merchandiser. IDF 25, TRU-A224.[11] Moreover, although clubs occasionally worked with manufacturers to develop specially-packaged products, such as "combo packs" containing multiple inexpensive toys or complementary products, they usually preferred regular-line products. As is well understood in the industry (and recognized by TRU executives), club customers generally resist "combo packs" because they are difficult to compare to the offerings of other retailers and are perceived as a means to force the sale of a second, unwanted item. Op. 10, 39; IDF 378-81, TRU-A283; *see* Lazarus Tr. 5431-33, FTC-A299-301; CX 592-A, FTC-A14.

The manufacturers' eager pursuit of club business was spurred by the need to reduce dependence on TRU and replace outlets lost after a spate of toy retailer bankruptcies. Op. 29; IDF 115, 443-46, TRU-A242, 292; CX 813, FTC-A22. No retail channel other than the clubs offered similar opportunities to increase sales and reverse the trend toward increasing retail concentration. Op. 28. With "[r]etail business * * * rapidly swinging to Clubs," Mattel felt the need "to establish a much more aggressive goal" for club sales in 1991. CX 523, FTC-A6; *see* CX 530-B, FTC-A8. A Fisher

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[11] For example, Little Tikes initially distributed its line only through full-line retailers. But in late 1990 or early 1991 — after its acquisition by Rubbermaid — it started to sell to the clubs; it continued such sales, because of their "tremendous upside potential" (IDF 262, 266-67, TRU-A265-66), until TRU intervened. Op. 25 n.24(5).

Price report called "the opportunity for growth * * * phenomenal." CX 698-B, FTC-A21. Even manufacturers that had reservations about selling to the clubs pursued club business for fear of yielding sales to their competitors. *E.g.,* Tr. 2651, FTC-A323.

D. TRU's Campaign Against the Clubs**.**

TRU noted with alarm that the clubs were "growing like a weed" (Goddu Tr. 6807, FTC-A231) and projected that, by 1997, clubs would sell from 6% to 8% of all toys in the United States. Op. 12. Having already lowered its prices on "price image" items to meet competition from Wal-Mart, TRU "feared that clubs would surpass even Wal-Mart as the downward price leader in the toy retail business." Op. 11-12. Accordingly, TRU began formulating a response to this perceived competitive threat. *Id.*; IDF 58-59, TRU-A229.

Beginning in 1989 and intensifying in late 1991 and early 1992, TRU executives embarked on a campaign to obtain commitments from suppliers to severely restrict sales to the clubs.[12] Op. 12-13; IDF 62-63, 81, 99, 101, 106, TRU-A230, 234, 238-40. Focusing first on the two largest manufacturers — Mattel and Hasbro — TRU asked suppliers for assurances that they would go along with a plan to sell to the clubs on

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[12] In 1992, at the same time it was intensifying its campaign to obtain commitments from its suppliers to restrict the clubs' access to key toy products, TRU felt compelled to lower prices for several high-profile products, by as much as 20%, to match club prices. Op. 13 n.15; IDF 56, TRU-A229; *see* IDF 390, TRU-A285.

discriminatory terms. Op. 16; IDF 62, 81, 119-20, 171-72, TRU-A230, 242-43, 252. TRU did not simply announce its policy; it asked each manufacturer for assurances. Op. 16. As TRU Vice-President Goddu frankly acknowledged, TRU "absolutely" wanted to find out what suppliers' intentions were and "directly or indirectly ask[ed] them that to find out." Op. 16.

Manufacturers were not happy with TRU's demands. Already dependent on TRU for about 30% of their sales, manufacturers wanted to expand, not restrict, the number of retail outlets. Op. 6, 29; IDF 171-72, TRU-A252. As TRU's CEO conceded, manufacturers expressed unhappiness concerning the policies, because "*they wanted to do all the business they could do.*" CX 1660-Z48, FTC-A96 (emphasis added); *see* Op. 28; CX 78, FTC-A3. Moreover, no manufacturer wanted to lose the clubs' growing volume to its competitors.[13] Op. 28, 32; IDF 67-68, TRU-A231. Although TRU told its suppliers that it would apply the "club policy" equally (Op. 30), the manufacturers wanted more: they sought assurances that they would not lose club sales to their competitors. Op. 29; ID 104, TRU-A321. As described by one high-level TRU executive, manufacturers resisted making "a decision on their own

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[13] For example, Hasbro told TRU it could not "sit by idly" while competitors sold to the clubs. Op. 30. Other leading manufacturers — Fisher Price, Mattel, Tyco, Little Tikes, and Sega — voiced similar concerns. Op. 37 nn.3-5; IDF 70-71, 89, TRU-A231, 235.

independent of what their competition did." Op. 29. Indeed, "virtually all of the manufacturers separately told TRU that they did not want to be prevented from selling regular-line product to the clubs without assurances that competitors would also abstain." Op. 30; *see* IDF 70-71, 75, 80, 86, 90, TRU-A231-32, 234-36; Lazarus Tr. 5443, FTC-A307; CX 1658-Z4-5, Z60-61, FTC-A69-70, 77-78.

Frustrated by suppliers' resistence to its demands (Goddu Tr. 6877, FTC-A234),[14] TRU made "a point to tell each of the vendors that [it] spoke to that [it] would be talking to [its] other key suppliers." CX 1658-Z10, FTC-A74. TRU then communicated conditional agreements between competing manufacturers. Op. 30; *see* Op. 27-33. For example, in October 1991, Mattel's CEO met with TRU's CEO, and promised to restrict club sales "*based on the fact that competition would do the same.*" CX 532-A, FTC-A9 (emphasis added). Later, around the time of Toy Fair 1992, TRU met with a top Hasbro official, telling him that it had met already with several Hasbro competitors — including Mattel and Fisher Price — and they had agreed not to sell promoted products to the clubs. Op. 36 n.30(2). Hasbro "didn't believe that it would

[14] Although Mattel had previously committed to try not to sell regular-line product and had sharply reduced the percentage of such product it sold to the clubs (IDF 119-20, TRU-A242-43), TRU believed that more stringent restrictions on club sales were necessary and intensified its campaign to eliminate club competition by broadening the restraints to encompass other products and manufacturers.

stick," but went along "because [its] competitors had agreed." Inano Tr. 3335, FTC-A281; *see id.* at 3338, 3342-43, 3603, FTC-A284-86, 292; IDF 177-82, TRU-A252-53. In negotiations with Hasbro, TRU provided further assurances that Hasbro's major competitors, including Tyco and Little Tikes, would not be selling regular-line product to the clubs. Op. 32; IDF 179, TRU-A253. In like fashion, TRU told Little Tikes — which asked specifically whether the "club policy" applied to competitor Today's Kids — that TRU had assurances from Today's Kids that it "would be getting out of the business of selling to the clubs." Op. 37-38 n.30(5,6). Reassured it would not lose volume to a competitor, Little Tikes committed to restrict the clubs to "discontinued or near discontinued product * * * going forward." DePersia Tr. 2151, FTC-A211; *see* Op. 25-26 n.24.[15]

Ultimately, TRU's "shuttle diplomacy" (Op. 52) secured the commitments of at least seven manufacturers — Mattel, Hasbro, Fisher Price, Tyco, Little Tikes, Today's Kids, and Tiger Electronics — to a common plan to restrict club sales. *See* Op. 27-33. Consistent with this mutual understanding, all seven of these manufacturers — plus at least three others as to which the Commission declined to make findings of direct

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[15] Little Tikes did not, as TRU suggests (Br. 15), "agree to disagree" about club sales, but resolved the issue by yielding to TRU. IDF 274-77, TRU-A267-68.

participation in the horizontal boycott — made commitments to TRU to adhere to such restrictions. Op. 15-22.

