RPM As An Exclusionary Practice

Ittai Paldor, Hebrew University
RPM as an Exclusionary Practice

Ittai Paldor†

† Research fellow, Law and Economics Forum, Hebrew University, Jerusalem (SJD - University of Toronto). I am greatly indebted to Edward Iacobucci, Michael Trebilcock and Ariels Katz for extremely helpful comments and suggestions on several earlier drafts of this paper. I also thank Roger Ware and Benjamin Alarie, as well as participants of the 18th Annual Meeting of the American Law and Economics Association for comments on an earlier draft of this paper. The financial support granted by the University of Toronto and by the Milton and Miriam Handler Foundation is appreciated.
Abstract

The existing explanations for resale price maintenance (RPM) are divided along a clear line, separating the pro- and anti-competitive explanations. The anti-competitive explanations suggest that RPM is introduced in furtherance of a cartel either at the retail level or at the manufacturing level. The pro-competitive explanations, by contrast, are all based on the assumption that RPM is designed to benefit a single manufacturer. A key distinction in classifying RPM systems according to the present state of the literature is thus the distinction between single-manufacturer-driven RPM and any other RPM system. This distinction is of major practical importance subsequent to the recent Supreme Court ruling in *Leegin v. PSKS*, which subjected RPM to scrutiny under the rule of reason rather than the *per se* illegality rule. In light of the existing explanations for RPM, it would seem logical to create a presumption, perhaps an irrefutable presumption, of pro-competitiveness when RPM is introduced at the genuine-initiative of a single manufacturer. The object of this paper is to challenge the consensus according to which single-manufacturer driven RPM is categorically pro-competitive, and caution against such RPM systems. I show that RPM can be used, and is likely to be used, as an exclusionary measure for the elimination of upstream competition. It thus has significant anti-competitive potential even when it is not introduced in furtherance of a cartel, which has important implications for the application of the rule of reason to the practice.
# Table of Contents

Introduction ......................................................................................................................................... 3

I. Pro- and Anti- Competitive Uses of RPM ................................................................................... 5

II. The Hypothesis – RPM as Consideration for Exclusivity........................................................ 8

   1) The General Profitability of Foreclosure for Upstream and Downstream Firms ............... 8

   2) The Applicability of the Hypothesis to Additional Settings............................................... 11

   3) The Anti-competitive Potential of Exclusivity ................................................................... 14

III. RPM v. Direct Payments for Exclusivity ............................................................................... 16

   1) RPM is Preferable to Per-unit Payments Because it Prevents Retailers from Competing the Manufacturer’s Payments Away ......................................................................................... 16

   2) RPM is Preferable to Lump Sum Payments Because it Creates a Sustainable Long-run Equilibrium ............................................................................................................................ 17

   3) Summary............................................................................................................................. 19

IV. Why is RPM Likely to be Used to Induce Anti-competitive Behavior?................................ 20

   1) Exclusivity and the Provision of Desired Services............................................................. 20

   2) Pro- and Anti-competitive Functions of Exclusivity.......................................................... 25

   3) Summary............................................................................................................................. 27

V. Objections to the Hypothesis .................................................................................................. 28

   1) Shirking on the Exclusivity Commitment – RPM and the ‘Price Umbrella’ ................. 28

   2) Selling the Product for a Lower Price or Engaging in Non-price Competition ............. 32

VI. Policy Implications ............................................................................................................... 35
Introduction

A divided U.S. Supreme Court has recently overturned its longstanding condemnation of minimum resale price maintenance (RPM), a practice whereby an upstream firm (normally a manufacturer) sets a minimum price for the resale of its product by independent downstream firms (normally retailers). The court did not rule that RPM is always legal. It merely lifted its century old per se ban on RPM, subjecting the practice to the standard rule of reason, according to which the legality of a practice depends on the balance between its pro- and anti-competitive effects under specific market circumstances. The court invited lower courts to develop workable litigation rules for the evaluation of the practice, saying:

As courts gain experience considering the effects of these restraints by applying the rule [of reason] over the course of decisions, they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses. Courts can, for example, devise rules over time for offering proof, or even presumptions when justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote competitive ones.

The existing explanations for RPM are divided along a clear line, separating the pro- and anti-competitive explanations. According to the anti-competitive explanations, RPM is introduced in furtherance of a cartel either at the retail level or at the manufacturing level. The pro-competitive explanations, by contrast, are all based on the assumption that RPM is designed to benefit a single manufacturer. Each of the pro-competitive explanations identifies an advantage a manufacturer may get

---

2 I generally use RPM as a shorthand for minimum resale price maintenance, which is the focus of this essay. In this context RPM does not include the practice of setting price ceilings.
3 Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911) [Dr. Miles].
4 Leegin, supra note 1 at 19.
5 On the retailers’ cartel explanation see infra note 15 and accompanying text. On the manufacturers’ cartel explanation see infra note 16 and accompanying text.
from elevating retail prices.\(^6\) A key distinction in classifying RPM systems according to the present state of the literature is thus the distinction between single-manufacturer-driven RPM and any other RPM system.\(^7\) This distinction was of little practical importance prior to *Leegin*, since RPM was *per se* illegal. But subsequent to the court’s ruling the issue of distinguishing pro- and anti-competitive RPM systems has become one of major importance. And in light of the existing explanations for RPM, it would seem logical to create a presumption, perhaps an irrefutable presumption, of pro-competitiveness when RPM is introduced at the genuine-initiative of a single manufacturer.\(^8\) In fact, the court in *Leegin* subscribed to this view, although it did not go so far as to create a presumption of pro-competitiveness.\(^9\) The object of this paper is to challenge the consensus according to which single-manufacturer driven RPM is categorically pro-competitive,\(^10\) and caution against such RPM systems. I attempt to show that RPM may be anti-competitive even when it is not introduced in furtherance of a cartel.

The remainder of this paper is structured as follows: section I briefly summarizes the current state of the literature on RPM, with a focus on the upshot of the commonalities among the pro-competitive explanations and the anti-competitive explanations. Section II introduces the hypothesis, according to which RPM may be used as a rent-shifting mechanism in return for retail-level exclusivity intended to forestall competition at the upstream level. Section III explains why RPM may be preferable, from the contracting parties’ perspective, to traditional exclusivity agreements. Section IV explains why RPM-induced exclusivity is likely to be anti-competitive, in contrast to traditional exclusivity agreements, which may also be pro-competitive. Section V addresses several potential objections to the hypothesis. Section VI enumerates the policy implications of the hypothesis.

---

\(^{6}\) See section I, below.


\(^{9}\) See *Leegin*, *supra* note 1 at 17 – 18.

\(^{10}\) See references in *supra* note 8.
I. Pro- and Anti-Competitive Uses of RPM

At first blush, RPM is a puzzling practice. For any given wholesale price, the lower the retail markup the larger the quantity the manufacturer will sell, and consequently the larger its profits. Raising retail prices reduces the total quantity of the product sold, and the manufacturer’s overall profits. This puzzle was observed as early as 1916 by Taussig, who pointed out:

“In all this price-fixing system, the price received by the manufacturer himself is in no way restricted or even directly affected. His own price to the trade remains no less and no more. It is only the resale price that is sought to be controlled. Now, the manufacturer’s immediate interest, and indeed his only interest, would seem to be in his own receipts. So long as he settles the price which comes to him, why should he concern himself with the terms of further sale by jobber or retailer? Nay, his interest would seem to be that these middlemen, and especially the retailers, should sell as cheaply as possible, and advertise as much as possible their cheap sales.”\(^{11}\)

The puzzle of RPM has resulted in a plethora of explanations for its existence. Scholars have identified a host of reasons for employing RPM, most of which are pro-competitive. Each of the pro-competitive explanations identifies an advantage that the manufacturer may get out of imposing RPM. An inflated margin between wholesale and resale price may facilitate investment in various kinds of point-of-sale product-specific services that consumers value at more than their cost, which retailers will not provide without a restriction on price competition, for fear that their competitors will free ride on their efforts and under-price them.\(^{12}\) An increased per-unit margin may also make it profitable for retailers to incur the costs of erecting establishments in remote locations and the like, thereby allowing consumers who would otherwise not have purchased the product to purchase it.\(^{13}\) In total, there are seven pro-competitive explanations for RPM, each focusing on a different advantage a single manufacturer may derive from the introduction of RPM.\(^{14}\) And since a manufacturer has no incentive in a retail-level

---

\(^{11}\) F.W. Taussig, “Price Maintenance” (1916) 6 Am. Econ. Rev. 170 at 171.
\(^{14}\) Additional hypotheses are developed in Ralph Winter, “Vertical Control and Price Versus Non-price Competition” (1993) 108 Quarterly J. of Econ. 61, Howard P. Marvel & Stephen McCafferty, “Resale Price Maintenance and Quality
markup absent an offsetting benefit, it can be assumed that the benefit derived offsets the cost. As the benefit to the manufacturer is derived from consumers’ willingness to pay for the product, it can generally be assumed that consumers value whatever retailers provide in return for RPM at more than the additional sum they are forced to pay for it. This, in turn, implies that total welfare is enhanced through RPM.

