PROCOMPETITIVE JUSTIFICATIONS FOR EXCLUSIVE DEALING:

PREVENTING FREE-RIDING AND CREATING UNDIVIDED DEALER LOYALTY

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Dentsply illustrates that the current economic foundations for procompetitive justifications for exclusive dealing are extremely narrow.

- The court rejected Dentsply's claim that exclusive dealing was used to:

  1. Prevent dealer free-riding on manufacturer-supplied promotional investments.

  2. Create dealers with "undivided loyalty" that more actively promoted Dentsply products.

The *Dentsply* court rejected that exclusive dealing was used to prevent dealer free-riding because:

- Dentsply did not make any investments that dealers could free-ride on by using the investments to sell rival products.
- There was no evidence of Dentsply dealers actually switching buyers to rival products.
- Dentsply executives testified that Dentsply would likely increase its promotional investments if there were no exclusive dealing.

The Dentsply court rejected that exclusive dealing was used to create dealers with "undivided loyalty" who would more actively promote Dentsply products because:

- "Enhancing dealer services" cannot be the justification for exclusive dealing.
    - In general, competition between dealers will lead dealers to supply the desired quantity of promotional services.
    - Only when there is an inter-dealer free-riding problem (as described in Sylvania) will competition between dealers not result in sufficient dealer services. But this problem would not be corrected by exclusive dealing.

The expanded economic framework under which we should conduct economic analysis of exclusive dealing contracts is based on two common sense business propositions.

1. Manufacturers often want their dealers to supply more promotion than the dealers would independently decide to provide.

2. Exclusive dealing, by creating undivided dealer loyalty, increases dealer incentives to more actively promote the manufacturer's product.

Manufacturers often want their dealers to supply more promotion than the dealers would independently decide to provide.

- Dealers do not take account of manufacturer profitability on incremental sales.
  - This is not a problem for dealer price and non-price competition that has significant inter-dealer quantity effects.
  - However, dealer promotion of a manufacturer's product has no significant inter-dealer quantity effects.

- Consumers do not pay for promotion because promotion is a way to provide an effective price discount to marginal consumers who would not otherwise buy the product.

Manufacturers solve this problem of insufficient dealer promotion by contracting with and compensating dealers for providing increased promotion.

- Manufacturers often compensate dealers with a valuable distributorship.
- Contractual arrangements generally will be self-enforced with dealer performance assured by manufacturer monitoring and the threat of termination.

Because dealers are contracting to supply more promotion than would otherwise be in their independent interests to supply, there is an inherent dealer performance problem.

- Dealers have an incentive to violate the contract and “free-ride” on the manufacturer’s compensation arrangement.

Dealers may "free-ride" in three distinct ways:

- Free-riding #1: dealers use the manufacturer-supplied promotional assets to sell rival products.
- Free-riding #2: dealers use the manufacturer paid-for promotion to sell rival products.
- Free-riding #3: dealers under-supply manufacturer paid-for promotion.

Dealer free-riding need not involve manufacturer investments or dealer switching.

- Free-riding #1: dealers use the manufacturer-supplied promotional assets to sell rival products.
- ⇨ involves manufacturer investments and dealer switching

- Free-riding #2: dealers use the manufacturer paid-for promotion to sell rival products.
- ⇨ occurs without any manufacturer investments

- Free-riding #3: dealers under-supply manufacturer paid-for promotion.
- ⇨ occurs without any manufacturer investments or dealer switching

