Federal Trade Commission

Vertical Restraints & Sherman Act § 2

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When I started practicing antitrust law in the mid-1960s, courts and the agencies had summarily condemned a variety of practices – tying, exclusive dealing, vertical mergers to name a few – under Clayton Act § 3, Sherman Act § 1, and the Federal Trade Commission Act § 5. However, practices that were once *per se* illegal under Sections 1 and 3 are now practically *per se* legal under those statutes. The discussion of the legality of vertical restraints under those statutes has been relegated to an academic debate between a small number of economists and an even smaller group of lawyers. Indeed, since 1980, the courts have rarely condemned, and the agencies even more rarely challenged, vertical practices largely because of the influence of academics and economists associated with the Chicago School who demonstrated that in many instances these practices were not only benign but efficiency enhancing. The one exception to this trend has been the application of these theories in Section 2 cases.

[1] The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my attorney advisor Kyle Andeer for his invaluable assistance in preparing this paper.

Historically speaking, exclusive dealing, tying, bundled discounting, and other vertical non-price restraints were rarely challenged under Section 2. The reluctance to bring these claims was likely a function of the fact that plaintiffs must prove that the defendant enjoyed monopoly or near-monopoly power as a threshold matter to sustain any claim under Section 2.[2] Yet over the last decade, several courts have sustained challenges to exclusive arrangements, tying claims, bundled discounts and other vertical practices under Section 2 despite finding that the facts did not support liability under Section 3 of the Clayton Act or Section 1 of the Sherman Act.[3]

It is the emergence of these two trends – a movement away from a standard of *per se* condemnation of vertical restraints and towards a standard of virtual *per se* legality under Section 1 or Section 3, and a movement toward liability for these same practices under Section 2 – that is the subject of my remarks today.

A. First Trend: Fewer Challenges to Vertical Restraints under Section 1 of the Sherman Act and Section 3 of the Clayton Act.

For a number of years vertical restraints were treated as *per se* illegal under Section 1 of the Sherman Act and Section 3 of the Clayton Act.[4] Exclusive dealing agreements, and to some

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[2] Prior to the Supreme Court's decision in *Spectrum Sports v. McQuillan*, 506 U.S. 447 (1993), an attempt to monopolize could be established in the Ninth Circuit simply by proof of anticompetitive conduct and a specific intent to monopolize, but vertical practices were generally challenged under the other statutes anyway.

[3] *United States v. Dentsply Int'l Inc.*, 399 F.3d 181 (3d Cir. 2005); *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003); *Conwood Co., L.P. v. U.S. Tobacco Co.*, 290 F.3d 768, 783 (6th Cir. 2002); *United States v. Microsoft Corp.*, 253 F.3d 34, 59 (D.C. Cir. 2001); *McKenzie-Willamette Hosp. v. Peace Health*, 2004-2 Trade Cas. (CCH) ¶ 74,600, at 100,610 (D. Or. 2004).

[4] *Dr Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911); *Albrecht v. Herald Co.*, 390 U.S. 145 (1968); *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967); *Northern Pacific Railway Co. v. United States*, 356 U.S. 1, 5-6 (1958) ("'Tying agreements serve hardly any purpose beyond the suppression of competition,'"). Plaintiffs have sought to challenge bundled discount strategies as *per se* unlawful tying arrangements under

extent tying arrangements, were often challenged under Section 3 of the Clayton Act, which, on its face is a prophylactic statute. Section 3 prohibits not only exclusive dealing arrangements that actually restrain competition (as required by Section 1), but it also prohibits any "lease, sale or contract of sale of commodities . . . that is conditioned on . . not dealing with a competitor or competitors, where the effect *may be* to substantially lessen competition or tend to create a monopoly." Even when the Supreme Court recognized that an exclusive dealing arrangement could have pro-competitive benefits, as it did in *Standard Oil Co. v. United States* (*Standard Stations*)[5], the Court held that full rule of reason analysis was not needed to condemn such an arrangement; the "substantial lessening of competition" requirement in Section 3 was "satisfied by proof that competition had been foreclosed in a substantial share of the line of commerce."[6]

1976 is generally described as the watershed year for vertical restraints. That year, the Supreme Court held in *GTE Sylvania*[7] that non-price vertical restraints like customer and territorial restraints and location clauses were not *per se* illegal but instead had to be analyzed under the rule of reason. However, it is strongly arguable that the dam was breached a decade and half earlier when the Court decided *Tampa Electric*.[8] In that case, the Court held that while the "percentage of the market foreclosed" by an exclusive dealing arrangement was relevant in

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Section 1 and Section 3. *See SmithKline Corp. v. Eli Lily & Co.*, 575 F.2d 1056 (3d Cir.) cert. denied, 439 U.S. 838 (1978) (affirming the rejection of the plaintiff's challenge to defendant's bundled discounting program as a *per se* illegal tying arrangement under Section 1 of the Sherman Act.).