The two anti-competitive explanations for RPM, by contrast, focus on RPM's attributes as a facilitating measure for cartels. The first anti-competitive explanation focuses on RPM as a stabilizing measure for a retailers' cartel. According to this explanation, RPM is one possible measure to rectify the prisoners' dilemma that is inherent to every cartel. Downstream cartel members, realizing that each of them has a private incentive to shirk on the cartelistic agreement and under-price the cartel with a view to increasing volume at other cartel members' expense, turn to a common supplier. The common supplier is in a good position to withhold supplies from cartel members attempting to increase volume, thereby stabilizing the cartel. According to this explanation, RPM is nominally 'imposed' by the manufacturer, but is in fact a product of retailers' pressure on the manufacturer to act as a cartel-enforcer.\(^{15}\)

The second explanation suggests that RPM may be used as an information tool and as an incentive management tool for manufacturers' cartels.\(^{16}\) As an information tool, RPM is valuable if retail prices are more observable than wholesale prices. By fixing retail prices manufacturers facilitate detection of cheating on wholesale prices. As an incentive management tool, when coupled with retail-level


exclusivity, RPM chills the incentives of upstream firms to cheat on the cartel because lower wholesale prices will not result in increased volume.\textsuperscript{17}

It is beyond the scope of the present paper to explore the existing pro- and anti-competitive explanations for RPM. In the present context it is sufficient to note that the pro-competitive explanations identify an advantage that a \textit{single} manufacturer gets from employing RPM. The two anti-competitive explanations, by contrast, focus on RPM's ability to facilitate coordination at either the upstream or the downstream level. Consequently, according to the prevailing view, RPM systems introduced at the genuine initiative of a single manufacturer carry no anti-competitive danger, and can be presumed (perhaps even irrefutably) to be pro-competitive. The hypothesis presented here suggests that courts should be much more suspicious of RPM, even when it is employed by a single manufacturer.

\textsuperscript{17} For a detailed explanation of both of these uses of RPM and the need for retail-level exclusivity see Ittai Paldor, “Rethinking RPM: Did the Courts Have it Right all Along?” [SJD Thesis] at 58 – 61 & 120 – 130, Available online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=994750>.
II. The Hypothesis – RPM as Consideration for Exclusivity

The basic hypothesis is simple and perhaps intuitive: RPM may be used by an upstream firm as a payment method in return for downstream-level exclusivity; this exclusivity chokes off the upstream firm's competitors' access to consumers, which in turn curbs upstream competition.\(^{18}\) According to the hypothesis, RPM is a rent-shifting device. By introducing RPM the manufacturer shares its own monopoly rents with retailers.\(^{19}\) Retailers’ share of the rents is, naturally, contingent on the preservation of the upstream monopoly. Retailers therefore have an immediate interest in the preservation of the monopoly. The therefore refrain from distributing goods originating from the manufacturer’s competitors. Consequently, competing manufacturers cannot reach consumers and competition at the manufacturer’s level is suppressed.

1) The General Profitability of Foreclosure for Upstream and Downstream Firms

\(a.\) the manufacturer

The general profitability of such a strategy for both retailers and the manufacturer stems from the fact that, as a general rule, rents are larger in an industry with a sole supplier than in an industry with more than one supplier.\(^{20}\)

---
\(^{18}\) In *Leegin*, for example, the court stipulated that RPM may be used in the manner suggested here (see *Leegin*, supra note 1, at 14), but offered no explanation for how RPM might induce exclusivity. And, as mentioned, ultimately subscribed to the view according to which single-manufacturer-driven RPM is regularly (if not categorically) pro-competitive (see *supra* note 9 and accompanying text, see also H. Hovenkamp, *Federal Antitrust Policy*, 3\(^{rd}\) ed., (St. Paul: Thomson/West, 2005) at 454).

\(^{19}\) The manufacturer need not be a monopoly in the ordinary sense of the word to share rents with retailers. Both the ability to share rents with retailers and the incentives to thwart competition at the upstream level exist as long as the manufacturer faces a less-than-perfectly-elastic demand curve. And no manufacturer is in perfect competition. See Edward Hastings Chamberlin, *The Theory of Monopolistic Competition*, 8\(^{th}\) ed., (Cambridge: Harvard University Press, 1962).

The manufacturer's incentives are evident. If the manufacturer is the sole supplier it accrues monopoly rents. If, by contrast, a competitor enters into manufacturing, rents at the manufacturing level will be eroded. Predicting the intensity of competition in a market as a function of the number of competitors is an unsettled problem. There are different models of competition, which make different assumptions regarding the nature of competition and consequently different predictions of price and quantity. But as a general rule, even models of duopoly – models of an industry with only two producers - predict that industry rents will be smaller than under monopoly.\textsuperscript{21} Therefore, if entry into manufacturing is achieved, monopoly rents will be diminished, at the very least, to duopoly rents. At the extreme, if manufacturing becomes perfectly competitive as a result of entry, the manufacturer’s rents will be eroded to a competitive return. It is therefore profitable for a manufacturer to share any portion (or even all) of the difference between its expected share of duopoly rents and the whole of monopoly rents with retailers, if this preserves its position as the sole supplier.

\textit{b. Retailers}

Retailers’ incentives to preserve an upstream monopoly are less straightforward.

Posner makes the point that downstream purchasers are adversely affected by the existence of upstream monopolies. Consequently, they should be reluctant to aid in the preservation of a monopoly at the

\textsuperscript{21} The predictions of these models range from the prediction that the ferocity of competition will be similar to that in a perfectly competitive industry to the prediction that duopoly rents will be only slightly smaller than monopoly rents. See F.M. Scherer, \textit{Industrial Market Structure and Economic Performance} 2\textsuperscript{nd} ed. (Chicago: Rand McNally College Publishing Company, 1980) at 199 – 200 & at 151 – 152. On different models of oligopoly and on the impossibility of outcome-prediction in specific cases see Trebilcock et al., \textit{The Law And Economics Of Canadian Competition Policy} (Toronto: University of Toronto Press, 2002) at 62 – 69 and David M. Kreps, \textit{A Course in Microeconomics} (Princeton: Princeton University Press, 1990) at 325 - 340. It should also be noted, that if there is a sufficient degree of differentiation between manufacturers or their products, industry rents may be larger with two competitors than with one. See e.g., \textit{Director of Investigation and Research v. D & B Companies of Canada Ltd.; Information Resources, Inc. et al., Interveners} 64 C.P.R. (3d) 216 (1995) at 273 – 275 [\textit{Nielsen}]. However, as long as the products are mainly substitutes for one another (which also implies that product-differentiation is not too pronounced), rents in a single-producer industry will be larger than in an industry with two producers (see Michal S. Gal, “The Nielsen Case: Was Competition Restored? On the Anti-competitive Effects of a Partial Enforcement of Competition Laws” (1998) 29 Can. Bus. L.J. 27 at 32, 37). In fact, the joint profits will only be larger than a single producer’s profit if the products are chiefly complements, making the two producers successive monopolies rather than a duopoly. As long as the duopoly model holds relevant, that is as long as the products are mainly substitutes, a larger number of competitors generally implies smaller rents.
upstream level. Alternatively, they will demand to be fully compensated for their prospective losses resulting from the preservation of the monopoly, which suggests that the manufacturer’s prospective gains from the preservation of the monopoly will all be dissipated in the form of payment to retailers.\textsuperscript{22} Posner concludes that although it is not impossible that out of ignorance or irrationality a firm will engage in exclusionary practices, “it is unlikely that a rational profit maximizing firm will use exclusive dealing as a method of excluding a competitor.”\textsuperscript{23}

Retailers are not end consumers of the product and therefore do not ultimately bear the cost of a price increase, which they pass on to their consumers. But Posner's argument can ostensibly be adjusted to apply to this setting as well. From retailers' perspective, a competitive upstream level or even an upstream duopoly is preferable to an upstream monopoly.\textsuperscript{24} Retailers' market power vis-à-vis manufacturers is greater under duopoly in manufacturing than under monopoly, so an upstream duopoly may enable them to negotiate a larger share of the rents than they are able to extract under monopoly. Retailers should therefore be reluctant to participate in the elimination of upstream competition.

But as explained, monopoly rents are generally larger than duopoly rents. Since total rents are larger, preservation of monopoly leaves the industry – retailers and the manufacturer as a whole – with larger profits. This invariably creates scope for a Pareto-superior arrangement (from the negotiating parties’ perspective) whereby the monopoly is preserved. The excess of monopoly rents over duopoly rents can be shared in a way that leaves both the manufacturer and retailers better off than they would have been under duopoly, or at least leaves one party better off and the other party no worse off. To use a numeric example, if monopoly rents are $100 and duopoly rents are $90, then regardless of what share of the $90 retailers would have appropriated under duopoly, the additional $10 of rents can be shared so that both the manufacturer’s and retailers’ total profits will have increased. As a general rule, a strategy of forestalling competition is, or at least can be made, profitable for both retailers and the manufacturer.