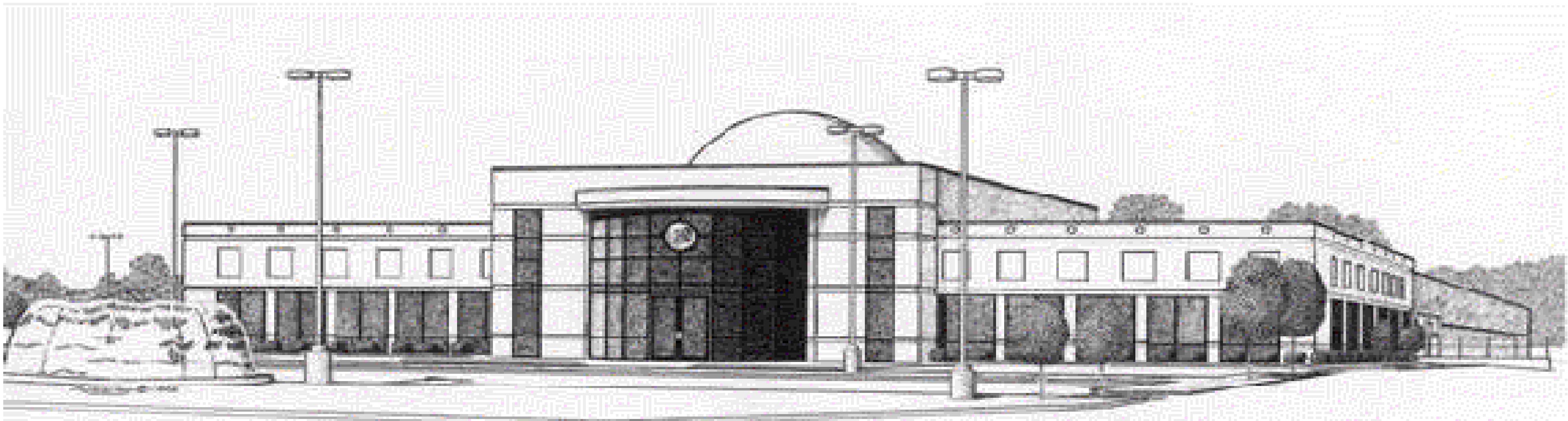
Exclusive dealing may be used to mitigate all three forms of free-riding.

- Exclusive dealing prevents free-riding #1 and #2 by preventing dealer switching of sales to rival products.

- Exclusive dealing prevents free-riding #3 by creating “undivided dealer loyalty” and thereby an incentive for dealers to more intensively promote the manufacturer’s product.

How does exclusive dealing increases the dealer’s incentive to promote?

- Consider the example where a customer leaning towards the purchase of a Honda comes into a Toyota dealership to check out the Toyota.



Honda

Toyota

M_H^D

M_T^D

A non-exclusive dealer will not make its "best efforts" to sell a Toyota.

- Dealer will choose level of promotional services (*S*) that maximizes its profitability.

$$Max \;\; (M_T^D - M_H^D) \cdot p(S) - C(S)$$

- Since it costs the dealer less to sell the Honda, the dealer can earn a higher net profit margin on selling the Honda.

$$C'(S) = p'(S) \cdot (M_T^D - M_H^D)$$

By selling the Honda rather than promoting the Toyota the dealer is free-riding.

