A Second Look at Category Management

by Thomas B. Leary[1]

I first became aware of "category management" and designated "category captains" about six years ago, when I was in private practice. A client and friend, the general counsel of a relatively small seller of some household products, came to me in distress because his company's largest competitor had been appointed as category captain for a major supermarket customer.

The client explained that a category captain was someone who advised the supermarket on the best way to price, display and promote products of a particular kind, including not only the products of the captain itself but also those of various competitors who sold to the store. I was amazed![2] After years of providing antitrust advice to manufacturers, I was aware that consultation on these subjects with a retailer can be delicate, even when you are talking only about your own brands. The idea that a manufacturer would provide advice about the pricing and promotion of competitive brands, as well, set off every antitrust alarm.

Since that time, I have thought a lot and read a lot about category management. I participated briefly in the hearings that the Commission held in May and June, 2000, on slotting allowances and other marketing practices in the grocery industry,[3] as well as a later roundtable discussion on category management in June 2003,[4] sponsored by the American Antitrust Institute. The defenders of category management explain that supermarkets sell thousands of items and do not have the internal expertise to price and display all of them most effectively.

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[1] Commissioner, Federal Trade Commission. This paper is based on oral remarks delivered on June 23, 2003, at the American Antitrust Institute's Roundtable Discussion on Antitrust and Category Captains, in Washington, D.C. *See* Antitrust and Category Captains Roundtable Discussion, a Report by Gabrielle Herderschee-Hunter, *available at* <http://www.antitrustinstitute.org/recent2/270.pdf> [hereinafter "AAI Report"]. It is particularly important to emphasize the usual caveat that the opinions expressed are individual and not necessarily shared by any other Commissioner.

[2] Apparently, with some reason. According to another observer: "[n]ever before in retail history have manufacturers advised retailers on what to do with their rivals' products." AAI Report, *supra* note 1, at 28.

[3] Report on the Federal Trade Commission Workshop on Slotting Allowances and Other Marketing Practices in the Grocery Industry: A Report by Federal Trade Commission Staff (February 2001), *available at* <http://www.ftc.gov/bc/slotting/index.htm> [hereinafter "FTC Staff Report"].

[4] *See* AAI Report, *supra* note 1.

Their vendors, particularly the largest ones, do have the needed expertise and are willing to provide valuable advice without charge. As summarized in the FTC Staff Report:[5]

> "Effective category management requires marketing expertise and continual analysis of data. Some speakers opined that even the very largest retailers are less well-informed about particular product areas than the manufacturers, and can thus benefit from their assistance. The manufacturer may know things like the times of year when a product will sell best, the kinds of promotions that are most effective in moving the product, or the kinds of complementary goods that might be advantageously displayed in adjacent space. Assistance often comes from a category captain – a leading manufacturer of products in the category who acts as a primary advisor for the retail chain's management of the category."

According to the FTC Staff Report, the services provided by a designated category captain or manager vary "widely across firms and product categories." In some cases, "retailers use the category captain only for advice," which is checked against other input; in other cases, "retailers delegate all category management responsibilities to the captain."[6] Even among defenders of category management, there seems to be a consensus – for practical business reasons, as well as antitrust concerns – that it is preferable for captains merely to advise and to reserve the ultimate decision to retailers.[7]

Both the customers and the category captains who provide the service seem satisfied. Only the smaller producers who do not have a shot at captaincy seem upset. However, they do not have firsthand knowledge of how the process works, and, even though there is some evidence of harm to individual competitors, it is hard to pinpoint the harm to the competitive process itself. In fact, there seems to be some evidence that sales in some product categories actually increased after the appointment of captains.

Notwithstanding these considerations, I still believe that some aspects of category management present high antitrust risks. In these brief comments, I will explain my reasons for continuing skepticism.

1. <u>Are the Issues "Vertical" or Horizontal</u>"?

The initial characterization of antitrust issues as "horizontal" or "vertical" is often outcome-determinative. Horizontal arrangements are far more likely to be condemned under a <u>per</u> <u>se</u> or a truncated analysis. Some insist that category management should be analyzed as a vertical restraint, presumably because category managers are primarily suppliers to, not

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[5] FTC Staff Report, *supra* note 3, at 47-48.

[6] *Id*. at 48.