The important distinction between retailers and other downstream buyers is that retailers’ only interest in the product is their retail profit margin. In Posner’s setting any dollar of profit the monopoly ultimately

\textsuperscript{23} \textit{Ibid.} at 205.
\textsuperscript{24} If retailing is perfectly competitive retailers make no economic profit (on the distinction between economic profit and accounting profits see Trebilcock et al., \textit{supra} note 21 at 56) and are indifferent to the structure of the upstream level. This does not undermine the analysis. First, perfect competition is only a theoretical benchmark. More importantly, the analysis is in fact even more compelling in this setting: under perfect competition retailers’ acquiescence to participate in a scheme designed to eliminate competition will be easier to obtain, because retailers lose nothing from the preservation of an upstream monopoly (see also Klein & Murphy, \textit{supra} note 14 at 268 - 269).
makes is a dollar less in the pocket of its customers, which makes it impossible to reach a mutually beneficial agreement to preserve the monopoly. But retailers, whose only interest in the product is their share of the rents associated with selling the product to consumers, can be made better off even though—and actually because—end consumers are exploited.

Moreover, even if for some reason retailers as a whole are not made better off, they face what is in essence a collective action problem. Even if it is in their best interest as a whole to withhold their consent to the incumbent’s scheme, they will ultimately participate in it. The reason for this paradoxical behavior is best explained by Aghion and Bolton:

…when one buyer signs a long term contract with the incumbent, he imposes a negative externality on all other buyers. By locking himself into a long-run relation with the seller, he reduces the size of the entrant’s potential market so that, ceteris paribus, the probability of entry will be smaller. As a result, the other buyers will have to accept higher prices. We show that the incumbent can exploit this negative externality to extract more (probably all) surplus out of each buyer.  

The setting of RPM as an inducement for retail level exclusivity does not change this analysis. Each retailer will prefer to participate in the scheme and be compensated for the future losses (or a portion of the future losses) than to allow other retailers to participate in the scheme and ultimately secure the upstream monopoly. Since each retailer faces the same incentives, all will accept the offer and competition at the manufacturing level will have been defeated even if it is contrary to retailers’ collective interest.

The upshot of this analysis is that, contrary to intuition, there is scope for a mutually beneficial agreement between an upstream firm and downstream firms to sustain an upstream monopoly.

2) The Applicability of the Hypothesis to Additional Settings

The hypothesis can be extended beyond the paradigmatic setting of a single manufacturer combating a single entrant.

---

a. *A manufacturer facing competition from more than one potential entrant*

First, the analysis can be extended to situations in which there is more than one potential entrant into manufacturing. It is easy to see that the analysis is equally valid in this setting. In fact, the explanation becomes more powerful the larger the number of potential entrants. This is true because as a general rule, which conforms to intuition, the more competitors produce a given product, the smaller industry rents are, and consequently the greater the incentive to forestall entry.\(^{26}\)

For simplicity I normally use the setting of a single (monopolistic) manufacturer combating one potential entrant.

b. *Several incumbent manufacturers facing potential entry*

The analysis is also theoretically applicable to settings in which there is more than one incumbent. A duopoly contested by a third potential entrant has an incentive similar (although not identical in magnitude) to the one a single monopolist has when the monopoly is contested. Each of the duopolistic firms will accrue a third of ‘triopoly’ rents if entry is achieved rather than a half of duopoly rents if entry is forestalled. However, if there is more than one manufacturer at the outset, coordination problems emerge. The oligopolistic firms must somehow share the costs of rent-shifting or else no single manufacturer will be willing (and at times unable) to incur the full costs of forestalling competition. Tacit or explicit collusion may facilitate this cost sharing, but the larger the number of existing competitors, the harder coordination becomes.

Additionally, the more firms there are at the outset, the less the industry as a whole is expected to lose from entry, and the smaller the percentage decrease in each of the firms’ share of the rents as a consequence of entry. In the previous example, when there is a sole supplier at the outset industry rents shrink from monopoly rents to duopoly rents, and the firm’s share of the rents shrinks from 100% to half. When there are two competitors, by contrast, industry rents shrink from duopoly rents to 'triopoly' rents, and each firm's share of the rents shrinks from only one half to one third. Consequently, at least under

\(^{26}\) See *supra* notes 20-21 and accompanying text.

\(^{27}\) The *share* of the rents the manufacturer will need to shift to retailers will be larger the more potential entrants there are, because the more competitive manufacturing would have been the greater retailers’ market power vis-à-vis manufacturers would have been, and the larger their expected share of industry rents. But the increase in total industry rents will still leave scope for a mutually beneficial agreement to preserve the monopoly.
most models of oligopoly, the incentive to forestall competition decreases dramatically as the number of firms active at the outset increases.\textsuperscript{28}

As a consequence of these two observations, the hypothesis becomes less plausible the more upstream firms are actually in the market prior to the introduction of RPM.

c. \textit{Barriers to Entry at the Upstream Level}

One final observation regarding the plausibility of this use of RPM in different settings is important. The need for retail-level foreclosure as a means of forestalling upstream competition may seem less evident when there are barriers to entry at the upstream level. If this is the case, the manufacturer seems to have no reason to share rents with retailers. It can appropriate all of the rents, and rely on barriers to entry at its level to fend off competition.

It is of course true that the importance of downstream foreclosure diminishes the higher barriers to entry at the upstream level are. But first, the opposite is also true; that is, the lower the barriers to entry at the manufacturing level, the greater the importance of downstream foreclosure.\textsuperscript{29} More importantly, however, retail-level foreclosure is an important supplement to existing barriers, even when these are not negligible. As long as the incumbent manufacturer’s advantages over potential entrants are not significant enough to impede entry, forcing potential entrants to overcome barriers to entry to the retail segment becomes not only important, but in fact essential in forestalling competition. Barriers to entry at the retail level need not be any higher than barriers to entry at the manufacturing level. As long as there are \textit{additional} barriers to entry at the retail level, foreclosing existing retail outlets makes entry into manufacturing less probable.\textsuperscript{30} Although there are indeed additional measures a manufacturer can employ to forestall entry, retail-level foreclosure is an important device in forestalling upstream entry.

\textsuperscript{28} Under pure Bertrand competition this is not the case, because two competitors are enough to make the industry perfectly competitive. Therefore, if there are two producers they should be indifferent to entry. However, the incentives of a single producer to impede the first competitor’s entry are, of course, even more pronounced.

\textsuperscript{29} It should be noted that if the retail sector were perfectly competitive, foreclosing the existing retail segment would have no effect. But retailing, like all industries, is not perfectly competitive (see Chamberlin, \textit{supra} note 19 at 56. See also \textit{Hovenkamp II, supra} note 15 at 445 – 447. See also Dennis W. Carlton, “A General Analysis of Exclusionary Conduct and Refusal to Deal – Why Aspen and Kodak are Misguided” (2001) 68 Antitrust L.J. 659 at 660, 663. Retailing through existing outlets is therefore more cost-effective than inducing independent entry into the retail level.

\textsuperscript{30} For an analysis of situations in which exclusivity may raise rivals’ costs see Thomas G. Krattenmaker & Steven C. Salop “Anticompetitive Exclusion: Raising Rival’s costs to Achieve Power over Price” (1986) 96 Yale L.J. 209.
This is certainly the case when an entrant has already signaled its ability to overcome barriers to entry at the upstream level and is on the verge of entry.\footnote{This explains why RPM may be an important supplement to, and even a substitute for, lowering wholesale prices as a tool for combating entry. If the incumbent simply lowers wholesale prices, it gains no inherent advantage over the entrant. Both the incumbent and the entrant lose the same amount from any price reduction. This does not mean that lowering wholesale prices is never an effective exclusionary method. For example, if the entrant can back out of any of the sunk costs, its computations may be different than the incumbent’s and it may be more inclined to withdraw from the market (for a discussion on sunk costs see Robert S. Pindyck, “Sunk Costs and Real Options in Antitrust” (June 2005) NBER Working Paper Series 11430 at 5 – 8, online: NBER <http://www.nber.org/papers/11430>). But unlike the foreclosure of existing outlets, lowering wholesale prices does not directly impose any cost on the entrant that is not borne by the incumbent as well.}

\section{3) The Anti-competitive Potential of Exclusivity}

At first glance, there may seem to be no anti-competitive potential in retail-level exclusivity. Exclusivity can be thought of as a retail-service sought by manufacturers. Much like other services performed by retailers, they will provide this service to the highest bidder. Manufacturers will therefore compete with each other for retailers’ exclusivity. This competition will result in manufacturers offering retailers larger margins between wholesale price and retail prices, thereby competing away larger portions of their rents.