Contrary to TRU's contentions (Br. 12-17), it was this web of horizontal and vertical agreements — not independent manufacturer judgments — that led to the restrictive club policies. For example, Mattel's strategy to sell customized products to the clubs was not of its own devising, but was prompted by its commitment to TRU "'to do [its] best'" to move the clubs away from its regular line of products. *See* Op. 17; IDF 119-20, TRU-A242-43. Similarly, Fisher Price's efforts to restrict club sales began after TRU's 1989 communications. IDF 217-22, TRU-A258-59. TRU also errs in relying on testimony by the former president of Hasbro's Milton Bradley division. *See* Br. 13. Despite that officer's own preferences, his division had no policy against sales to the clubs in 1991 (Wilson Tr. 5803-04), and Hasbro's corporate policy restricting club sales was adopted only after discussions with TRU at which the two companies came to a "meeting of the minds." Op. 23 n.24(2).[16] Other manufacturers

[16] TRU mistakenly relies on policy statements by Hasbro and Mattel. Br. 12-13. The cited statements were drafted *after* TRU had induced the toymakers to alter their distribution policies. Op. 14 n.16; IDF 162-64, 213-14, TRU-A250-51, 257.

similarly wanted to pursue club sales and restricted such sales only by dint of the agreements forged by TRU.[17]

Although details of the restrictive policies varied somewhat, their essential feature was that manufacturers would not provide the clubs the same products they sold to TRU, but instead would offer only "combo packs" and discontinued and near-discontinued items. Op. 14, 25 n.24(5). Alternatively, suppliers could impose

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[17] *E.g.,* Fisher Price: IDF 217-20, TRU-A258; Hilson Tr. 4601 (some regular line sold to clubs into the early 1990s); Op. 21-22, 24 n.24(3), IDF 218-225, TRU-A258-59 (TRU reported that Fisher Price "agreed not to sell promoted product to the clubs" and Fisher Price "promised this wouldn't happen"); Tyco: IDF 235, TRU-A260 (Tyco sold clubs regular-line items); Op.25 n.24(5), IDF 255-56, TRU-A264 (Tyco's Playtime subsidiary promised TRU it "will not offer any merchandise to warehouse clubs that is bought by Toys "R" Us. This will make our policy exactly the same as Tyco's."); Op. 24 n.24(4), IDF 235-43, TRU-A260-62 (after promising to report to TRU about its club policy, Tyco informed TRU in 1992 that it had adopted a 25-item minimum purchase requirement, which Tyco later characterized as a "no ship" policy); Little Tikes: IDF 266-67, TRU-A266 (new CEO in 1992 recognized clubs' "tremendous upside potential" and began selling regular-line items); Op. 25 n.24(5), IDF 268-79, TRU-A266-68 (after meetings with TRU, Little Tikes committed to restrict club sales to discontinued and near discontinued items or special packs); Today's Kids: IDF 285-86, TRU-A269 (until 1993, sold regular-line products without restriction); Op. 25-26 n.24(6) (following negotiations with TRU, Today's Kids assured TRU it would not to sell to the clubs); Tiger Electronics: IDF 301, TRU-A271 (selling regular-line product to clubs 1991-1993); Op. 26 n.24(7), Shiffman Tr. 2035-36, 2042-43; CX 814, FTC-A23 (although Tiger informed TRU that it "agreed we were not going to sell the same product to the clubs that we were selling to Toys 'R' Us," TRU let Tiger "off the hook" and informed it that old product, as well as "multipack with high price point" could be sold to clubs); Op. 26 n.24(7) (understood from TRU that Tiger could go back to TRU to review Tiger's club strategies and get approval in advance, even for specific products and packaging).

conditions that effectively would prevent sales to the clubs. *See, e.g.*, Op. 19 n.21; *id.* at 21 (discussing Tyco's application of such a policy, in consultation with TRU, to effectively preclude club sales); IDF 240-41, TRU-A261. TRU also retained the remarkable right to review and veto sales of toys that its suppliers considered offering to the clubs. *See* Op. 14, 19-20, 25 n.24(5), 32-33; CX 550-A, FTC-A11; CX 626, FTC-A16-17.

After achieving this network of agreements, TRU solicited its suppliers' assistance in helping to police each other. Op. 59. TRU confronted wayward suppliers with their competitors' complaints. Op. 34-35. As a Playskool executive recalled, TRU "took him to the shed" after a Fisher Price account manager complained to TRU about Playskool products in a club. Op. 35. TRU's president "would get calls all the time from Mattel saying Hasbro has this in the clubs or Fisher Price has that in the club." CX 1659-Z34, FTC-A85. Similarly, in the summer of 1992, TRU made a "forceful presentation" to Mattel of Hasbro's complaints about Mattel products in the clubs. Op. 34.[18] By relaying complaints back and forth between firms, TRU maintained the club restrictions. Op. 35.

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[18] Similar policing by TRU occurred in late 1993, when Tiger Electronics complained to TRU about a competitor's product at BJ's. TRU told Tiger that it would tell the competitor "don't do it again or God knows what." IDF 304-05, TRU-A272.

E. The Impact on Competition.

The loss of access to regular-line merchandise effectively reversed the rapid growth of the clubs' toy sales. It denied clubs the merchandise they needed to compete effectively, forced clubs' customers to buy products they did not want, and frustrated consumers' ability to compare TRU's prices with club prices. Op. 38-41; IDF 367-412, TRU-A281-88.

As the TRU-instigated restrictions hardened in late 1992 and 1993, sales to the clubs by leading toy manufacturers dropped precipitously. Op. 40. The combined club sales of Mattel and Hasbro, the two industry leaders, fell from $32.5 million in 1991 to $10.7 million in 1993. *Id.* Without access to regular-line product from the major manufacturers, the clubs were forced to shift to secondary manufacturers, thus eliminating competition between TRU and the clubs on a broad range of products, including the TV-promoted products that constitute the "lifeblood [of] the toy industry." CX 1657-Z44, FTC-A53; *see* IDF 383, 386, TRU-A284. What TRU calls "only a few toy manufacturers" restricting club sales (Br. 18) in fact included most of the top toymakers; the seven firms the Commission found to be boycott participants accounted for approximately 40% of the output of all traditional toys (*i.e.,* toys other than video games, *see* Op. 3 n.4) in 1992. Op. 4.

TRU claims the clubs had "ample access" to "comparable toys" (Br. 18). The record shows, however, that lack of access to regular product from leading manufacturers severely impaired the clubs' toy business. "Combo packs" were far less popular with consumers than individually packaged items, for they made it difficult to compare the prices of an individual toy at different retail outlets, and raised the average price of toys at the clubs with no improvement in value. Op. 39. Moreover, toys are highly differentiated, and the products of secondary manufacturers are not good substitutes for those of industry leaders. Op. 2; IDF 386-87, TRU-A284; Hilson Tr. 4538, FTC-A272. "[I]f you [don't] have access to the larger toy manufacturers' products, you [don't] have a toy department." Halverson Tr. 356-57, FTC-A257-58; *see also* Amerman Tr. 3721. Thus, toy SKUs carried by the clubs *decreased* from 1992 to 1995 (*cf.* TRU Br. 18 (using 1991 as base point)), and the loss of many of the toys that would enable the clubs to compete head-to-head with TRU engendered a drop in their overall market share. Op. 39-40.

The restrictions halted the rapid growth of the clubs' toy business. Op. 40. For example, after toy sales at Costco increased by a stunning 51% from 1991 to 1993 — a rate that was more than double the increase in its overall sales — Costco toy sales *decreased* by almost 2% between 1993 and 1996, despite continued double-digit growth in its overall sales. IDF 385, TRU-A284; CX 1745-Z9, FTC-A101. More

fundamentally, by limiting club access to major brand toys, TRU was no longer "embarrassed" into lowering its own prices. IDF 56, 147, 390, TRU-A229, 247, 285; Weinberg Tr. 7696-99, 7701, FTC-A348-51, 353. By mid-1993, TRU's success in restricting the clubs mainly to non-comparable combination packs eliminated the clubs' downward price pressure on TRU and other retailers. ID 111, 123, TRU-A328, 340; IDF 382, 388, 393-97, TRU-A283-86. The Commission found that the elimination of competitive pressure from the clubs cost consumers as much as an extra $55 million *per year* on top-selling products purchased at TRU alone. Op. 41; *see* CX 1822 ¶ 58, FTC-A135.

SUMMARY OF ARGUMENT

I. TRU's campaign to stifle competition from the warehouse clubs went far beyond the announcement of a unilateral "club policy." TRU entered into agreements with and among leading toy manufacturers, eliciting mutual commitments to restrict supplies to the clubs. The Commission's finding of a horizontal boycott agreement is supported by substantial evidence, and TRU has now waived any objection to the Commission's finding that it entered into a series of ten vertical agreements with manufacturers.

A. 1. The Commission's finding of a hub-and-spokes conspiracy engineered by TRU is fully consistent with a long line of Supreme Court precedent, including the

Court's most recent pronouncements regarding the pertinent evidentiary standard. An agreement to restrain trade need not be express, but may be shown by direct or circumstantial evidence that *tends* to rule out independent action. Certainty is not needed, and a defendant cannot prevail simply by advancing a theory of independent action.