[7] *Id*. *See also*, *e.g.*, AAI Report, *supra* note 1, at 14, 35, and 43.

competitors of, the retail customers they advise.[8] I believe the matter is more complex. In my view, the nature and context of the communication should control, not the formal relationship between the parties. In short, advice on the resale of the manufacturer's own product should be viewed as vertical; advice on the resale of a competitor's product should be viewed as horizontal.

Consider the rationale for distinguishing between horizontal and vertical arrangements in the first place, which was first clearly articulated in the landmark Sylvania[9] opinion. Before Sylvania, courts tended to focus on formal distinctions like the passage of title.[10] After Sylvania paved the way, courts have recognized that a manufacturer has a legitimate interest in the way its products are distributed to consumers, even if it no longer owns them. It can not only advise but in some cases, actually obtain agreement on these matters (except for the per se strictures on resale price maintenance). The concept becomes easier to grasp if you think of a manufacturer as "buying" a package of services from a retailer, which it pays for by selling its products to the retailer at a discount. The services that a manufacturer may want to "buy" include not only pre-sale advice and post-sale repairs for customers but also attractive and convenient displays. Various vertical agreements can increase the likelihood that these services will actually be provided by each dealer and reduce the risk of "free-riding" by non-compliant dealers, with correspondingly lower costs, which could impair the effectiveness of a manufacturer's entire distribution system. This is a legitimate vertical interest.

It is, however, hard to imagine that a category captain really cares whether a retailer provides its competitors with the services that they have "bought," nor is the captain likely to be concerned about the overall effectiveness of a competitor's distribution system. Any advice that the captain gives to a customer about the appropriate ways to distribute a competitor's product is not likely to serve a legitimate vertical interest, but rather affects horizontal competition and serves a horizontal interest. It should be viewed as a horizontal communication. It is the nature of the interest, rather than the formal relationship, that should control.

This view is supported by the legal principles applied in cases of so-called "dual distribution." The term describes a situation where a manufacturer sells to independent retailers and also sells through its own retail outlets. It has been argued that any territorial or customer limitations that such a manufacturer places on the independent retailers are horizontal agreements - - and hence per se illegal - - because the manufacturer acts as a retailer itself. Recent authorities tend to reject this formalistic analysis, however, and instead emphasize whether the restraint in question serves a vertical or a horizontal interest.[12]

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[8] *See* AAI Report, *supra* note 1, at 32, 50 (remarks of David Balto).

[9] Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977).

[10] *See*, *e.g.*, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 409 (1911).

[12] *See generally* discussion in Antitrust Law Developments (Fifth) at 160-61 (2002).

Look at it another way. The post-Sylvania law of vertical restraints recognizes that a manufacturer has a right to do certain things that affect competition in the retail market place. The legitimate reach of its activities extends forward into the next level of distribution and the manufacturer is allowed to exert its influence at the retail level, even though it does not operate there formally. However, Sylvania also makes it clear that this permissiveness extends only to activities that are designed to rationalize intrabrand competition at the retail level. To the extent that the manufacturer attempts to rationalize interbrand competition at that level, it is directly affecting horizontal competition and the activity should be analyzed as a horizontal restraint.[13]

The clear distinction between a category captain's advice on the resale of its own products and advice on the resale of competitors' products seems to be recognized by expert counselors, even though they do not overtly raise the spectre of a horizontal standard. Thus, one expert says flatly that a category captain "can transmit information that suggests how to shelve but should not advise on prices, costs, or about the pricing or the discontinuation of a rival's product."[14] Another proposes antitrust guidelines that say category captains "should not suggest to retailers what a rival is promoting or marketing or how rivals are pricing."[15]

Experienced counselors also point to complicating factors, which present potential horizontal issues even more clearly and which may therefore be particularly dangerous for retailers. These include situations where a manufacturer and dealer discuss sales strategy for both the manufacturer's brand and the retailer's private label brand, which compete head-to-head.[16] There are also special risks when one captain provides advice to competing retailers, with the attendant potential for a claim of "hub-and-spoke" conspiracy to coordinate retailer marketing strategies.[17] But, even absent these complications, I believe that a category manager's advice on competitors' products presents horizontal issues.