5 337 U.S. 293, 306-07 (1949).

6 *Id*. at 313-14.

7 *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977).

8 *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961).

assessing its effects, contrary to *Standard Stations* it was not dispositive; courts could and should examine other factors such as the duration, purpose, and effect of the arrangement in assessing its legality. In holding that the exclusive dealing arrangement did not violate Section 3 (or *a fortiori,* Section 1) under that analysis, the Court arguably embraced the rule of reason rather than *per se* treatment in dealing with challenges to exclusive dealing arrangements.

There is no question that in the thirty years since *Sylvania*, challenges to vertical restraints have grown far more difficult for plaintiffs. That has been true for vertical price restraints – *Kahn*[9] repudiated *Albrecht* and no matter what happens in *Leegin*[10] the very high standard required in *Monsanto*[11] and *Sharp Electronics*[12] to prove an "agreement" in vertical price fixing cases has gutted *per se* illegality in vertical minimum price fixing cases *de facto.* After *Jefferson Parish,*[13] tying is *per se* illegal in name only as lower courts increasingly require proof of market power in both the tying and tied product markets.[14]

The evolution of the Section 3 and Section 1 law respecting the treatment of exclusive dealing agreements has been, if anything, even more hostile to plaintiffs using those statutes to attack such arrangements. As I have observed before, "nearly all exclusive dealing agreements

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9 *State Oil Co. v. Khan,* 522 U.S. 3 (1997).

10 *Leegin Creative Leather Prods. v. PSKS, Inc.,* 127 S. Ct. 763 (2006), *granting cert.* to Fed. Appx. 464 (5th Cir. 2006).

11 *Monsanto Co. v. Spray-Rite Serv. Corp.,* 465 U.S. 752, 761 (1984).

12 *Business Electronics Corp. v. Sharp Electronics Corp.,* 485 U.S. 717, 724 (1988).

13 *Jefferson Parish Hosp. Dist. No. 2 v. Hyde,* 466 U.S. 2 (1984).

14 *See e.g., Hack v. President and Fellows of Yale Coll.,* 237 F.3d 81, 86 (2d Cir. 2000); *United Farmers Agents Ass'n v. Farmers Ins. Exch.,* 89 F.3d 233, 235-36 (5th Cir. 1996); *Carl Sandburg Vill. Condominium Ass'n v. First Condominium Dev, Co.,* 758 F.2d 203, 210 (7th Cir. 1985).

that were challenged in the courts of appeals under Section 3 and Section 1 were held to be legal, as a matter of law."[15] Those cases, moreover, were decided by some of the most distinguished antitrust scholars sitting on the federal bench – Judge Breyer in *Barry Wright*,[16] Judge Posner in *Roland Machinery Co. v. Dresser Indus.*,[17] Judge Boudin in *U.S. Healthcare v. Healthsource*,[18] and Judge Easterbrook in *Paddock Publications*.[19]

B. Second Trend: Challenges to vertical restraints under Section 2 of the Sherman Act.

Several recent appellate courts have condemned exclusive dealing, bundled discounting strategies that create virtual exclusivity, and even tying arrangements under Section 2 of the Sherman Act.[20] In several of those cases, the court explicitly dismissed challenges to those practices under Section 1 while simultaneously sustaining challenges to the same practices under Section 2 of the Sherman Act.

The roots of this recent trend in Section 2 can be traced to the Third Circuit's 1978 decision *SmithKline*.[21] In that case, the court found that Eli Lilly violated Section 2 when it sold

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[15] J. Thomas Rosch, "The Evolution of Exclusive Dealing Law," 7 THE SEDONA CONFERENCE JOURNAL 51, 52 (2006).

[16] *Barry Wright Corp. v. ITT Grinnell* Corp., 724 F.2d 1228 (1st Cir. 1983)

[17] *Roland Machinery Co. v. Dresser Indus.*, 749 F.2d 380 (7th Cir. 1984).

[18] *U.S. Healthcare, Inc. v. Healthsource, Inc.*, 986 F.2d 589, 594 (1st Cir. 1993).

[19] *Paddock Publications, Inc. v. Chicago Tribune Co.*, 103 F.3d 42, 47 (7th Cir. 1996).