2. The evidence shows that TRU succeeded in forging a horizontal boycott agreement. As TRU executives complained, manufacturers were *unwilling* to curtail club sales absent assurances that competitors would do likewise. And, contrary to TRU's simplistic theory of individual responses to a "dichotomous choice" between club sales and sales to TRU, the manufacturers' desire not to yield sales to competitors gave them good reason to resist yielding to TRU's demands. TRU overcame this reluctance to curtail club sales only by engaging in protracted "shuttle diplomacy," relaying the message, "I'll stop if they stop," between competitors. Op. 30. Subsequent efforts to police the boycott provide further evidence of a mutual agreement.

B. 1. Relying principally on the cautious approach suggested by the Supreme Court in *Northwest Wholesale, supra,* the Commission held the boycott here illegal *per se* after a careful analysis of several factors, including the boycotting parties' dominant market position and the absence of plausible procompetitive justifications.

(a) Despite its preeminent position in toy retailing, TRU denies that it has enjoyed "market power," emphasizing that it accounted for "only" 20% of toy sales

nationally. The Commission properly recognized that this statistic masked the real strength of TRU's market position, which resulted from a combination of much higher market shares in several major metropolitan markets, its unique stature in the toy industry, and the added leverage against manufacturers it derived from its status as a multi-brand dealer. Taken together, these factors gave TRU the ability to induce manufacturers to use their own market power to serve TRU's ends. The result, in the present case, was an output-reducing boycott to stifle a new class of retail competitor. This concrete *exercise* of market power amply justifies the Commission's finding that TRU and the other boycott participants enjoyed dominant market positions.

(b) TRU's only efficiency argument — regarding ostensible "free-riding" by the clubs — is nothing more than a pretext for its anticompetitive scheme. TRU does not offer the sort of presale services that typically support a free-riding argument, and is amply compensated for whatever services it provides. TRU's argument ignores entirely the fundamental basis of free-riding concerns, which is the realistic prospect of reduction of services to consumers. The Commission reasonably found no indication that TRU would or did respond to club competition by curtailing the very business practices that have brought it success.

2. (a) The Commission also assessed the concerted restraints organized by TRU under the rule of reason. Beyond the factors addressed in its *Northwest Wholesale*

analysis, the Commission focused on the actual anticompetitive effects of the TRU-engineered boycott, and concluded that it constituted an unreasonable restraint of trade. The boycott "hobbled" the clubs as retail competitors (Op. 40), depriving consumers of: (1) the enhancement to competition that an innovative, low-cost competitor brings; (2) price reductions that TRU and others would have made to compete with the clubs; and (3) head-to-head product competition that would enable consumers to make meaningful price comparisons.

(b) Equally important, the Commission concluded that these same detriments to competition and consumer welfare would warrant condemnation of TRU's actions under the rule of reason even in the absence of a finding of a horizontal boycott, because the ten vertical agreements TRU entered into with its suppliers imposed unreasonable restraints of trade. TRU advances no plausible benefit to interbrand competition that could justify the serious anticompetitive effects these vertical agreements engendered.

II. The Commission's order is well within its remedial discretion. The order's provisions are all reasonably related to the violations found, and were carefully drawn to alleviate the harm wrought by TRU's unlawful conduct.

ARGUMENT

STANDARDS OF REVIEW

1. This Court reviews the Commission's legal analysis *de novo*. *FTC v. Indiana Federation of Dentists*, 476 U.S. 447, 454 (1986).

2. The "findings of the Commission as to the facts, if supported by evidence, shall be conclusive." 15 U.S.C. § 45(c). Reviewing courts may not "make [their] own appraisal of the [evidence], picking and choosing * * * among uncertain and conflicting inferences." *Indiana Federation of Dentists,* 476 U.S. at 454. This Court has emphasized the "deferential" nature of such "substantial evidence" review. *See Hospital Corp. of America v. FTC*, 807 F.2d 1381, 1386 (7th Cir. 1986). The Commission reviews the ALJ's decision *de novo* (16 C.F.R. § 3.54(a)); "[t]he court's deference is to the agency determination, not that of the ALJ." *Southwest Sunsites, Inc. v. FTC*, 785 F.2d 1431, 1437 (9th Cir. 1986).[19]

3. The Commission's responsibility for determining what relief is necessary - gives it wide discretion in selecting a remedy. *FTC v. National Lead Co*., 352 U.S. 419, 428-29 (1957); *Jacob Siegel Co. v. FTC*, 327 U.S. 608, 612-13 (1946). A

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[19] TRU therefore gains nothing by its complaint that the ALJ drew upon findings proposed by complaint counsel and adopted one proposed finding that had been withdrawn. In any event, the Commission nowhere cited or relied upon the withdrawn finding, IDF 86.

reviewing court may not set aside or modify the Commission's order if the remedy has a "reasonable relationship" to the unlawful conduct. *Id.* at 613; *FTC v. Ruberoid Co.*, 343 U.S. 470, 473 (1952); *Avnet, Inc. v. FTC*, 511 F.2d 70, 79 (7th Cir. 1975).

I. The Commission Properly Found A Violation Of Section 5.

The Commission concluded that TRU had engaged in "unfair methods of competition," in violation of Section 5 of the FTC Act, 5 U.S.C. § 45, applying the standards of Section 1 of the Sherman Act, 15 U.S.C. § 1. *See generally FTC v. Cement Institute*, 333 U.S. 683, 689-93 (1948) (Sherman Act violations redressed as violations of Section 5).

The Commission's conclusions are amply supported. In this appeal, TRU does not challenge the Commission's findings of vertical *agreements* between it and at least ten toy manufacturers.[20] And, as we show below, TRU also orchestrated a horizontal agreement among at least seven of the ten to boycott the warehouse

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[20] Despite TRU's passing assertions that the restrictions on club sales were entirely the product of independent decisionmaking (*e.g.,* Br. 17), its brief nowhere asks this Court to review the Commission's finding that TRU entered into vertical agreements with ten leading toy manufacturers. See Op. 46-50. Accordingly, the issue is waived. *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 667-68 (7th Cir. 1998); *cf. Hospital Corp. of America v. FTC*, 807 F.2d at 1392-93 (declining to address issue raised in "off-hand manner").

clubs. These agreements unreasonably restrained trade. They squelched a new form of competition in toy retailing, deprived consumers of choices and of competitively valuable information, and ultimately restricted output and maintained prices over what they would have been had the clubs been able to compete freely.

A. The Commission Correctly Found That TRU Engineered A Horizontal Agreement Among Toy Manufacturers.

The Commission found that TRU engineered an agreement in which toymakers agreed not to sell certain desirable merchandise to warehouse clubs. TRU contends that there was no horizontal agreement, arguing that the toymakers "independently" adopted restrictive club policies when confronted with the "dichotomous choice" between selling to TRU or selling to the clubs. Br. 26-27. This argument is based, however, on a simplistic view of the situation faced by the manufacturers, ignoring both their expressed unwillingness to restrict club sales "without assurances that competitors would also abstain" (Op. 30), and important reasons why such reluctance was economically rational. TRU overcame these concerns by relaying the assurance, "I'll stop if they stop" from manufacturer to manufacturer (*id.*), thus forging a *joint* undertaking by toy manufacturers to limit the clubs' access to their products.

1. The Commission Applied The Correct Legal Standards In Finding A Horizontal Conspiracy To Boycott The Warehouse Clubs.

The Commission's finding of a horizontal combination based on TRU's "shuttle diplomacy" between competitors is solidly grounded in precedent. Indeed, the pattern of conduct established here is strikingly similar to that in *United States v. Parke, Davis & Co.,* 362 U.S. 29 (1960), where the Supreme Court upheld allegations of both vertical and horizontal conspiracies, based on initiatives by a single firm at one level who elicited commitments to a common plan of action by multiple competitors at another. *See* 362 U.S. at 46-47; *see also Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 735 (1988) (confirming horizontal aspect of *Parke, Davis* holding). As the Commission recognized, TRU's service as an intermediary permitted the toy manufacturers to reach an accord without "hav[ing] to meet to hammer out a horizontal agreement." Op. 52-53.

Furthermore, the Supreme Court has long recognized that a finding of agreement may be based on circumstantial evidence if, analyzed in context, such evidence "tends to exclude the possibility of independent action." *See Monsanto Co. v. Spray-Rite Service Corp.,* 465 U.S. 752, 764, 768 (1984); *Interstate Circuit, Inc. v. United States,* 306 U.S. 208 (1939). The Commission — while noting the caution necessary when applying this principle — explained in detail why the present case

fits within a "sensible reading of *Interstate Circuit,*" for here the manufacturers' actions against the clubs reflected abrupt changes in their business practices, which made sense only as part of an agreed course of action. Op. 53-57. The present case is markedly stronger than *Interstate Circuit,* moreover, because the record here includes *direct* evidence of the sort of communication "that was only probable in *Interstate Circuit*." Op. 57.