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[13] Consider another hypothetical example where a seller can serve a horizontal interest in a market in which it does not compete directly. Suppose a patent holder granted a license to manufacture a product in return for a royalty based on a percentage of dollar sales. If the patentee does not sell the product itself, the relationship is purely vertical. However, if the patentee sought to influence the sales strategies of companies that sell unpatented products which compete with the offerings of its licensee, it should be analyzed as a horizontal restraint.

[14] AAI Report, *supra* note 1, at 35 (remarks of Christopher MacAvoy).

[15] *Id.* at 44 (remarks of Irving Sher). (It seems to me, as an outsider, that adherence to these appropriate boundaries may require people to rethink some fundamental premises of category management.)

[16] *See, id.* at 35, 43-44 (remarks of Christopher MacAvoy and Irving Sher).

[17] *Compare* Toys-"R"-Us, Inc. v. FTC, 221 F2d 928 (7th Cir. 2000).

2. What Difference Does It Make?

If certain aspects of category management are analyzed under standards applied to horizontal arrangements, one consequence would be to undercut further the distinction between mere "advice," subject to final "approval" by the retailer, and outright "agreement" by the retailers. In the vertical context, advice about prices is viewed benignly; in the horizontal context, mere discussion of prices followed by action consistent with the discussion can support an inference of illegal agreement, and cautious counsel advise against it. Contrast, for example, the commonplace practice of suggesting resale prices (which could theoretically be "accepted" by performance), and the risks associated with horizontal exchanges of price information.[18] In my view, the different standards for inferring "agreement" in the horizontal and vertical contexts were likely prompted originally by an intuitive sense that their effects were very different, but at the time the analytical tools for distinguishing these effects were not available. The persistence of different standards for proof of "agreement," however, means that characterization could be important. In other words, it could make a difference if a communication is labeled "horizontal" or, alternatively, labeled "vertical" but outside the protective mantle of Sylvania.

Regardless of the label, there also appears to be some tension between the claim that category captains merely give advice, which a retail customer is free to reject, and the claim that the practice is efficient because the captain knows so much more about the subject.[19] Why would a relatively uninformed customer feel confident enough to override the captain's advice? The advice is not purely gratuitous; a "captain" does, after all, have some mutually recognized stature.

It is plausible to assume that a category captain who tries to disadvantage competitors in obvious ways will lose credibility and may well be replaced entirely. A case as extreme as Conwood v. U.S. Tobacco[20] is unlikely to be encountered often. On the other hand, it is not plausible to assume that a category captain will give entirely disinterested advice.[21] (All of us –

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[18] *Compare, e.g.*, United States v. Container Corp. of America, 393 U.S. 333, 337-38 (1969) (prohibiting verification of competitors' prices) *with, e.g.*, United States v. Parke, Davis & Co., 362 U.S. 29,44 (1960) (no violation if dealers "independently" adhere to suggested resale prices).

[19] If, as some suggest, there is a trend away from management of product categories toward management of supermarket "aisles" that feature a number of products, the specialized knowledge argument is further weakened. On the other hand, the risk of biased "advice" may be reduced, as well. *See* AAI Report, *supra* note 1, at 25.

[20] 290 F.3d 768 (6th Cir. 2002). In this case, the captain's efforts for the home team apparently included the destruction or removal of rivals' displays.

[21] The assumption is particularly implausible if a manufacturer has actually paid for the privilege of rendering the service. *See* AAI Report, *supra* note 1, at 26.

including government employees like me – have an uncanny ability to discern objective virtue in policies that favor our individual interests.) A retail customer may have neither the sophistication nor the incentive to object when the bias is subtle.

The best strategy for a captain may be to recommend a plan that will preserve its already strong market position rather than blatantly enhance it - - a plan that will also channel existing competition away from "disruptive" initiatives and discourage maverick entry.[22] A strategy of this kind may not be perceived as biased and may also be attractive to the retailer, particularly if the same captain or a like-minded counterpart gives similar advice to the retailer's own competitors.

I will revisit this surmise, in a different context, later on. The principal point here is that we cannot draw much comfort from the factual distinction between advice and agreement.[23] A diplomatic captain should be able to get agreement – by action if not by words – on a plan that preserves its own interests. And, if the advice is judged by horizontal standards, this fact is fatal.