[20] *See Microsoft*, 253 F.3d 34; *Conwood*, 290 F.3d 768; *see also* Tyler Baker, "Thoughts on Exclusive Dealing and Related Practices," 7 THE SEDONA CONFERENCE JOURNAL 43, 48-50 (2006).

[21] S*mithKlineCorp.*, 575 F.2d 1056.

a bundle of three pharmaceuticals – two of which were patented and thus faced no competition – at a deep discount over what it charged for each of the three products separately. The Third Circuit held that the purpose and the effect of Eli Lilly's strategy was to eliminate the competition it faced in the third product by making it impossible for its competitor to profitably match its discounts.[22] In other words, the discounting practices were such that rival SmithKline was foreclosed from the marketplace.

For a number of years that case stood as an outlier. However, the D.C. Circuit's decision in *Microsoft* reignited the debate over the legality of "exclusive" practices under Section 2. The government alleged that Microsoft's exclusive dealing arrangements with distributors and its integrating, or technological tying, its internet browser to its operating system software were *per se* violations of Section 1. It also alleged that those same practices allowed Microsoft to illegally maintain its operating system monopoly in violation of Section 2. The monopolization claim focused on the defensive effect of these practices in preserving Microsoft's operating system monopoly.

As to the exclusive dealing claims, the district court dismissed the Section 1 count because Microsoft had not "completely excluded Netscape" from reaching any potential user. However, the district court, and ultimately the D.C. Circuit, found that those same agreements supported liability under Section 2 of the Sherman Act despite the fact that those agreements foreclosed less than the roughly 40% or 50 % share usually required to establish a Section 1 violation.[23] The D.C. Circuit held that by foreclosing a substantial percentage of the available

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[22] *Id*. at 1065.

[23] *Microsoft*, 253 F.3d at 70.

opportunities for browser distribution, Microsoft managed to preserve its monopoly in the market for operating systems.

As to the tying claims, the district court found that Microsoft's efforts to integrate its browser into its operating system software violated both Sections 1 and 2 of the Sherman Act. The D.C. Circuit reversed the district court's findings on the Section 1 claim after it held that the per se rule was inappropriate where the tying product is "software whose major purpose is to serve as a platform for third-party applications and the tied product is complementary software." It remanded the issue to the district court to review the practice under the rule of reason. However, it found that some of Microsoft's efforts to integrate its browser violated Section 2.

In 2002, the Sixth Circuit upheld a jury verdict against U.S. Tobacco for violating Section 2 of the Sherman Act.[24] In that case, there was evidence that U.S. Tobacco had engaged in a variety of conduct with the purpose and effect of excluding competition. The appellate court condemned U.S. Tobacco's so-called "exclusive vending" agreements with retailers under which U.S. Tobacco was the exclusive supplier of display racks for the relevant product at those retailers. These racks were emblazoned with U.S. Tobacco advertising and prominently featured U.S. Tobacco's products to the detriment of its competitors. The Sixth Circuit was concerned with the effect of these and other practices on the maintenance and durability of U.S. Tobacco's moist snuff monopoly.

The Third Circuit had the opportunity to analyze these practices in a pair of recent decisions – *LePage's* and *Dentsply*. In *LePage's*, the Third Circuit confronted challenges to exclusive dealing and bundled discount practices. At trial, the jury found that the defendant's

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[24] *Conwood*, 290 F.3d 768.

exclusive dealing agreements did not violate Section 1 or Section 3, but that those same agreements and the defendant's bundled discounting program violated Section 2.[25] The Third Circuit, in a decision which has spawned a great deal of debate, affirmed the jury's verdict after it concluded that 3M's exclusive dealing arrangements *and* bundled rebates allowed it to exclude LePage's from the market in violation of Section 2.[26] The court found that it was impossible for LePage's to meet 3M's discounts because it did not sell the same array of products.

In *Dentsply,* the Third Circuit focused squarely on the treatment of exclusive dealing under Section 2. The district court rejected the government's allegations that Dentsply's exclusive agreements with a number of the largest distributors violated sections 1 and 2 of the Sherman Act and section 3 of the Clayton Act. The district court found that competing suppliers were not completely foreclosed from the market because there were at least some alternative means of distribution, such as direct distribution. The government's appeal focused solely on its Section 2 claim, and the Third Circuit held that the test under Section 2 was "not *total* foreclosure, but whether the challenged practices bar a substantial number of rivals or severely restrict the market's ambit (citing *LePage's* and *Microsoft*)."[27] In reversing the district court's

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[25] The court explained that a finding in favor of the defendant under Section 1 of the Sherman Act and Section 3 of the Clayton Act did not "preclude the application of evidence of . . exclusive dealing to support the [Section] 2 claim." *LePage's*, 324 F.3d at 157. *See also Dentsply*, 389 F.3d 197.