This is true, but it does not follow that exclusivity is not competitively harmful. The reason is that although manufacturers will indeed compete with each other for retailers’ exclusivity, the effects of this type of competition will not be those welfare enhancing effects normally associated with competition. Competition between manufacturers will result in larger portions of the monopoly rents being shifted to the retail segment, but they will not increase total output, lower prices, or make the product more appealing to consumers. Manufacturers will compete with each other over which of them will be granted the position of sole supplier and the opportunity to exploit consumers by reducing quantities and elevating prices. A portion of the rents, perhaps a significant portion of the rents, will be shared with retailers, but the deadweight loss and wealth transfer associated with the exertion of market power will remain unchanged.

This point is illustrated by the \textit{Nielsen} case.\footnote{\textit{Supra} note 21.} Nielsen is a Canadian subsidiary that offers a large variety of marketing research services. The data for Nielsen’s analyses come from various sources. One of these
sources is scanner data, obtained from retail outlets which scan the product at the checkout and hold valuable information regarding the time of purchase, price, quantity, and so on. These data are an important input for Nielsen’s analyses, which are then sold to manufacturers and retailers to assist them in planning marketing and distribution.\(^3\) In 1995 the Canadian Director of Investigation and Research sought to obtain an injunction enjoining Nielsen from engaging in certain practices, among which were exclusivity provisions which stipulated that retailers would not sell their data to anyone but Nielsen. Such clauses existed in Nielsen’s contracts with all major grocery retailers.\(^4\) Nielsen’s arguments and the Tribunal’s response to these arguments are illuminating in this context:

Nielsen and its experts have advanced the view that the exclusives have not resulted in the substantial lessening of competition because it was and is open to IRI [Nielsen’s main competitor] to ‘compete’ with Nielsen for the exclusives each time they come up for renewal. Thus, the argument proceeds, in 1986 and 1991, IRI could have outbid Nielsen and secured for itself exclusive access to the scanner data and can do so upon expiry of the current agreements. This, it is argued, results in a competitive market. [Nielsen] does not, however, provide any evidence or, indeed, any argument as to how or why this type of ‘competition’ for exclusives would produce the results that one looks to competition for, namely lower prices and better products. Dr. Winter describes what occurred in 1986 with respect to retailers’ scanner data as ‘competition for the market’, in contrast to competition within the market… The winner becomes the sole supplier of the service for the duration of the exclusives. As noted by Dr. Winter, the most likely effect of this type of competition for exclusives is higher prices to retailers for their data which would be incorporated into the price charged for the market tracking services based on the data.\(^5\)

\(^4\) *Ibid.* at 257.
\(^5\) *Ibid.* at 268. Nielsen’s expert, Dr. Mathewson, suggested “that there was a possibility that that the payment received by retailers might get passed on to their consumers.” But the Tribunal rejected this proposition, saying: “While raised as a possibility, there was no reason given as to why this might be expected to happen and no evidence was before us relating to the possibility. We believe that the more likely outcome is that the payments received for exclusive access are simply reflected in the retailers’ bottom line, since it is difficult to see how the payments would enter into the retailers’ pricing decisions” (268).
III. RPM v. Direct Payments for Exclusivity

The preceding analysis does not explain why RPM would be chosen over direct payments as a payment method for exclusivity. Entry can also be forestalled by signing exclusivity contracts with retailers and paying them directly for their loyalty. An incumbent manufacturer may make direct cash payments to each of the retailers for each unit sold of the incumbent’s product. Alternatively, the incumbent may pay retailers a lump sum equal to each of their expected gains from selling the product at the RPM price.\(^{36}\) Each of these may have the same effect as RPM. However, RPM carries certain advantages compared to both of these alternatives in the context of preserving a monopoly.

1) RPM is Preferable to Per-unit Payments Because it Prevents Retailers from Competing the Manufacturer’s Payments Away

The first direct payment option is a per-unit payment. The manufacturer may pay retailers a fixed sum that is not contingent on retail prices for each unit of its product that they sell. If this sum is equal to the margin created by RPM, the overall payment to each retailer will be the same as through RPM.

Per-unit payments, however, may not work well due to competition at the retail level. If the manufacturer offers per-unit cash payments in return for exclusivity, retailers will regard the payment as a unit-price reduction and discount the product in an attempt to increase volume. Each retailer will attempt to slightly under-price other retailers’ selling prices until all additional rents paid by the manufacturer have been passed on to consumers, leaving retailers no better off and consequently with no preference for the manufacturer’s product. RPM is therefore preferable to making per-unit cash payments in return for exclusivity, because it ensures that retailers’ payments are not lost. By introducing RPM the manufacturer not only pays retailers for their loyalty, but also prevents the dissipation of these payments.\(^{37}\)

---

\(^{36}\) Each of the retailers’ expected gains from selling the brand at the RPM price may be different for two reasons: first, the number of units each of the retailers sells may vary. Second, their respective buying (wholesale) prices may differ, which creates unequal per-unit margins.

\(^{37}\) Subject to the prevention of cheating on RPM through non-price competition, an issue I later address (see section V(3), below).
2) **RPM is Preferable to Lump Sum Payments Because it Creates a Sustainable Long-run Equilibrium**

A second alternative to RPM is paying retailers lump sums (independent of the actual number of units they sell) in return for exclusivity. This overcomes retailers’ tendency to compete the payment away, because a lump sum is not part of retailers’ marginal cost and is therefore not incorporated into their unit pricing decisions.\(^{38}\)

However, lump sums introduce a different problem, which stems from fluctuations in retailers’ respective market shares over longer periods of time. Over time market shares cannot be expected to remain constant. The kinds of fluctuations I refer to here are those that are caused by reasons external to retailers’ actions. For example, if a construction site is set up in the vicinity of one establishment, some consumers may reevaluate their preferences and purchase the product from a different outlet. If an office building starts to operate near an establishment some of the people who work in the building may start purchasing the product from that establishment, and so on. As a result of changes in market shares, retailers whose market share has grown find themselves underpaid for their exclusivity and retailers whose market share has shrunk are overpaid for their loyalty. This, in turn, may create an incentive for the underpaid retailers to breach the exclusivity agreement in return for a payment from the entrant that is better calibrated to their new market share. Although this will ultimately cause total industry rents to shrink, the underpaid retailers’ share of the rents will have increased. If the increase in these retailers’ share of the rents outweighs their private loss from the decrease in total rents, they will find it profitable to breach their exclusivity agreement with the incumbent.\(^{39}\)

In order to overcome this problem the incumbent must ensure that retailers’ payments are adjusted to their respective market shares. But this re-introduces the per-unit problem discussed earlier; that is, since consideration for exclusivity becomes dependent on marginal units, retailers will attempt to discount the product in order to increase volume and thus receive larger payments, which will ultimately result in the dissipation of rents through competition.

Lump sum payments therefore result in an unstable system which will ultimately collapse. RPM, by contrast, addresses this concern. Because it is paid on a per-unit basis, retailers’ return is automatically adjusted to their respective market shares. Therefore, a retailer whose market share has increased for some exogenous reason immediately receives a larger portion of the rents shared with retailers, and is


\(^{39}\) For a numeric example see text accompanying *infra* notes 47 – 48.
not underpaid. By assuring that retailers with exogenously-increased market shares receive adequate compensation, RPM achieves a stabilized system of returns which is not jeopardized by fluctuations in market shares.

It should be noted, that while that the adjustment of retailers’ payment to fluctuating market circumstances addresses the discrepancy that may arise due to exogenous reasons, namely reasons external to retailers’ actions, it also adjusts retailers’ payments to endogenous fluctuations; that is, retailers’ payment is also increased if they increase their market share by cheating on the RPM system and lowering retail prices or by engaging in non-price competition. Non-price competition refers to the numerous possible ways of effectively discounting a product without nominally lowering its price. Favorable credit terms, free delivery, a complementary item for an extremely low price (or even for free) and so on, are but few of the numerous forms of competition which may be economically equivalent to nominally lowering retail prices.\(^\text{40}\) The possibility of cheating on the RPM system through direct price competition or through non-price competition is addressed later, and I explain how this potential challenge to the system is resolved.\(^\text{41}\) For present purposes, the important point is that RPM automatically adjusts retailers’ payment to their respective market shares and thus resolves a problem that compromises the manufacturer’s ability to sustain an exclusivity system with direct payments.\(^\text{42}\)

\(^{41}\text{See section V(3), below.}\n
\(^{42}\text{Of course, these advantages would be valueless if contracts were complete in the sense that their enforcement was guaranteed and costless; If that were the case, the incumbent could sign exclusivity contracts and be guaranteed of their performance, and there would be no need to prevent fluctuations in retailers’ incentives pursuant to the agreement. However, perfect contracts are only a theoretical benchmark. Much like perfect competition, they are useful in theoretical studies and arguments but can never exist (Ronald H. Coase, “The Nature of the Firm” (1937) 4 Economica 386 at 390 – 392; Benjamin Klein, Robert C. Crawford, & Armen A. Alchian, “Vertical Integration, Appropriable Rents, and the Competitive Contracting Process” (1978) 21 J.L. & Econ. at 301). In the present context, although neither writing an exclusivity clause nor observing that such a clause has been breached seem to be very burdensome, satisfactorily proving damages arising from such a breach in court as well as immediately putting an end to the breach may be. Therefore, there is value in creating a system through which the manufacturer can privately punish retailers for observed breaches of the agreement without resorting to the judicial process.}\n
18
3) Summary

Introducing RPM as a means of achieving retail-level exclusivity may be preferable (from the upstream firm’s perspective) to customary exclusivity agreements for two main reasons. First, RPM ensures that retailers do not lose the payment they receive for exclusivity due to competition between them, which in turn maintains their incentive to adhere to the agreement. Second, it overcomes a problem associated with lump sum payments, which is the destabilization of the equilibrium due to incentive distortions.
IV. Why is RPM Likely to be Used to Induce Anti-competitive Conduct?