TRU does not contest the continuing vitality of *Parke, Davis* and *Interstate Circuit*,[21] but argues that the Commission's findings run afoul of the evidentiary standards articulated in *Monsanto* and in *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). Br. 21-24. On the contrary, the Commission expressly followed (Op. 61-63) and scrupulously applied those standards. *Monsanto*, as already noted, requires only the presence of evidence — direct *or* circumstantial — that "*reasonably tends* to prove * * * a conscious commitment to a common scheme." 465 U.S. at 768 (emphasis added); *see Illinois Corporate*

[21] TRU attempts without success to distinguish these cases factually. For the reasons discussed below (pp. 30-32), TRU's argument that the manufacturers here differ from the retailers in *Parke, Davis* in that the toymakers had no "rational economic incentive" to agree (Br. 35) simply ignores the evidence on which the Commission based its findings. And TRU's effort to distinguish *Interstate Circuit* on the basis of the toymakers' denials of an agreement (Br. 37) fails because the Commission reasonably discredited those denials as contrary to the weight of the evidence. *See* note 39, *infra*.

Travel, Inc. v. American Airlines, Inc., 806 F.2d 722, 726 (7th Cir. 1986). Although a simple showing that defendants have engaged in conduct that would be consistent with a theory of concerted action is not sufficient under *Monsanto*, it is likewise clear that an agreement *need not* be express. *See Isaksen v. Vermont Castings, Inc.,* 825 F.2d 1158, 1164 (7th Cir. 1987); *Parke, Davis,* 362 U.S. at 44 (agreement need not be "contractual").

Nor is there any basis for TRU's suggestion that *Matsushita* somehow heightened the *Monsanto* standards. The Supreme Court itself has explained that *Matsushita* did not "introduce a special burden on plaintiffs * * * in antitrust cases," and did not hold

> that if the [defendant] enunciates *any* economic theory supporting its behavior, regardless of its accuracy in reflecting the actual market, it is entitled to summary judgment. *Matsushita* demands only that the [plaintiffs'] inferences be reasonable in order to reach the jury * * * .

Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451, 468 (1992); *see Rossi v. Standard Roofing, Inc.*, 156 F.3d 452, 466-67 (3d Cir. 1998). Contrary to TRU's assertions (Br. 22), *Monsanto* and *Matsushita* do not allow the Commission's decision to be set aside merely because TRU has articulated a theory of independent conduct, or that TRU assertedly could have achieved the same result without conspiring. The question is simply whether, on the record before the

Commission, there was substantial evidence from which an inference of concerted action could reasonably be drawn.

2. *Substantial Evidence Supports The Commission's Finding That TRU Orchestrated A Horizontal Agreement.*

Based on the testimony of TRU and toy company executives, as well as substantial documentary evidence, the Commission found that "TRU in fact acted as the 'hub' in a conspiracy to disadvantage the clubs by inducing all the key suppliers of toys to adopt parallel restrictions on club sales." Op. 56. To rebut this evidence, TRU hypothesizes possible independent economic motives for the manufacturers to comply with its demands. Br. 23-28. But TRU systematically ignores evidence that conflicts with its position and, in the end, asks this Court to substitute TRU's view of the evidence for the Commission's.

The Commission found that "[m]ost toy companies are saturation retailers, meaning that they seek sales whenever and wherever possible." Op. 44.[22] When TRU began organizing the boycott, the manufacturers were "aggressively" pursuing warehouse club sales (Op. 28-29), because the clubs were the fastest growing market for toys and "the opportunity for growth [was] phenomenal." CX 698-B,

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[22] For example, both before and after the club restrictions were imposed, manufacturers continued to sell to drugstores, despite the fact that they carry few SKUs and do little advertising. *See* Shiffman Tr. 2052-53.

FTC-A21. The clubs presented an opportunity to reduce manufacturers' reliance on TRU (Op. 29; CX 1301), and manufacturers did not want to give up these lucrative sales to their competitors (Op. 29-30; *see* IDF 66-71, TRU-A230-31). Despite these incentives, seven key manufacturers ultimately joined TRU's boycott. As the Commission recognized, this conduct "was squarely *contrary* to the independently determined business interests" of toymakers, unless as part of an agreement that assured each that its rivals would adhere to the same rules. Op. 57.

TRU counters that this Court should reject the finding of a horizontal agreement since toy companies could have decided individually to forgo club sales to curry favor with TRU, their largest and most powerful customer. Br. 27-28. The Commission, however, recognized that manufacturers were not prepared individually to curtail club sales and thus yield business to rivals. "TRU's own executives, from Lazarus to Goddu, with admirable clarity, explained that the toy manufacturers were simply unwilling to comply with TRU's demand unless they were confident that competitors would do the same." Op. 57; *see id.* at 30, citing Lazarus Tr. 5443, FTC-A307; CX 1658-Z4-5, FTC-A69-70. Indeed, TRU's Roger Goddu expressed "frustrat[ion]" that toymakers were unwilling to make commitments "independent of what their competition did." Tr. 6877, FTC-A234.

In speculating why the manufacturers purportedly *should have* found it prudent to bow to its demands, TRU ignores not only the evidence of their actual preferences, but reasons why a rational manufacturer would *not* yield independently. Although TRU asserts that each toymaker faced the "dichotomous choice" of selling to it or the clubs (Br. 26), the reality was not so simple. The record shows, for example, that Hasbro "didn't believe that [the agreement] would stick, meaning that * * * somebody would break and sell promoted product to the clubs, at which time then the door would be open for [Hasbro]." Inano Tr. 3335, FTC-A281; *see* Op. 32. As complaint counsel's expert pointed out, manufacturers had reason to question whether and to what extent TRU would follow through with its threats to stop purchasing items sold to the clubs — implementation of which would also hurt TRU in the short run. CX 1822 ¶¶ 47-48, FTC-A127-28. This uncertainty accentuated the dilemma each manufacturer faced: although acceding to TRU's demands might offer some prospect of gain, it could also lead to the unquestionably *worst* individual result — *i.e.*, losing sales while competitors continued to sell to the clubs without penalty. *Id.* ¶¶ 41-46 & Exhs. 7a, 7b, FTC-A124-27, 162. The horizontal agreement that TRU engineered solved this problem, by "present[ing the plan] to TRU's suppliers in 'competition-free wrapping.'" Op. 53 (quoting *Parke, Davis,* 362 U.S. at 47).

The Commission did not, however, base its finding of a horizontal agreement solely on the fact that manufacturers were acting against their expressly stated (and economically rational) interests. It also focused on extensive evidence of a network of communications in which TRU shuttled from manufacturer to manufacturer, informing each of the other's concerns and facilitating a joint plan of action. "Overall documents and testimony connect at least seven firms — Mattel, Hasbro, Fisher Price, Tyco, Little Tikes, Today's Kids, and Tiger Electronics — to these conversations in which TRU discussed rivals' conduct with respect to TRU's club policy." Op. 31. A Hasbro executive stated, for example, "because our competitors had agreed not to sell loaded [i.e., promoted] product to the clubs, that we would * * * go along with this * * * ." Op. 32. Similarly, a Mattel memorandum memorializing an October 1991 meeting with TRU stated: "I believe we [Mattel] said we would not sell the clubs the same items we were selling to [TRU]. *This was based on the fact that competition would do the same*." Op. 32 (emphasis added). Little Tikes likewise committed to club restrictions only after being reassured that competitor Today's Kids had similarly agreed. DePersia Tr. 2149-51, FTC-A209-11. These statements, reflecting assurances that the toy companies gave and received, provide ample evidence of a "meeting of the minds." *See Monsanto*, 465 U.S. at 764 & n.9.

TRU attacks the Commission's finding that TRU "communicated the message 'I'll stop if they stop' from manufacturer to competing manufacturer" (Op. 30), contending that its executives never admitted doing so. Br. 32. One TRU executive expressly acknowledged, however, that this was *precisely* the message he received from manufacturers. Goddu Tr. 6877, FTC-A234 ("'if my competitor would stop, I'd stop'"). He and other TRU executives then engaged in "frequent and constant" communications with competing manufacturers,[23] conveying that very message:

> I do recall on a general basis us always acknowledging to a vendor that, you know, their competitor would say, "He's there because you're there." We had that conversation ongoing. Because they would always tell us, "I'm only there because my competitor is there." And we would say, "Well, he keeps saying he's only there because you're there."