[26] *LePage's*, 324 F.3d at 158. The Third Circuit cited evidence that the foreclosure caused by exclusive dealing practices was magnified by 3M's discount practices, as some of 3M's rebates were "all-or-nothing" discounts, leading customer to maximize their discounts by dealing exclusively with the dominant market player, 3M, to avoid being severely penalized financially for failing to meet their quota in a single product line. Only by dealing exclusively with 3M in as many product lines as possible could customers enjoy the substantial discounts.

[27] 399 F.3d 191.

decision, the Third Circuit found that Dentsply's exclusive agreements allowed it to "keep sales of competing teeth below the critical level necessary for any rival to pose a real threat to Dentsply's market share."[28] The exclusive agreements protected its monopoly from new competition because new entrants could not access effective distribution channels.

The Ninth Circuit is currently weighing some of these issues in an appeal from a jury verdict in favor of the plaintiff in *McKenzie-Willimette v. PeaceHealth*.[29] McKenzie-Willimette alleged that PeaceHealth violated Sections 1 and 2 of the Sherman Act by engaging in tying, exclusive dealing, conspiracy to monopolize, attempted monopolization, and monopolization in the hospital services market. The jury found that the PeaceHealth attempted to monopolize the market. Among the evidence that supported that finding were PeaceHealth's exclusive agreements with managed care organizations, restrictive agreements with physicians, and restrictive covenants.[30] However, the most attention on appeal has been directed at PeaceHealth's pricing practices which allegedly involving price bundling and discounting.[31] The district court cited *LePage's* with approval and held that "a monopolist's bundling of products to reward buyers with discounts for purchasing multiple products could reasonably be viewed as improper." PeaceHealth's appeal to the Ninth Circuit focuses on the appropriate standard for

28 *Id.*

29 *PeaceHealth*, 2004-2 Trade Cas. (CCH) ¶ 74,600, at 100,610 (D. Or. 2004).

30 *Id.* at 10.

31 *Id.* at 11 ("The jury also heard evidence suggesting that defendant exploited its monopoly in tertiary services by bundling strategic discounts for these services to obtain competitive advantages.").

evaluating these discounts.[32]

These recent cases illustrate two trends in the Sherman Act case law. On the one hand, the standards for liability under Section 1 (and Section 3 of the Clayton Act) have toughened considerably over the last three decades as *per se* rules for exclusive dealing and tying practices have fallen into disfavor. In fact, in the twenty years since *Jefferson Parish* I am not aware of any court upholding liability for exclusive dealing practices under Section 1 or Section 3 – and I am aware of only a handful of tying cases in which liability was found under one of those two statutes. On the other hand, there has been a series of cases recognizing liability for these practices under Section 2. The standard applied to the claims under Section 2 are different. Indeed, in many of those cases the court rejected the Section 1 or Section 3 challenges to the conduct while at the same time finding that same conduct violated Section 2.

Today, from a plaintiffs' standpoint, a Section 2 challenge is more attractive than a Section 1 or Section 3 challenge even though monopoly or near monopoly must be proved, given the way the case law has evolved during the past three decades. This raises two questions – the first goes to the cause of these trends; the second is what is likely to happen in the future.

As to why, I think there are three reasons. First, from a court's standpoint Section 2 is attractive because it imposes a limiting principle on a challenge to these practices that does not exist when the challenge is mounted under Section 3 or Section 1. Absent a showing of monopoly or near-monopoly power, a Section 2 claim will fail.

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[32] The Ninth Circuit issued an order soliciting amicus briefs to address the question of the appropriate standard. *Cascade Health Solutions v. PeaceHealth*, Order Requesting Amicus Briefing (Mar 20, 2007) *available at* http://www.ca9.uscourts.gov/ca9/newopinions.nsf/F8B20F9778A1E58C882572A3007823D7/$file/0535627o.pdf?openelement. A number of amicus briefs were filed in mid-April 2007.