Thus far I have shown that RPM may be used as an inducement to exclusivity. I have also explained why RPM may be preferable to directly paying retailers for exclusivity. But the analysis does not show that RPM is anti-competitive. According to the hypothesis RPM itself does not create a welfare loss. It is simply a way of sharing rents with retailers. Exclusivity, which is what retailers provide in return for RPM, is the competitively problematic practice. The creation or preservation of monopoly rents, rather than the fact that they are shared with retailers, is what raises competitive concerns. This implies that if RPM can be used to induce services other than exclusivity it is not necessarily anti-competitive. Even assuming that RPM is more likely to induce exclusivity than it is to induce other services, if exclusivity itself is not unequivocally anti-competitive, RPM is not necessarily anti-competitive either. I now proceed to show first that RPM is more likely to be used to induce exclusivity than it is to induce other services. I then show why the kind of exclusivity RPM induces is the anti-competitive exclusivity which forecloses a market and not other kinds of exclusivity.

1) Exclusivity and the Provision of Desired Services

One of the pro-competitive explanations for RPM is an explanation developed by Klein and Murphy. According to this explanation, RPM may be used as a contract enforcement mechanism. According to this hypothesis, RPM is a way to share rents with retailers in order to induce the provision of services the manufacturer desires, when it is uneconomical for the manufacturer to write an explicit contract with its dealers regarding some aspect of desired dealer performance. The use of RPM as a contract enforcement mechanism according to the contract-enforcement mechanism hypothesis is similar to its use according to the exclusivity-inducement hypothesis. RPM is simply a way to share rents with retailers in return for services. But these services, according to Klein and Murphy, are welfare

---

43 See also Hovenkamp, *supra* note 18 at 454.
44 Klein & Murphy, *supra* note 14 at 267.
enhancing. RPM may seemingly be used to induce pro-competitive services in the same way that it can induce exclusivity.

There are several problems, however, with the contract enforcement mechanism hypothesis. These shortcomings challenge the idea that RPM is used to induce the provision of services other than exclusivity.

a. Direct Payments

One respect in which the contract enforcement mechanism hypothesis is different from the exclusivity-inducement hypothesis is the adequacy of direct payments as a rent-sharing device.

I have explained why both direct lump sum payments and direct per-unit payments would not work as an inducement to exclusivity. To briefly recapitulate, lump sum payments would result in a distortion of incentives when market shares fluctuated and per-unit payments would soon be dissipated through competition.

According to Klein and Murphy’s hypothesis, by contrast, there is no reason for the manufacturer not to pay retailers directly. The payment would need to comprise a per-unit component and a fixed component. The former would be calculated to equal exactly the per-unit cost of providing the service. Thus, retailers could not use this payment to discount the product: they would have to provide the service in order to receive the per-unit payment, and they would need to use the per-unit payment to fund the service. The per-unit sum would also automatically adjust to fluctuations in market shares. The lump sum component would be the portion of the rents retailers retain. This sum, unrelated to the number of units sold, would not be used by retailers to discount the product because it is not contingent on marginal sales. The manufacturer need not forego the benefits of competition at the retail level according to the contract-enforcement mechanism hypothesis.

The combination of a fixed sum and a marginal per-unit payment would not alleviate the concern according to the exclusivity-inducement hypothesis. If any share of the payment is a lump sum, it will create a distortion in retailers’ incentives when market shares fluctuate. If any share of the payment is contingent on marginal sales, it will be dissipated through competition.

Klein & Murphy give several examples of such welfare enhancing services, such as rotation of products with limited shelf-life and promotional services such as shelf space or product demonstrations. See ibid. at 266, 280 - 292.
There are two important distinctions between the contract-enforcement hypothesis and the exclusivity-inducement hypothesis. The first is that according to the contract-enforcement hypothesis retailers are expected to incur a marginal cost in the provision of services. Therefore, a marginal sum equal to the cost of providing the services cannot be ‘spent’ on competition. According to the exclusivity-inducement hypothesis retailers are not expected to incur a cost, so any marginal component will be used to compete, unless competition is prevented through RPM.

Second, according to the contract-enforcement hypothesis there is no opportunity cost to providing the sought services. Retailers either provide the service the manufacturer desires and get a share of the rents or do not provide it and get nothing. According to the exclusivity-inducement hypothesis, retailers have an opportunity cost to receiving a lump sum payment. This opportunity cost is the lump sum payment they can obtain from the entrant in return for distributing its product. This payment would be equal to a share of the duopoly rents corresponding to the retailers’ respective market share. Consequently, any discrepancy between a lump sum payment and retailers’ respective market shares will compromise the stability of the exclusivity scheme. Under the contract-enforcement hypothesis, a lump sum payment will not result in retailers under-providing the service if their market shares change. They receive immediate compensation for the additional cost of providing additional units of service, and the lump sum they receive is valuable regardless of their exact number of units. Their opportunity cost to providing the service is zero because if they do not provide the service they get no compensation. To be sure, even under Klein and Murphy’s explanation retailers whose market share has increased can be expected to negotiate larger lump sum payments from the manufacturer. But their second best option to larger lump payments is to continue providing the services in return for the original lump sum and not to cease providing the service. Consequently, discrepancies in the lump sum payments caused by market fluctuations do not undermine the stability of the equilibrium suggested by Klein and Murphy, but they do compromise the manufacturer’s ability to pay retailers directly for exclusivity.

Therefore, a direct payment calculated on the basis of a marginal component and a fixed component may induce the provision of services sought by the manufacturer, but is less adequate to induce exclusivity.

---

46 A direct payment which is a combination of a fixed sum and a marginal sum has an additional advantage according to Klein and Murphy’s hypothesis. In real life settings, the provision of services probably entails a combination of fixed and marginal costs. A lump sum calculated to both cover the fixed cost and share rents coupled with per-unit remuneration equal to the marginal cost of providing the service is consequently best tailored to repay retailers for these services.
Consequently, the manufacturer is more likely to forego the benefits of competition at the retail level in return for exclusivity than it is to do so in return for the provision of desired services.\textsuperscript{47}

A numeric example may be helpful in clarifying this argument: suppose that a manufacturer values some form of desired retail conduct at $150. There are ten retailers, and each sells ten units of the product for a total of 100 units sold. The cost of providing the service is $1 per unit. The manufacturer decides to pay retailers $140 for their services. It can either set a minimum retail price that is $1.4 higher than the price that would have otherwise prevailed, or pay retailers $1 for each unit of the product sold and an additional $4 per retailer (irrespective of the number of units sold). If the manufacturer opts for the second option, retailers will be unable to shirk on the agreement, because if they do not provide marginal units of service they lose $4. If retailers’ market shares change they are automatically compensated for the additional costs of providing the service, and continue to receive an additional $4. They therefore have no incentive to discontinue their spending on providing the sought services. Both systems thus result in retailers providing the service, and a manufacturer should therefore be reluctant to forego the benefits of retail-level competition, which may result in lower retail prices and larger manufacturing-level profits.

Suppose now, that it is not a service but rather exclusivity that the manufacturer values at $150. This is the case, for example, if monopoly rents are $290 and duopoly rents are $280, of which the manufacturer will accrue only half ($140). As in the previous example, the manufacturer decides to pay retailers $140 for exclusivity. If it pays each retailer $14, a retailer whose market share has increased from 10% to 11% finds itself underpaid for exclusivity. More importantly, this retailer will find it profitable to accept an offer from the entrant to carry the entrant’s product in return for 11% of the entrant’s share of duopoly rents ($15.4), which of course the entrant should be willing to pay, making the exclusivity arrangement extremely vulnerable to market fluctuations. If, however, retailers are paid through RPM, a margin of $1.4 per unit will automatically adjust this retailer’s compensation to fluctuating market circumstances. RPM is therefore better tailored to sustain an exclusionary long-run equilibrium than direct payments.