CX 1658-Z8-9, FTC-A72-73. Following such communications, the manufacturers fell into line, adopting similar (if not identical) policies restricting club sales.[24]

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[23] The evidence is not limited to discussions between TRU and manufacturers; several manufacturers talked directly to each other about their respective practices regarding the clubs. Op. 33. However, such evidence is not essential to this case. As the Commission noted, conspiracies may be proven even where the conspirators reach a meeting of the minds only through an intermediary. Op. 59-60.

[24] TRU also objects that "substantial unanimity was never achieved" and therefore a finding of a horizontal agreement is improper. While TRU's brief conveniently scrambles the facts to obscure the cohesiveness that the toy companies achieved (Br. 34-35), its argument fails because it is contrary to the evidence. *See* Op. 14 n.16, 22 n.24(3), (5), 35 n.30(4); IDF 295, 309-10, TRU-A271-73. The manufacturers indeed adopted essentially the same basic policy of restricting club sales. As the Commission found, "most substantially complied with that policy from approximately early 1993."

Given such a record, it was altogether appropriate for the Commission to conclude that, "[a]t that point a 'conscious commitment to a common scheme' was perfected, and a uniform, clearly interdependent, course of conduct came into being * * * ." Op. 61-62. *Cf. Parke, Davis,* 362 U.S. at 46.

The evidence contradicts TRU's claim that the boycott (Br. 28-34) merely reflects normal communications within the distribution chain. The communications between TRU and the toy companies here differ from what the Court found harmless in *Monsanto* and in *Sharp Electronics*.[25] In those cases, several distributors independently urged a single manufacturer to effect unilateral restrictions. Here, several competing firms at the manufacturing level — where the restrictions were to be imposed — engaged in communications (often with TRU as an intermediary) aimed at achieving a uniform policy. Such a situation poses a far greater threat of lessened interbrand competition.[26]

Op. 63.

[25] For all TRU's reliance on *Monsanto,* it ignores the fact that the Supreme Court there ultimately *upheld* the finding of concerted action. The present record, moreover, includes far more extensive evidence of concerted action than the showing deemed sufficient in *Monsanto*. *See* 465 U.S. at 765-68.

[26] TRU misplaces its reliance (Br. 30-32) on *H.L. Hayden Co. v. Siemens Med. Sys., Inc.,* 879 F.2d 1005 (2d Cir. 1989), and *Davis-Watkins Co. v. Service Merchandise,* 686 F.2d 1190 (6th Cir. 1982). Both cases concerned a single manufacturer's response to multiple complaints from independent dealers. Neither

Finally, the Commission's finding that "TRU requested and then passed complaints about breaches of the boycott agreement from one supplier to another when regular product was found in the clubs" (Op. 34) confirms the participants' commitment to a common scheme. Manufacturers repeatedly complained to TRU about boycott violations, and TRU policed the agreement vigorously, discussing those complaints with the offending party and, in certain cases, imposing sanctions. Op. 33-35. As the Commission found, these practices were parallel to those held illegal in *United States v. General Motors Corp.*, 384 U.S. 127 (1966),[27] for "'[w]hat resulted was a fabric interwoven by many strands of joint action to eliminate the discounters [the clubs] from participation in the market, to inhibit the free choice of

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included the repeated give-and-take among competitors present here. Similarly, cases such as *Market Force, Inc. v. Wauwatosa Realty Co.,* 906 F.2d 1167 (7th Cir. 1990), add nothing to TRU's argument, for they simply recognize that competitors' "aware[ness] of" each other's policies is insufficient to infer collusion. 906 F.2d at 1172. The evidence here goes far beyond a mere showing of such mutual knowledge. *Cf.* TRU Br. 33. Indeed, the record shows that the manufacturers sought and obtained mutual assurances that all would adhere to substantially similar restrictions, *before* making commitments to do so.

[27] TRU's attempt to distinguish *General Motors* on the basis of the "source" of the agreement (Br. 29-30) is meaningless. Although the existence of multiple vertical agreements is not, by itself, proof of a horizontal agreement, this Court has recognized that a horizontal agreement may be "orchestrated through" a single firm at one level. *See Illinois Corporate Travel,* 806 F.2d at 726. TRU offers no support for its supposition that it matters who initiates discussions; the question is simply whether horizontal competitors ultimately agree to a joint course of action.

[toy manufacturers] to select their own methods of trade and to provide multilateral surveillance and enforcement.'" Op. 59 (quoting 384 U.S. at 144).

B. The Commission Correctly Found That The Agreements in This Case Resulted in an Unreasonable Restraint of Trade.

The next question under Section 1 is whether an agreement resulted in an unreasonable restraint on competition. This analysis proceeds either under a *per se* rule or by application of the rule of reason; under either approach, the purpose of the inquiry is to "form a judgment about the competitive significance of the restraint." *National Society of Professional Engineers v. United States*, 435 U.S. 679, 692 (1978).

Per se treatment is confined to agreements that, "because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." *Northern Pacific R. Co. v. United States*, 356 U.S. 1, 5 (1958). "The decision to apply the *per se* rule turns on 'whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output * * * .'" *Northwest Wholesale* 472 U.S. at 289-90 (quoting *Broadcast Music, Inc. v. Columbia Broad-casting System, Inc.*, 441 U.S. 1, 19-20 (1979)).

Where an agreement's competitive effects are not so plain, Section 1 analysis proceeds under the rule of reason. *See Chicago Board of Trade v. United States*, 246 U.S. 231 (1918). Under that rule, a tribunal assesses a restraint's reasonableness, principally in light of its effects on competition or the market power of the parties to the agreement.[28] The analysis takes into account any showing that anticompetitive effects are outweighed by benefits to competition. *Professional Engineers*, *supra*.

The Commission concluded that the horizontal boycott TRU engineered was unlawful under the careful approach of *Northwest Wholesale,* which permits a conclusion of *per se* illegality once a number of factors have been considered. The Commission also concluded that both the horizontal and vertical agreements unreasonably restrained trade, under a full rule of reason analysis. Under either approach, the Commission's order should be affirmed.

[28] As the Supreme Court has instructed, market power is essentially a surrogate for anticompetitive effects. *See Indiana Federation of Dentists*, 476 U.S. at 461.

1. The Horizontal Boycott Was Unlawful Per Se.

Although the term "group boycott" has proven to be less than precise (*see Northwest Wholesale*, 472 U.S. at 293), the agreement orchestrated by TRU is the very sort that has been recognized as a true horizontal boycott: a group of competing suppliers came to a mutual understanding that they would restrict sales to a distinct target group, withholding merchandise that directly competes with that sold to favored customers. Moreover, there was no apparent efficiency-enhancing integration of productive activities, of the sort that took the horizontal arrangements in *Broadcast Music* and *Northwest Wholesale* out of the *per se* category. As the Commission recognized, this stark type of boycott could be condemned without extensive analysis under the Supreme Court's ruling in *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959). Op. 65. Since the Commission's ruling, moreover, the Supreme Court has reaffirmed the vitality of the *Klor's* principle regarding "horizontal agreements among direct competitors," including those that result from "a threat made by a single powerful firm." *See NYNEX Corp. v. Discon, Inc.*, 119 S. Ct. 493, 498 (1998).

The Commission, however, chose not to rely principally on *Klor's*, but on the more nuanced analysis suggested by the Supreme Court's subsequent decision in *Northwest Wholesale.* Using that approach, the Commission condemned the

boycott engineered by TRU only after examining it for four "traits" identified in *Northwest Wholesale*: (1) the boycotts "have generally involved joint efforts by a firm or firms to disadvantage competitors;" (2) "frequently the boycotting firms possessed a dominant position in the relevant market;" (3) "the boycotts have frequently cut off access to a supply, facility, or market necessary to enable the boycotted firm to compete;" and (4) "the practices were generally not justified by plausible arguments that they were intended to enhance overall efficiency and make markets more competitive." *See* 472 U.S. at 294.

TRU does not seriously contest the Commission's findings on points (1) and (3): it does not deny that the very purpose of its campaign was to disadvantage the clubs by restricting their access to products that would allow head-to-head competition. *See* Op. 67, 75. Instead, TRU focuses on the Commission's findings regarding "market dominance" and the lack of any plausible, procompetitive rationale justifying the agreement. The Commission's conclusions on both, however, are correct as a matter of law and well-supported in the record.

(a) The Boycotting Firms Possessed A Dominant Market Position.