3. Is the Standard Too Harsh?

Would consumer welfare be adversely affected if a captain's advice about competitive products were inhibited by such a harsh legal standard? There is, apparently, some research that indicates category management generally increases sales of the products in question, which could suggest that the practice contributes to efficiency and the expansion of output.[24] Apparently, there is also research that points in the other direction.[25] Even if the results could be reconciled, however, I am not sure that the research of this kind would provide a definitive final answer to the precise question.

First, we do not know what effects are attributable to conduct that I would agree is likely to be benign (a manufacturer's recommendations about its own brands) and what effects are attributable to conduct that I suggest is probably pernicious (a manufacturer's recommendations

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[22] If a retailer attempts to neutralize bias by appointing competing manufacturers as "co-captains" to manage a category, the cure may be worse than the ailment. Two manufacturers can then coordinate efforts to discourage disruptive competition. *See, e.g., id.* at 43 (remarks of Irving Scher).

[23] The rigor of horizontal competition may be reduced, even if a category captain's advice is ignored, because the captain may acquire sensitive information about the strategies of its rivals. Suggestions that "firewalls" could cure the problem may be unrealistic. *See, e.g., id.* at 35 (remarks of Christopher MacAvoy).

[24] *See, e.g., id.* at 13 (remarks of Paul Christman), 21 (remarks of Richard Gooner), and 26 (remarks of Debra M. Desrochers).

[25] *See, e.g., id.* at 16 (remarks of Suman Basuroy).

about a competitor's brands). In other words, we do not know whether there is a potentially "less restrictive alternative" that would yield substantially the same results.

Second, an increase in sales may not be an unambiguous pro-competitive effect. Short-term efficiencies may be associated with long-term harm.[26] A category captain is likely to have an interest in a regime that not only preserves its leading position but also avoids competition that will be "disruptive." The captain would likely prefer to have its special product promotions separated in time and space from the promotions of its competitors, and to minimize the impact of an innovative new product. Retailers may also prefer to compete in the same orderly way with their own rivals. This kind of orderly competition within stores and across stores, may appear to be efficient in the short run because resources are not wasted on mutually cancelling efforts. (Short-run efficiencies may help to explain why category management is favored by many retailers, as well as by large suppliers.) On the other hand, orderly competition might stifle disruptive innovation that yields long-term benefits. In fact, I question whether arguments about the superiority of orderly competition are legally cognizable when horizontal restraints are involved.[27]

The fundamental premise of our antitrust laws is that consumers are ultimately best served by interbrand competition that is uncoordinated, unstable and unpredictable. If rival producers were to combine and rationalize their sales and promotion efforts, they would get indicted for it.[28] I question whether it is any less harmful when a designated "captain" acts as a czar for the group - - even, or particularly, if the captain makes some effort to accommodate the interests of its competitors. The market will simply be less dynamic in the long run, something that is difficult to measure but reasonable to predict.

Conclusion

I personally continue to have grave concerns about certain aspects of category management. "Foreclosure" of competitors may not be the most important issue, but rather rationalization of interbrand competition to achieve market stability. To the extent that a category captain influences the way in which its own competitors' products are distributed, the conduct lies outside the protective mantle of Sylvania. This caveat also applies if the conduct

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[26] Increased sales might also coincide with a reduction in the variety of products sold, a potentially important issue in the case of differentiated consumers products. *See* Thomas B. Leary, The Significance of Variety in Antitrust Analysis, 68 Antitrust Law Journal 100 (2001).

[27] *Cf.* National Collegiate Athletic Ass'n v. Board of Regents of the University of Oklahoma, 468 U.S. 85, 117 (rejecting an efficiency argument that is "inconsistent with the basic policy of the Sherman Act."); PolyGram Holding, Inc., FTC Docket No. 9298 (July 24, 2003)(Commission opinion), *available at* <http://www.ftc.gov/os/2003/07/polygramopinion.pdf>.

[28] *See, e.g.*, U.S. v. Allegheny Bottling Co., et al., 695 F. Supp. 856 (1988).

affects the marketing activities of competing retailers. Both outcomes are appropriately analyzed as horizontal restraints.

It is encouraging to read that experienced counselors advise category captains to avoid recommendations about their competitors' products and counsel retailers about the risks of hub-and-spoke combinations. I hope their clients are following this good advice, and would be particularly pleased if it were therefore not necessary to test the legal theory outlined in this paper.