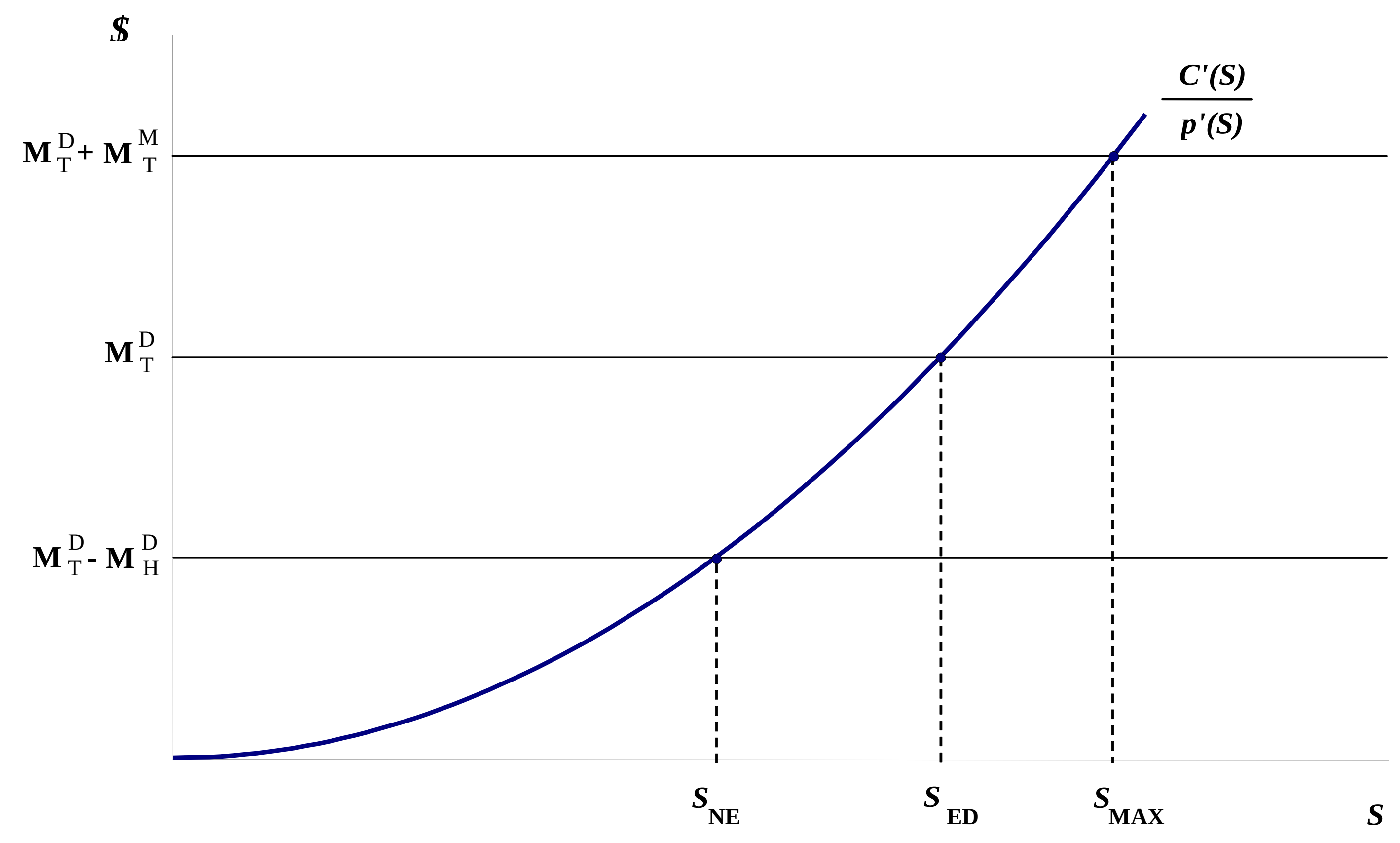
- The dealer is not switching, *i.e.*, actively promoting the rival Honda brand as an alternative to Toyota for customers that prefer Toyota (as in free-riding #1 and #2).
- Instead, the dealer is violating the implicit dealer contract with Toyota by failing to actively promote Toyota automobiles.

An exclusive dealer will make an increased effort to sell Toyota automobiles because the dealer does not make any sale if it does not sell Toyota.

- Undivided loyalty leads dealers to expand their promotional efforts.

$$C'(S) = p'(S) \cdot M_T^D$$

Promotional Effort Undertaken by Dealers Under Alternative Contractual Arrangements



Lessons

- The court's rejection of Dentsply's procompetitive rationales is an example of a common error:
  - trying to fit the facts of a case into a preconceived economic model rather than developing a model to fit the facts.
- Because there are more likely to be valid procompetitive justifications for exclusive dealing, "no economic sense" is less likely to be a useful test for antitrust liability.