\textsuperscript{47} The idea of a direct payment comprised of a fixed and a marginal sum may seem complicated, but calculating the direct payment would be no more complex than calculating the RPM price according to the contract-enforcement hypothesis. According to this hypothesis, the RPM price is calculated so as to leave a per-unit margin equal to the marginal cost of providing the service and the additional sum the manufacturer decides to share with retailers (divided by the number of units each retailer sells). A direct payment system would comprise the same components.
b. Diminishing Returns to Service

A second problem with the contract-enforcement mechanism explanation is that if remuneration for services is offered through RPM, retailers will provide less than the desired amount of services. Since RPM offers a per-unit return, it must be calculated to cover the *average* per-unit cost of providing the services. The payment for services is uniform across units. However, if there are diminishing returns to services or an upward sloping supply curve of providing the services, both of which are usually true, dealers will have an incentive to supply less than the desired amount of service.\(^{48}\) Direct payments, by contrast, overcome this problem by forcing retailers to provide *all* units of service in order to receive payment.\(^{49}\) Alternatively, direct payment can be designed so that the returns to the marginal units of service are higher than the returns to the infra-marginal units of service. The important point is that direct payments are again preferable to RPM in achieving the manufacturer’s goal, if the sought retail-conduct is the provision of a service that has a direct cost.

According to the exclusivity-inducement hypothesis, by contrast, retailers are not expected to provide any costly services in return for their share of the rents. They are simply required to preserve the rents. Therefore, a per-unit return does not distort the incentives to provide anything. Retailers have a vested interest in the preservation of the monopoly because they share the rents with the monopolist. Therefore, direct payments have no advantage over RPM as a remuneration mechanism according to the exclusivity-inducement hypothesis.

c. Summary

RPM’s function according to the exclusivity-inducement hypothesis is similar to its function according to Klein and Murphy’s contract-enforcement hypothesis. According to both explanations, RPM is used as a rent-shifting mechanism to induce desired retail-level conduct. Nevertheless, despite the similarity, the two hypotheses differ in relation to the sought conduct. The different characteristics of exclusivity and pro-competitive services suggest that inducement of the former is a more compelling explanation for RPM than inducement of the latter. While the achievement of the goals identified by Klein and Murphy

\(^{48}\) For an elaborate explanation of this objection see Paldor, *supra* note 17 at 202 - 203.

\(^{49}\) If the direct payment is a combination of a lump sum and a marginal sum, as previously suggested, only the lump sum needs to be contingent on the provision of all units of service. The marginal sum can be paid regardless of whether or not all units of service have been provided. The reason for this is that retailers do not make a profit when they receive the marginal sum. It simply covers the cost of the additional unit of service.
can be done as effectively, and in some respects even more effectively, without compromising competition at the retail level, the achievement of exclusivity is more effective through RPM than through direct payments.

2) Pro- and Anti-competitive Functions of Exclusivity

An issue closely related to the previous one is the competitiveness of exclusivity itself. The previous analysis explains why RPM is more likely to induce exclusivity than it is to induce other services. But this too does not automatically lead to the conclusion that this use of RPM is anti-competitive. Exclusivity may indeed be anti-competitive and result in market foreclosure. But exclusivity also has a host of pro-competitive effects identified by scholars. First, exclusivity guarantees a supplier that all of the customer’s future quantities will be purchased for the duration of the exclusivity agreement. This decreases uncertainty, which lowers the costs of manufacturing.

Second, exclusivity may reduce the uncertainty associated with future fluctuations in market prices, which may facilitate investment in entry or expansion, especially when entry requires significant sunk costs.  

Thirdly, exclusivity may be necessary in circumstances under which the manufacturer assumes the risk associated with low quality vis-à-vis final consumers, for example through warranties. Under such circumstances, exclusivity may be a cost-effective way for the manufacturer to verify that products purchased from a specific retailer originated from the manufacturer.

Finally, exclusivity may be used as a device to eliminate inter-brand free riding. For example, if a manufacturer invests in training retailers’ personnel, or aids a retailer in the construction of retail facilities and so on, a competing manufacturer may be able to free ride on these investments and offer a competing product for a lower price at the same retail outlet. Exclusivity prevents such inter-brand free

---

50 Although exclusivity standing alone may leave the parties exposed to opportunistic behavior, and may require specific contractual provisions. See Victor P. Goldberg, “Quantity and Price Adjustment in Long-term Contracts: A Case Study of Petroleum Coke” (1987) 30 J.L. & Econ. 369.

riding, and by allowing the manufacturer to capture the gains from such a system facilitates undertaking such investments when they are welfare enhancing.

It is true that exclusivity may achieve each of these advantages. However, none of these advantages explains why RPM would be used as an enforcement mechanism for exclusivity. The rationale behind exclusivity in each of these settings, with the exception of eliminating inter-brand free riding, is that through exclusivity the manufacturer is able to economize on costs.\textsuperscript{52} These costs may be the costs of insurance the manufacturer would have otherwise needed to purchase to protect itself from potential changes in market prices; they may be higher monitoring costs of verifying whose product the end consumer has purchased, and so on. But regardless of the kind of cost exclusivity allows the manufacturer to economize on, exclusivity allows it to save part of these costs, which in turn implies that total production costs will have decreased due to exclusivity.\textsuperscript{53} This can be expected to result in lower wholesale prices than would have prevailed but for exclusivity.

Consequently, there is no need to implement RPM in order for retailers to agree to exclusivity. Simply offering lower wholesale prices to exclusive outlets will suffice. It is only when exclusivity is used anti-competitively (to preserve an upstream monopoly) that its immediate effects on retailers are detrimental, raising the need for a system that compensates retailers for the elevated wholesale prices (facilitated by their own actions).

The elimination of inter-brand free riding is an exception to the previous observation. Unlike the other pro-competitive functions of exclusivity, the elimination of free riding does not allow the manufacturer to economize on costs. Quite the contrary: the elimination of inter-brand free riding allows the manufacturer to \textit{incur} additional costs, namely to pay for desired retail-level activity, which is unprofitable if competing manufacturers can sell their products at the same outlet (and thereby free ride on the services). This, however, does not change the analysis. Rather than lower wholesale prices, the manufacturer can simply fund the activity (on which competitors can free ride) for those retailers who agree to exclusivity. Retailers who agree to exclusivity will be given a free service, the economic equivalent of a reduction in wholesale prices, leaving them better off than had they not agreed to

\textsuperscript{52} The cost-savings associated with exclusivity are not limited to upstream firms granted downstream-level exclusivity. I focus here on the manufacturer’s savings because the exclusivity RPM induces is exclusive purchasing, \textit{i.e.} retail-level exclusivity.

\textsuperscript{53} As Hovenkamp stipulates: “A dollar saved in transaction costs saves consumers just as much as a dollar saved in production costs” (Hovenkamp, \textit{supra} note 51 at 122).
exclusivity. Very similarly to other pro-competitive functions of exclusivity, there is again no need for RPM in order for retailers to agree to exclusivity.

Much like the contract-enforcement mechanism hypothesis, pro-competitive exclusivity does not require competition at the retail level to be forestalled.

3) Summary

The analysis in this section explains why RPM is not likely to be used pro-competitively, but is likely to be used anti-competitively. The elimination of competition at the retail level is unnecessary to induce the provision of services sought by the manufacturer. Although rent-sharing can indeed be an effective contract enforcement mechanism, it does not require the manufacturer to forego the advantages of competition at the retail level. When rent-sharing is used to induce exclusivity, by contrast, rents must be shared through RPM to prevent the rents from being dissipated through competition (if they are paid on a per-unit basis) or creating a distortion which destabilizes the equilibrium (if they are calculated on a fixed basis). Finally, I have also explained why the kind of exclusivity that requires RPM is the anti-competitive exclusivity that preserves (or creates) monopoly rents. Exclusivity contracts designed to achieve pro-competitive goals will result in added value that allows the manufacturer to lower wholesale prices or offer retailers free services, not in higher wholesale prices for which retailers need to be compensated through RPM. This explains why the use of RPM as a rent-sharing mechanism can be expected to be anti-competitive.
V. Objections to the Hypothesis

There are two important objections to the foreclosure hypothesis. One is that even if retailers grant the manufacturer exclusivity and receive a supra-competitive per-unit profit in return, each will attempt to under-price its competitors by breaching their exclusivity commitment and selling a competing product for a price that is lower than the RPM price. Alternatively, they may attempt to discount the RPMd product itself either directly or by engaging in non-price competition. These objections will be addressed next.

1) Shirking on the Exclusivity Commitment – RPM and the ‘Price Umbrella’

One potential objection to the hypothesis is that each individual retailer may, in pursuing its own self interest, find it profitable to shirk on the exclusivity commitment and sell the competing product. The collective action problem discussed earlier in the context of rejecting an unprofitable offer\(^\text{54}\) is also prevalent in the context of adhering to retailers’ commitment once it has been made. RPM artificially raises retail prices, thus creating a ‘price umbrella’ under which the competing product can be profitably sold.\(^\text{55}\) Each retailer is better off if other retailers remain exclusive, and she herself sells the competing product for a price that is lower than the RPM price. This will allow the shirking retailer to both increase volume at other retailers’ expense and make a supra-competitive return on each sale. Each retailer faces the same incentives, and the system will seemingly collapse.