Market power is demonstrated by either "direct evidence of the injurious exercise of market power," or, more commonly, "circumstantial evidence pertaining

to the structure of the market." *Rebel Oil Co. v. Atlantic Richfield Co.,* 51 F.3d 1421, 1434 (9th Cir. 1995). This Court has similarly said: "Market share is just a way of estimating market power, which is the ultimate consideration. When there are better ways to estimate market power, the court should use them." *Ball Memorial Hosp., Inc. v. Mutual Hosp. Ins., Inc.,* 784 F.2d 1325, 1336 (7th Cir. 1986).

Ignoring the "direct evidence" of anticompetitive effects in this case, TRU asks this Court to adopt its view of the "circumstantial evidence," and hold that it lacked the market power to accomplish the very effects that it achieved. Those effects, however, are clear: competition from the clubs was stymied; consumers found it more difficult to compare prices; and TRU was relieved of pressure to lower prices. Given these effects, the Commission did not need to engage in further analysis of TRU's "market power." *See Indiana Federation of Dentists*, 476 U.S. at 461.

Nonetheless, the Commission did so, and found ample evidence of TRU's power to harm competition. The Commission first considered standard indicia of market power. While TRU's national share of retail sales was approximately 20%, the Commission recognized that this figure masked TRU's true strength: in many of the *local* markets in which competition for retail sales actually takes place, TRU's strength was far greater, with shares ranging from 35% to 49% in 18 major

metropolitan areas and in excess of 50% in 8 others (as well as in Puerto Rico). Op. 5-6, 70. These are shares that suggest an ability to wield market power over one's rivals or suppliers. *See* Op. 73-74 (collecting cases).

As the Commission recognized, the real salience of TRU's dominance of important local markets as a seller was that it gave it enormous power, as a buyer, in the national wholesale market that is the focus of this case. Op. 70-71. Several other factors, moreover, enhanced TRU's power: substantial barriers to entry as a national retailer (Op. 69; *see* CX 1031-C; CX 1830-G; the dependence of major manufacturers on TRU for a large percentage of sales (Op. 6); TRU's unique position in the industry, as the largest seller of toys with by far the broadest inventory (Op. 70-71);[29] TRU's preeminent position among U.S. firms as a toy retailer in overseas markets (Op. 70); and its status as a multi-brand retailer, able to "amplify" its power by "playing favorites" among suppliers (Op. 71).[30] Taken together, these

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[29] Case law squarely recognizes that market power may flow from a firm's unique product or marketplace position. *See, e.g., Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 17 (1984); *Kodak,* 504 U.S. at 464. TRU gains nothing from *United States Steel Corp. v. Fortner Enterprises, Inc.,* 429 U.S. 610, 621-22 (1977), where the Court simply concluded that the financing defendant offered was not really unique, as other lenders could readily offer it. 429 U.S. at 622; *see Kodak*, 504 U.S. at 464. Here, by contrast, the record demonstrates TRU's singular role in the toy industry and its powerful influence over manufacturers.

[30] TRU contends (Br. 42) that *Brokerage Concepts, Inc. v. U.S. Healthcare, Inc.*, 140 F.3d 494, 517-19 (3d Cir. 1998), rejected reliance on this factor. In that case,

factors gave TRU the ability to induce manufacturers to accept restrictions on their output that would not be possible in a competitive market. In other words, TRU's own market power gave it the leverage to bring the collective power of the manufacturers to bear against the clubs. *Id.* at 72-75.

The boycotting manufacturers, in turn, had great collective power, for they accounted for 40% of the traditional toy market, including a disproportionate share of the most popular toys. Op. 73. The loss of access to those products was the real sting to the clubs.[31] This 40% figure amply meets the *Northwest Wholesale* criterion that the "boycotting firms" possess a "dominant position" in the relevant market. *See* 474 U.S. at 294.

Contrary to TRU's assertions, the Commission's market power analysis was hardly a "radical departure" (Br. 39), but simply a proper application of precedent to

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however, the court rejected a different argument, based on the profit-sensitivity of the entities allegedly subject to market power — an argument which, if accepted, would have implied that 40 sellers had "market power" in a single market. 140 F.3d at 518. That is a far cry from the dominant position TRU enjoyed.

[31] TRU suggests that, whatever the power of the participants, no boycott against the clubs could succeed because the clubs could secure equivalent merchandise from non-boycotting manufacturers. But without popular, directly-competitive products at the clubs, consumers could not make direct price comparisons (s*ee* Op. 38-39), the clubs were rendered ineffective competitors, and overall market competitiveness declined. *Id*. at 39-40; *see* pp. 18-20, *supra*.

the facts of this case.[32] The essence of market power is "the ability to raise prices above competitive levels by restricting output." *Wilk v. American Medical Ass'n*, 895 F.2d 352, 359 (7th Cir. 1990).[33] TRU possessed *and used* precisely that ability, and its contrary arguments simply ignore the Commission's analysis. TRU notes, for example, that it did not exercise monopsony power to induce a reduction of manufacturer output by curtailing its own purchases. Br. 38. But it did not need to do so here; rather, it used the *threat* of lost sales to induce manufacturers to restrict output by limiting their sales to the clubs. While the boycott mechanism through which TRU exercised its market dominance differs from the simple reduction of output by a monopolist, the result was the same: the reduction of output and maintenance of high prices.

Similarly, TRU misses the point by arguing that the presence of competitors like Wal-Mart and Target constrained its ability to raise prices. Br. 41. That TRU

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[32] TRU also faults the Commission for relying, in its market power analysis, upon "output enhancing" aspects of TRU's business. Br. 39, 42. This is a *non sequitur*. A firm may acquire market power by perfectly lawful, output-enhancing means that bring consumer benefits. But that neither means that it lacks market power nor excuses subsequent actions that amount to unlawful *abuse* of that power. *See, e.g., Jefferson Parish,* 466 U.S. at 19.

[33] *Wilk* also points out that "[w]hether market power exists in an appropriately defined market is a fact-bound question, and appellate courts normally defer to [lower tribunal] findings on that issue." *Id*. at 360.

could effect such increases was not the theory of this case; rather, the Commission found that TRU had the power to preserve the comfortable equilibrium it enjoyed with such competitors, by squelching the pressure to *reduce* prices that the clubs would exert if allowed to compete freely.[34] Furthermore, TRU ignores the varying ways in which market power may be wielded. Even if, for example, a 40% share in a metropolitan retail market was not sufficient to permit TRU to raise prices without losing sales to Wal-Mart (*cf.* TRU Br. 41), the record shows that such a market position was indeed enough to enable TRU to alter the behavior of manufacturers, who faced the dire prospect of losing outlets representing 40% of the sales volume in a major market. While TRU insists that this is mere "bargaining power" (Br. 42-43), the fact remains that TRU was able to use its position as a dominant retailer to force concerted, output-reducing actions by a dominant group of manufacturers.[35] By any reasonable definition, this is market power, and TRU's ability to enlist major

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[34] For this reason, the regression analyses on which TRU relies (Br. 19, 43) do not advance its case. Its expert focused on the fact that, in areas where TRU faced a rival such as Wal-Mart or Target, the addition of another similar rival did not engender a further price reduction. RX 877 ¶¶ 246, 247, E250. Such a showing has little bearing on the question whether TRU avoided further downward price pressure by avoiding direct competition with the clubs, which were applying innovative, cost-reducing methods.

[35] TRU's denials of such power contrast with its unabashed assertions about its power to force changes on toymakers by presenting them with the "dichotomous choice" of club sales or sales to TRU. Br. 26.

manufacturers to boycott the clubs plainly meets the "market dominance" trait in *Northwest Wholesale.*

(b) TRU's Efficiency Claims Are Insubstantial.

A restraint in the form of a "boycott" might nevertheless escape condemnation if "'designed to increase economic efficiency and render markets more, rather than less, competitive.'" *Northwest Wholesale*, 472 U.S. at 295 (quoting *Broadcast Music,* 441 U.S. at 20). Recognizing this, the Commission carefully considered the sole efficiency TRU asserted: the ostensible benefit of counteracting free-riding by the clubs. Op. 41-44, 76-82. As the Commission concluded, the record belies any genuine free-riding concerns.

TRU attempts to pose the free-riding issue as one of law, seemingly urging a rule of *per se* legality wherever free-riding concerns are advanced (Br. 43-44) and implying that the Commission imposed a rule that *any* compensation for services solves the problem as a matter of law (*id*. at 46). But the real issue here is factual — *i.e.*, did the restraint protect consumers from a loss they would suffer in its absence? The Commission's negative answer to that question is amply supported.