Second, from a plaintiffs' standpoint, a Section 2 claim is especially attractive to a lay jury. While there is case law stressing that "zero-plus-zero equals zero," there is substantial case law blessing proof that is often derisively called "monopoly broth" – evidence that the tying, bundling, or exclusive dealing is just part of an overall course of exclusionary conduct including even some lawful conduct.[33]

Finally, although there is abundant (and I think sound) Section 2 case law to the effect that proof of anticompetitive purpose or intent, standing alone, will not support a Section 2 claim, there is also authority that this evidence may illuminate the effects of the conduct at issue – i.e., whether it is likely to foreclose competition. From a plaintiff's standpoint, that evidence can be dynamite.[34]

As to what these considerations portend for the future, I would make two observations. The first is that the Chicago School critique of vertical restraints, echoed by many microeconomists, are not limited to Sections 1 and 3. Many in those circles criticize the decisions finding liability for these practices under Section 2 in *LePage's*, *Dentsply*, and *Conwood*. They seem to liken these decisions to the opening of Pandora's Box – that these cases

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[33] *See Continental Ore Co. v. Union Carbide and Carbon Corp.*, 370 U.S 690, 698-99 (1962); *City of Mishawaka v. American Electric Power Co.*, 616 F.2d 976; *Conwood Co., L.P. v. United States Tobacco Co.*, 2000-2 Trade Cas. (CCH) ¶ 73,077, at 89,014 (W.D. Ky. 2000). *But see Intergraph Corp. v. Intel Corp.*, 195 F.3d 1346, 1366-67 (Fed. Cir. 1999); *MCI Communs. Corp. v. AT&T*, 708 F.2d 1081 (7th Cir. 1983).

[34] *See In re Rambus*, 2006 FTC LEXIS 60 at 174-175 (2006); *Microsoft*, 253 F.3d at 59 ("[e]vidence of the intent behind the conduct of a monopolist is relevant . . . to the extent it helps us understand the likely effect of the monopolist's conduct."); *Chicago Board of Trade v. United States*, 246 U.S. 213, 238 (1918)("[K]nowledge of intent may help the court to interpret facts and to predict consequences."); *United States Football League v. NFL*, 842 F.2d 1335, 1359 (2d Cir. 1988) ("Evidence of intent and effect helps the trier of fact to evaluate the actual effect of challenged business practices in light of the intent of those who resort to such practices.").

will spawn challenges to benign conduct and chill pro-competitive behavior. Some of those criticisms were voiced during the agencies' recently concluded hearings on Section 2.

There is no question that vertical restraints can sometimes be pro-competitive – the Chicago School and economists have done an excellent job describing the benefits of these practices. Yet even the most ardent critic should admit that these practices can also sometimes damage competition to the detriment of consumers. The debate lies in our ability to discern between pro-competitive and anti-competitive conduct. Many respected economists believe that they do not yet have the tools to answer that question. That uncertainty, coupled with the demonstrated benefits of vertical restraints in many instances, leads some to conclude that those restraints should not be challenged. However, there are others that believe that we should not abandon the field altogether – that the only way to advance our learning is to pursue cases where we have some indication that the practice is harming competition.

I agree with Joseph Farrell that no practice should be condemned simply because it excludes a rival or even several rivals – rather there should be proof of "exclusion plus" some other factor.[35] I also agree with him that the economics community has not supplied a definition of a "plus" factor that commands a consensus. I am skeptical about tests like the "profit sacrifice" test, the "no economic sense" test, or tests based on the relative efficiencies of firms (or conduct) because, in the end, those tests all require assessments of costs and/or profitability that are difficult, if not impossible, to make in the real world. (These practical concerns also lead me to have serious doubts about always basing liability on the application of *Brooke Group*.)

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[35] Joseph Farrell, "Freedom to Trade," Remarks before the CRA Intl. Conference on Current Topics in Antitrust Economics and Competition Policy, Washington, D.C. (June 13, 2007).

Echoing Professor Gavil, I wonder whether the difficultly of administering these tests simply means that successful challenges cannot be made.[36]

This leads me to my second observation. Section 2 of the Sherman Act exists independent of Section 1 of that Act and Section 3 of the Clayton Act. It provides an important screen in these cases. It only applies when a firm has monopoly power – or a dangerous likelihood of obtaining monopoly power. Personally, I believe the proof of monopoly or near monopoly power is only the threshold requirement. The inquiry should not end there. There should also generally be evidence that the primary practice at issue does not exist in isolation – that it was accompanied by at least some other exclusionary practice. There should also be evidence that the defendant engaged in the practice with the intent to acquire or maintain enduring monopoly power, and that evidence should be strong enough to support an inference that the conduct had that effect. In those circumstances, consumer injury is likely to occur over the long run, and I believe the courts are right to cast a skeptical eye on them. These practices will continue to be challenged – successfully – under Section 2. And where the challenges are successful, I am loathe to second-guess them.

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[36] Andrew I. Gavil, "Are the Antitrust Rules for Monopolists Really 'Unclear' or 'In Flux'?," Before the American Bar Association, Section of Antitrust Law, Washington D.C., (November 15-16, 2005).