But breaches of the exclusivity agreement are both detectable and punishable. If a retailer diverts demand to the competing product, this will have a twofold effect. First, the breaching retailer’s market share of the incumbent’s product will shrink. Second, total demand for the incumbent’s product will be smaller. As the sole supplier of its own product, the incumbent should have no difficulty in detecting either of these phenomena. If total demand for the product decreases coupled with a decrease only in quantity ordered by a specific retailer this implicates the specific dealer as a seller of the competing brand. Breaches of this kind are automatically observed by the incumbent. There is no need for external monitoring. By simply keeping track of its own records the incumbent can identify breaches of the agreement.

\(^\text{54}\) Text accompanying supra note 25.  
I have earlier argued that one of the advantages RPM has over lump sum payments is that it automatically adjusts retailers’ remuneration to their market share, when market shares change due to exogenous reasons. The argument made here is in tension with that argument. Although RPM indeed adjusts retailers’ remuneration to exogenous changes in market share, it also adjusts their remuneration to endogenous changes.⁵⁶ When a decrease in a retailer’s market share is observed the manufacturer cannot automatically know if this is a result of an exogenous change in market shares or an endogenous change in market shares. Put differently, a retailer’s share may have shrunk because a construction site was set up in the vicinity of that retailer’s establishment or because the retailer has breached the exclusivity agreement. This does not, however, undermine the present argument.

First, when exogenous reasons are the cause of a fall in a specific retailer’s market share, a portion of the lost demand can be expected to shift to competing outlets. Although some consumers will probably cease to purchase the product altogether, others will purchase it from competing outlets. Therefore, total demand can be expected to have decreased by less than the decrease in quantities sold by the specific retailer, and competing retailers’ market share can be expected to slightly increase.⁵⁷

By contrast, when a retailer diverts demand to a competing product the fall in total demand for the incumbent’s product can be expected to precisely mirror the fall in quantities of the product sold by the retailer. The retailer simply offers consumers a competing product. The retailer can continue carrying the incumbent’s product and sell it to consumers who are not persuaded to purchase the competing product. Consequently, there should be no ‘spillover effect’ to competing retail outlets, or a very insignificant one. A fall in quantities ordered by a specific outlet coupled with a similar fall in total quantities ordered is distinctive to endogenous reasons for the fall. Exogenous reasons will also result in a drop in quantities sold by a retailer coupled with a drop in total quantity sold by the manufacturer, but the latter will be smaller than the former. Thus, the fact that RPM has the positive feature (from the manufacturer’s perspective) of automatically adjusting to exogenous changes in retailers’ market shares does not preclude RPM from effectively signaling that an endogenous change, namely cheating on the exclusivity, is occurring.

⁵⁶ Text accompanying supra notes 39 - 42.
A second explanation for how both arguments are consistent with one another is that even if both endogenous and exogenous changes to market shares have similar outcomes, RPM is nonetheless valuable in addressing both. When a manufacturer observes a fall in a specific retailer’s quantity coupled with a drop in total quantities it simply needs to visit the retail outlet to see whether or not the outlet is carrying the competing product. As suggested earlier, breaches of exclusivity are observable.\textsuperscript{58} It is simply a question of whether or not the retailer carries the competing product. RPM therefore automatically adjusts retailers’ returns to exogenously-changed market shares while at the same time making detection of exclusivity breaches forthcoming, even if not automatic.

Once a breach has been detected, the incumbent can respond in one of two ways. The first may be to offer the breaching retailer additional compensation for exclusivity. The specific retailer may have a different cost structure than other retailers, or may simply have some degree of market power vis-à-vis the incumbent, which justifies larger margins. If that is the case the incumbent will respond by lowering the specific retailer’s wholesale price, thereby enlarging that retailer’s profit margin. If, however, the incumbent finds that the retailer’s breach is unjustified, the incumbent may punish the retailer by withholding supplies. Of course, this will force the retailer to purchase all of its demand from the competition, so intuitively withholding supplies from a retailer works to the incumbent’s detriment. However, for exclusivity to effectively exclude a competitor the incumbent need not fully foreclose the retail segment. A significant percentage of the retail segment may make a competing enterprise unsustainable. The entrant is forced to bear the fixed costs of entry regardless of the number of units it sells. Consequently, the smaller its market share the less profitable entry is. As Aghion and Bolton stipulate:

\begin{quote}
…In general… the size of the market will affect the probability of entry. For example, if the entrant must pay a fixed cost of entry, then his average cost is decreasing in the number of customers served and the probability of entry is increased in the number of customers. In the latter case, when one buyer signs a long term contract with the incumbent, he imposes a negative externality on all other buyers. By locking himself into a long-run relation with the seller, he reduces the size of the entrant’s potential market so that, \textit{ceteris paribus}, the probability of entry will be smaller.\textsuperscript{59}
\end{quote}

\textsuperscript{58} Text accompanying \textit{supra} note 56.

\textsuperscript{59} Aghion & Bolton, \textit{supra} note 25 at 395 – 396.
Hovenkamp suggests that exclusivity may have an anti-competitive effect if a large percentage of the single available mode of distribution is foreclosed, but does not specify what a large percentage means. Courts generally condemn exclusivity agreements foreclosing a market share of 30 to 40 percent and up, with the FTC exhibiting an even more aggressive approach. In their joint treatise Areeda and Hovenkamp suggest that exclusivity may be anti-competitive in cases where a “large downstream market share” is covered by the restraint. Although the term ‘large’ is not translated into a number, the examples given of large market shares are of 80 percent.

The important point in the present context is that in its campaign against competition at its own level a percentage of retail outlets are dispensable from the incumbent’s perspective. The exact percentage of dispensable outlets will depend on numerous factors such as the relationship between fixed costs and marginal cost at the retail level and at the manufacturing level, other barriers to entry, and the demand for the product. But the important point is that the incumbent can afford to alienate a certain number of retailers and still successfully combat entry. Therefore, terminating supplies to a specific dealer, who has breached the exclusivity contract and is already carrying the competing product, will not sustain the competing enterprise. From the breaching dealer’s perspective, termination is costly. First, the retailer loses its share of the monopoly rents. Second, it is cut off from the only dependable supply-source. If the incumbent’s campaign is successful and entry fails, the breaching retailer will be left unable to retail the product. If the product is a significant component of the retailer’s business this may even jeopardize its enterprise completely.

If a large enough number of retailers decide to carry the entrant’s brand the incumbent may be unable to ‘punish’ them all. Alienating a significant enough number of retailers will force these retailers to carry the competing product and secure entry. But the analysis offered earlier is key in understanding why this will not happen. As explained earlier, if retailers coordinate with each other they have no incentive to cause the RPM system to collapse because as a whole they are made better off by participating in the campaign.

60 Hovenkamp II, supra note 15 at 438.
61 See survey in Hovenkamp, ibid. at 435 – 437.
63 Once entry has failed and the monopoly secured, the incumbent may have little reason to withhold supplies from the retailer. However, ex ante the incumbent may be willing to commit to terminating breaching dealers (or threaten to do so) to prevent breaching in the first place.
64 See section II(1), above.
If retailers do not coordinate, each retailer alone will have no incentive to breach the exclusivity agreement. In this the situation differs from the regular cartelistic situation. In ‘regular’ cartels a specific firm’s deviation results in short-run gains to that firm on one hand and long-run losses associated with the collapse of the cartel on the other. Either of these may dominate. But in the present context short-run gains from non-cooperation are very limited and long-run losses stemming from punishment can be expected to dominate. There are two determinants of the sustainability of cartelistic agreements that are relevant to the present analysis. One is the detection period. The shorter the detection period, the less profitable cheating is. A second determinant is the ability to target and punish cheating cartel-members. If a cheating cartel-member can be individually targeted, disciplining cheating cartel members does not require all firms to forego supra-competitive profits. As explained, in the setting described here detection can be expected to be relatively swift, and the previous analysis suggests that deviating members can be targeted without collapsing the system completely.

The upshot of this analysis is that non-coordinated breaches of the exclusivity will not occur for fear of termination and coordinated breaches will not occur because as a group retailers will find it unprofitable. So, the system is fairly resilient to breaches, which are both detectable and punishable.