A "free-rider" problem can arise when competing dealers provide different levels of costly promotional services. If a manufacturer does not compensate a high-service dealer for providing these services, consumers have the opportunity to

shop for a product at one outlet and purchase at a different, lower-cost outlet. If the high-service dealer cannot recoup his costs, he may be forced to reduce services to compete. To prevent such service reductions, a manufacturer may be justified in imposing vertical restraints. *See, e.g.*, *Sharp Electronics.,* 485 U.S. at 731; *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 54-55 (1977). In keeping with the antitrust laws' focus on consumer welfare, however, restraints can only be justified on this ground if, without them, there is a realistic prospect that some valuable services will be "driven from the market." Op. 77; *see id.* at 78 n.65, 80.

The Commission correctly found there is no real prospect of such harm here. First, TRU itself does not offer the kind of services usually associated with free-rider claims. It "provides no customer services such as product demonstration or installation assistance." Op. 79. "There are few if any sales people in a TRU store available to guide or advise shoppers," and no evidence that "anyone sought demonstration or explanation of a toy product at TRU and then purchased the product at a club." *Id*; *see* IDF 481, TRU-A297. Furthermore, vendor compensation ensures that club competition will not diminish TRU's incentive to provide its current level of the other "services" it mentions (Br. 44): advertising and maintaining a full-year, full-line inventory. As acknowledged in a 1993 TRU memorandum,

advertising was "essentially free."[36] Op. 79. TRU is also substantially compensated for carrying a broad range of products throughout the year.[37] Op. 42-43, 79-80. As this Court has repeatedly recognized, the provision of compensation for services alleviates free-riding concerns, for it means that the dealer cannot contend that it can "recover his cost only by selling the product * * * ." *General Leaseways, Inc. v. National Truck Leasing Ass'n,* 744 F.2d 588, 593 (7th Cir. 1984); *see Chicago Professional Sports Ltd. Partnership v. National Basketball Ass'n*, 961 F.2d 667, 675 (7th Cir. 1992).

While TRU attempts to distinguish *General Leaseways* and *Chicago Professional Sports* on the ground that they involved compensation by competitors (Br. 46-47), that argument loses sight of the focus of the analysis: whether, in the restraint's absence, valuable services would likely leave the market. TRU's ability to receive compensation for the functions it performs — as well as the competitive

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[36] As TRU's economic expert has explained, compensation can vitiate free-rider claims. *See* D. Carlton & J. Perloff, *Modern Industrial Organization* 531 (2d ed. 1994) ("advertising subsidy from the manufacturer to the dealer prevents the free-riding problem from eroding the distributor's incentive to advertise"). In the toy industry, moreover, demand for new products is generated principally by manufacturer television advertising. IDF 470, TRU-A296. As Professor Carlton also noted in *Modern Industrial Organization*, at 530, "[i]f the manufacturer takes over the sales effort and handles the advertising, it does not have to worry about free riding among distributors."

[37] As TRU's CEO explained, TRU's early purchases are "financed in large part by the manufacturers * * *. You buy now; you pay later." Op. 42.

advantages it derived from performing them (IDF 491-93, TRU-A299) — made it most unlikely that it would curtail those services. As the Commission recognized, there was "no reason to expect" that TRU would alter the very business practices — such as providing an "unusually broad year-round inventory" — that had brought it such success.[38] Op. 80; *see id.* at 44 n.38.

Indeed, as the Commission found, TRU's free-riding concerns are simply a pretext; there was no indication, before TRU began its campaign against the clubs, that any manufacturer (or even TRU itself) was genuinely concerned about free riding. Op. 45 & n.39, 82; CX 1831-E.[39] The lack of any such expressions of

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[38] The Commission found no indication that club competition would induce TRU to reduce the number of items it stocks below the level it set in 1996. Op. 80. The 1996 reduction was not even aimed at free-riding concerns, but at TRU's desire to "create a cleaner looking shopping floor." *Id.* Moreover, TRU made that change as a competitive response to Wal-Mart; it was plainly not a response to the clubs, whose sales had peaked four years previously. *Id.*

[39] Some manufacturers testified about supposed free-riding concerns, but the Commission agreed with the ALJ that such testimony was not credible, relying in part on the absence of contemporaneous documents expressing any such concern. Op. 45 n.39. In its vehement attack on this point (Br. 14 n.4), TRU itself gets the facts wrong. Regardless of what limitations Fisher Price may have placed on "allocated or new items" (Br. 14), the 1990 document on which TRU relies gives no indication of the sort of broader ban on sales of regular-line items that TRU later insisted on, and says nothing whatever about free-riding. RX 280, E16.

Furthermore, the Commission's finding regarding the pretextual nature of TRU's free-riding assertions is supported by the entire record, including "testimony from TRU's own officials that the club policy was difficult to implement" because of

concern *by manufacturers* is particularly significant. As this Court has explained, antitrust law generally takes a benign attitude toward manufacturers' efforts to combat free-riding because the economic interests of manufacturers tend to be aligned with those of consumers. *See Premier Electrical Construction Co. v. National Electrical Contractors Ass'n*, 814 F.2d 358, 369 (7th Cir. 1987). "Destroy that alignment and you destroy the power of the argument." *Id.* The present record makes abundantly clear that manufacturers adopted club restrictions not on the basis of free-riding concerns, but in response to pressure from TRU (and the assurances it conveyed regarding competitor compliance). The Commission properly concluded that the club restrictions were not an effort to preserve services and benefit consumers, but simply a means of "eliminat[ing] the increasing competition provided by the clubs * * * ." Op. 82.

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manufacturers' reluctance (Op. 45 n.39), and evidence showing that club competition would not plausibly result in any withdrawal of services. Resolving arguable conflicts in the evidence and assessing credibility are prerogatives of an administrative agency, with which this Court does not interfere on substantial evidence review. *See, e.g., Brewer v. Chater*, 103 F.3d 1384, 1390 (7th Cir. 1997).

2. *TRU's Conduct Was Unlawful Under the Rule of Reason.*

The Commission also assessed the club restrictions under a full rule of reason analysis. Op. 83-88. Drawing on its extensive consideration of the *Northwest Wholesale* factors, as well as its assessment of the restrictions' competitive effects, the Commission concluded that TRU's actions were unlawful under the rule of reason. *Id.* First, it concluded that the horizontal boycott agreement orchestrated by TRU, even if not subject to *per se* condemnation, unreasonably restrained trade. Op. 83-87. Second, it concluded that the restrictions engineered by TRU unreasonably restrained trade even under a purely "vertical" analysis — *i.e., even if* one were to conclude, in spite of the strong evidence discussed above, that there was no meeting of the minds among manufacturers. Op. 87-88. This holding is important for the disposition of the present appeal, since TRU has now waived any argument against the Commission's findings that TRU entered into at least *ten vertical agreements* with individual manufacturers (*see* note 20, *supra*) — agreements the very purpose of which was to restrict the clubs' access to toy products. Accordingly, the Commission's order should be upheld under the rule of reason, *whether or not* this Court upholds the Commission's finding of a horizontal agreement among toymakers. *Cf.* Swindle Op., TRU-A441-46.

(a) The Horizontal Boycott Unreasonably Restrained Trade.

In its full rule of reason analysis, the Commission added, to the considerations already reviewed under the *Northwest Wholesale* approach, an assessment of the marketplace effects of the TRU-engineered restraints. Op. 84-85, 88.[40] While TRU's brief ignores the impact of its boycott, that impact was real and substantial. The clubs' overall sales grew impressively between 1990 and 1995. CX 1824. With respect to toys, the clubs were selling 1.9% of all toys in the United States by 1992 (Op. 40) and appeared to be "growing like a weed" (Goddu Tr. 6807, FTC-A231). Before initiating the boycott, TRU itself predicted that, by 1997, the clubs would sell 6-8% of all toys. Op. 12; IDF 54, TRU-A228. This did not happen, however. After the boycott took effect, the clubs' share fell and by 1995 was only 1.4%. Op. 40; CX 1822, Exh. 4a, FTC-A157. The Commission found Costco's experience "illustrative" (Op. 40):

> While [Costco's] overall growth on sales of all products during the period 1991 to 1993 was 25%, Costco's toy sales increased during the same period by 51% * * * . But, after the boycott took hold in 1993, Costco's toy sales *decreased* by 1.6% despite total sales growth of 19.5% * * *. This change reflects the sudden loss of supply of key toy products.

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[40] As this Court has recognized, the assessment of actual and likely competitive effects is a factual inquiry as to which judicial deference to the Commission is appropriate. *See Hospital Corp. of America,* 807 F.2d at 1386.

TRU protests that, in focusing on the neutralization of the clubs as effective competitors, the Commission confuses injury to competitors with injury to competition. Br. 38-39. Not so. The Commission recognized that, under the rule of reason, the focus is on harm to the competitive process. Op. 84-85. But the Commission also recognized that the clubs represent "a distinctly new and efficient method of distribution," elimination of which would shield incumbent firms from competitive pressures. Op. 84. That the clubs' sales have not yet exceeded 2% of the national market does not mean they are competitively insignificant, but simply that they were prevented from achieving the growth TRU feared. Restraints having such an impact represent a serious detriment to competition — as would efforts to eliminate any small-but-emerging competitive force, such as internet retailing. *See generally International Travel Arrangers, Inc. v. Western Airlines, Inc.,* 623 F.2d 1255, 1268 (8th Cir. 1980). This Court has recognized that exclusion of individual competitors can indeed be "cause for antitrust concern" if (as here) the likely effect is to increase price or reduce output, or "otherwise [to] injure competition." *Roland Machinery Co. v. Dresser Indus., Inc.,* 749 F.2d 380, 394 (7th Cir. 1984).

In this case, anticompetitive effects are not only likely but demonstrable. Although TRU previously lowered prices in response to club competition, it was no longer "embarrassed" into doing so once the boycott restricted club supplies. Op.

84. The Commission found that, had TRU met club competition with price reductions on its most popular items, consumers would have saved $55 million per year in purchases at TRU alone. Op. 41; CX 1822 ¶ 58, FTC-A135-36. Had other retailers followed suit (a likely event), savings would have been even greater. *See id.*; Goddu Tr. 6616, FTC-A225; Blaine Tr. 6372, FTC-A201. Loss of such a price reduction is a serious detriment to consumers, equally subject to condemnation under the antitrust laws as a collusive price increase. *See FTC v. Staples, Inc.,* 970 F. Supp. 1066, 1082-83 n.14 (D.D.C. 1997).

The Commission also found that these restraints upset the market's price-setting mechanism. "The whole point of [TRU's] club policy was to deny the clubs product, or at least product in a form capable of being compared to TRU's products, in order to eliminate price competition." Op. 75. As the Supreme Court has recognized, depriving consumers of information needed to make meaningful price comparisons is itself a significant anticompetitive effect, for it "disrupt[s] the proper functioning of the price-setting mechanism of the market * * * ." *Indiana Federation of Dentists*, 476 U.S. at 461-62.

Under the rule of reason, an otherwise unreasonable restraint may be tolerated if there are sufficient countervailing competitive benefits. In the present case, the only ostensible benefit of the club restrictions that TRU proffered is their

supposed role in countering free-riding.[41] As already shown, however, any such benefits are wholly illusory, for there was no realistic prospect that consumers would lose valuable services. Accordingly, the boycott agreement engineered by TRU poses serious and unalloyed detriments to competition, and was properly condemned.

(b) The Vertical Agreements Themselves Unreasonably Restrained Trade.

As the Commission recognized, the *effects* of the restraints TRU engineered are every bit as serious, even if one assesses them solely as the product of a series of vertical agreements between TRU and its suppliers. Op. 88. Such a rule of reason assessment must take into account the fact that each of the vertical agreements was entered into as part of an acknowledged *pattern* of agreements, the common goal of which was systematically to restrict the supply of toys to the clubs. Where, as here, a party has engaged in a course of conduct, it is error to "compartmentaliz[e] the various factual components" of the case. *Id.*; *Continental Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690, 698 (1962). Thus, even

[41] TRU also claims, in passing, that its conduct was designed to address product shortages. Br. 10-11. But testimony of a TRU executive regarding the policy's purpose (*see* IDF 110, TRU-A241; CX 1651-Z25, FTC-A49) and evidence that even "old and basic product" sold to clubs had to be in special packs (CX 1681, FTC-A100) belie this contention.

if there were insufficient evidence of a horizontal boycott, the collective impact of the vertical agreements whose existence is now unchallenged comprises *all* of the anticompetitive effects discussed in the preceding section. The vertical restraints must therefore be condemned under the rule of reason unless there are compensating efficiencies.

In the context of a restrictive vertical agreement, the ostensible benefit that would usually be proffered is a possible enhancement of interbrand competition (at the expense of some loss of intrabrand competition), deriving from the restraint's enhancement of a particular brand's ability to compete. *See generally Continental TV, Inc. v. GTE Sylvania, Inc., supra*. As the Commission recognized, however, there were no such potential enhancements of interbrand competition here. Op. 85. TRU offered no manufacturer special treatment, but rather a "level playing field" for major toymakers. Op. 31. Thus, implementation of vertical restraints did not provide enhancements to any particular manufacturer's distribution that would give it an edge and spur interbrand competition. On the contrary, interbrand competition among toymakers to gain access to an effective, low-cost outlet was stifled.

II. The Commission's Order Is Reasonable.

The Commission's final order (TRU-A346-48) is straightforward. It requires TRU to refrain from agreeing with or pressuring suppliers to limit sales to toy discounters (¶¶ II.A, II.B); it prevents TRU from requesting information from suppliers about sales to discounters (¶ II.C); and it prohibits TRU from arranging agreements among suppliers to limit sales to discounters (¶ II.D). For a period of five years, it also bars TRU from refusing to make purchases from a supplier because that supplier sold toys or related products to any discounter, or from announcing in advance that it will do so. ¶ II.E.

These provisions all relate directly to the very conduct the Commission has held illegal. They are "reasonably related" to TRU's unlawful practices and accordingly within the Commission's remedial discretion. *Jacob Siegel Co.,* 327 U.S. at 611-13; *Ruberoid Co*., 343 U.S. at 473; *Avnet, Inc.,* 511 F.2d at 79. The Commission is not limited to prohibiting the precise practice that existed in the past; it may also restrain "like or related" acts. *FTC v. Mandel Bros., Inc.*, 359 U.S. 385, 393 (1959). Moreover, it may restrain otherwise lawful commercial practices that have served as the means to effect an unlawful result. *See National Lead*, 352 U.S. at 425; *Jacob Siegel Co.,* 327 U.S. at 611-12. As this Court has explained, a law

violator "'must expect some fencing in.'" *Hospital Corp. of America v. FTC*, 807 F.2d at 1393 (quoting *National Lead*, 352 U.S. at 431).

TRU complains that the order will force "irrational dislocations" on the market, interfering with its "right" to decline merchandise for any reason and imposing a "gag order" on "protected" communications with suppliers. Br. 48-49. These overwrought protests are without merit. As the Commission pointed out, the provision TRU attacks as violating its "*Colgate* rights"[42] leaves it free to make stocking decisions based on a wide range of business reasons; it must simply make those decisions — for a period of five years — independent of whether clubs or other discounters are carrying the same item. Op. 89. While this may result in TRU's facing some of the head-to-head competition it has sought to avoid, the Commission reasonably concluded that this modest step was necessary to remedy TRU's unlawful (and successful) campaign to stifle competition from the clubs.[43] Similarly, the Supreme Court's recognition that dealer-supplier communications *often* serve competitive purposes (*Monsanto*, 465 U.S. at 763-64) is entirely consis-tent with the Commission's imposition of carefully-tailored restrictions on the very

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[42] *United States v. Colgate & Co.*, 250 U.S. 300 (1919).

[43] Specifically, this provision is needed to dissipate the effects of TRU's unlawful conduct, by making clear to suppliers who have restricted club sales through concerted action that they are indeed now free to change course and sell to the clubs.

type of communications TRU used to further unlawful ends. *See* Op. 89. The Commission's order violates no "right" of TRU,[44] but is a measured response to TRU's unlawful conduct.

CONCLUSION

For the foregoing reasons, the Commission's order should be affirmed and enforced.

Respectfully submitted,

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[44] As the Commission noted, *Colgate* does not define distinct "rights" but simply "describes the boundary between concerted conduct * * * and unilateral conduct" — a boundary that TRU repeatedly crossed. Op. 89.

CERTIFICATE OF COMPLIANCE

I hereby certify, pursuant to Fed. R. App. P. 32(a)(7), that the foregoing brief complies with the type-volume limitations of that rule. The brief — excluding tables of contents and authorities, this certificate, and the certificate of service — contains 13,944 words, as counted by the WordPerfect 8 word-processing system used to prepare the brief.

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