2) Selling the Product for a Lower Price or Engaging in Non-price Competition

A second challenge to the hypothesis is the possibility of cheating on the RPM system by selling the RPMd product for a lower price. Much like in a cartel, each member will find it profitable to slightly under-price the maintained price and increase volume, and the price will return to the competitive level. Although initially beneficial to the incumbent due to increased volume, the loss of supra-competitive rents will quickly result in the preservation of the monopoly having no appeal to retailers. Retailers will

---

65 See Trebilcock et al., supra note 21 at 95.
66 Ibid. at 65 – 66.
67 Ibid. at 95.
68 A retailer may also find it profitable to breach the agreement if enough retailers have been terminated so that the incumbent cannot afford to lose even one more retailer; that is, if even one more retailer carries the entrant’s brand the entrant’s enterprise will reach the minimum efficient scale of production and become sustainable (on the measurement of minimum efficient scales of production see Dennis W. Carlton & Jeffrey M. Perloff, Modern Industrial Organization 3rd ed. (Reading, Menlo Park, New York: Addison Wesley Longman, 1999) at 40 – 42). But this is not a major qualification. First, knowing that this is the situation requires a significant amount of information. Second, and more importantly, the situation will never be reached if the first retailers (who are dispensable) are deterred from breaching.
consequently start carrying both the incumbent’s product and the competing product, which will erode the monopoly rents.

Much like breaching the exclusivity commitment, cheating on the cartel is not a serious threat to the stability of the system. Indeed, the main contribution of the incumbent to profits at the retail-level is its ability to efficiently monitor and enforce the retail-level cartel. And similar to breaches of the exclusivity commitment, cases of cheating are detectable and punishable. Cheating on the RPM price by a retailer will have a distinctive twofold effect: first, total demand for the product will increase. Second, the cheating retailer’s market share will grow. An increase in total quantity sold, coupled with a specific retailer increasing its market share is a signal that the manufacturer receives almost instantly. And this signal is both strongly suggestive of the fact that cheating is occurring and an implication of the specific retailer as the cheating retailer. It does not matter if the retailer cheats on the cartel by lowering prices or by competing along non-price dimensions. If the retailer is effectively lowering retail prices the outcome will be the same. All the data relevant to monitoring the cartel and detecting breaches is not only within the incumbent’s reach, but in fact in its own records.

Once again, the signal the manufacturer receives from an increase in total quantity coupled with an increase in quantities ordered by a specific retailer may be the result of exogenous reasons. But very similarly to the argument made regarding breaches of exclusivity, RPM can both achieve automatic adjustment to exogenous market-share changes and act as a signal of endogenous reasons for market-share increases. When a manufacturer observes an increase in a specific retailer’s quantity coupled with an increase in total quantities it simply needs to visit the retail outlet to see whether or not the outlet is offering the product for a lower price or engaging in non-price competition. Similarly to breaches of the exclusivity, cheating on the RPM price is observable.

Moreover, an increase in the specific retailer’s market share implies lost sales for competing retailers. Therefore, each of them has an incentive to verify the reason for the drop in their own sales and report to the manufacturer if a competing outlet has breached the agreement.\textsuperscript{69} RPM ensures that not only the manufacturer but also each of the retailers receives a signal that a competitor may be lowering prices. And each retailer has an immediate incentive to investigate the matter and report findings of breaches to the manufacturer. Thus, RPM again makes detection of cheating forthcoming, although not automatic.\textsuperscript{70}

\textsuperscript{69} See also \textit{Monsanto, supra} note 8 at 761 - 764.

\textsuperscript{70} Endogenous and exogenous reasons may also have different outcomes if the inter-retailer effects of price competition are more pronounced than the inter-retailer effects of exogenous changes. If this is the case, the inter-retailer effects of price-cuts should be similarly more pronounced than the effects of exogenous changes (see e.g. \textit{Winter, supra} note 14, \textit{Wright, supra}
As for punishing the cheating member, very similarly to the analysis offered for breaches of the exclusivity commitment, the incumbent can afford to terminate a certain number of cheating dealers despite the fact that the terminated dealers are automatically driven to the competing product. As long as the number of terminated dealers remains sufficiently low, the loss of the cheating retailer is not a serious cause of concern for the incumbent. The threat of termination coupled with the almost immediate detection of cheating thus works to stabilize the system *ex ante*.

---

note 57, Klein & Wright, *supra* note 57). which makes detection of cheating even easier. Endogenous changes (cheating on the RPM price) should result in a larger increase in the cheating retailer’s demand than exogenous changes.
VI. Policy Implications

The hypothesis advanced in this paper suggests that RPM is potentially anti-competitive even in settings in which it is considered by theorists (and the courts) to be categorically pro-competitive, namely when it is introduced at the initiative of a single manufacturer in furtherance of that manufacturer’s interests. This in itself does not, of course, imply that RPM should be treated as *per se* illegal. Even if it can be used anti-competitively, it nonetheless has widely accepted pro-competitive potential, which I do not challenge here. The conclusion to be drawn from this paper is that when applying the rule of reason to RPM, courts should be much more careful than the present state of the literature suggests. The next paragraphs offer some thoughts on the applicability of the hypothesis to different settings, which may help courts in evaluating real-life RPM systems that come before them.

First, the agreement between the incumbent and retailers may be an explicit agreement or a tacit one. The incumbent may explicitly agree with retailers that they will remain exclusive in return for RPM. Alternatively, the incumbent may simply introduce RPM and rely on the incentives created by the system to assure that retailers carry only the incumbent’s product. The analysis offered throughout this paper is equally applicable to both scenarios. For simplicity, I have generally assumed that there is an explicit agreement between the parties at least in the sense that each party is fully aware of the other party’s expectations. But this does not suggest that the analysis is irrelevant to a tacit arrangement.

Second, an intuitive setting for the use of RPM in this manner is an incumbent upstream firm combating entry. In other settings, exclusivity is necessary in order to *create* the rents, whereas in the setting of an existing monopoly threatened by potential entry the rents already exist and merely need to be preserved. In the former case, retailers may be less confident that the manufacturer offering to share rents is capable of servicing the whole market, that the manufacturer is able to pinpoint the correct monopoly price, and so on. Thus, there may be a higher degree of uncertainty associated with the viability of the manufacturer’s plan when the manufacturer is not an incumbent monopoly. Therefore, although from an

---

71 Challenging these explanations is the thrust of chapter III in Paldor, supra note 17 (p. 145 – 239).

72 If the manufacturer is unable to identify the correct monopoly price, industry rents will be too small either because a lower price is received for each unit (if prices are set sub-optimally) or because too little units are sold (if prices are set supra-optimally). If this is the case, the scheme may be unprofitable for retailers, for the manufacturer, or for both. The losing party will consequently withdraw from the agreement and the monopoly will not be sustained.
economic perspective there is no difference between creating a monopoly and preserving an existing monopoly, as a practical matter retailers’ acquiescence may be more forthcoming in the latter case.  

Additionally, in a setting in which an entrant has already signaled that it can profitably incur the costs associated with manufacturing, the erection of barriers to entry at an additional level may be essential in preventing competition. One example of such a case is the Israeli Tambur case, in which a paint manufacturer who had been a monopoly for years introduced RPM shortly after a competitor entered the market and began increasing its market share.

But although this is a natural setting for this anti-competitive use of RPM, the use of RPM as an inducement to exclusivity is by no means limited to incumbents attempting to forestall entry. It may similarly be used by a firm active in a market to drive out its competitor or competitors, or even by an entrant attempting to drive an incumbent out of the market. The fact that at the outset the manufacturer introducing RPM is not a monopolist does not make the hypothesis irrelevant. This is again illustrated by the Nielsen case, in which

"[t]hroughout the course of the proceedings counsel for Nielsen returned again and again to the origin of the present exclusive arrangements and the role of IRI to argue that, because IRI ‘initiated’ the practice of exclusives, Nielsen’s use of exclusives cannot be anti-competitive… In the view of the tribunal, retaining or obtaining a dominant position in order to defend against another firm potentially becoming dominant is not an acceptable business justification. If IRI had succeeded in its project with the retailers and continued to use exclusives… it would have been a candidate for the status of respondent in an

73 A monopolist may simply be seeking to improve its distribution system in face of emerging competition. Although a manufacturer should always seek to optimize its distribution system regardless of the emergence of competition, as a practical matter emerging competition may be a compelling reason to do what was neglected by the incumbent. (Areeda, supra note 15 at 96 & at n. 30). The introduction of RPM in response to emerging competition does not necessarily indicate that its purpose is to exclude competition. On the other hand, it would seem highly implausible that just as competition emerged an incumbent manufacturer suddenly realized that pre-sale demonstrations, time-reducing services, a different number of retail outlets, quality certification, or a different brand image were a critical component of the optimal distribution system; or that just as competition emerged the incumbent discovered enforcement problems with its distribution contracts. An incumbent manufacturer initiating RPM just as competition becomes a threat is highly suggestive of a ‘foreclosing use’.

74 On the importance of retail-level barriers see also supra note 31.

application launched by the Director. That is the position in which Nielsen now finds itself.  

It should also be noted that exclusivity-inducing RPM is likely to be introduced not only in the face of an immediate threat of entry, but also when barriers to entry (to the upstream level) are lowered. When this occurs the upstream firm is likely to respond by substituting an artificial barrier for the barriers to entry that were removed, so that potential competitors who are contemplating their response to these recently removed barriers are deterred from investing in entry.  

For example, RPM systems introduced subsequent to the lifting of bans on importation, reduction of tariffs, or other relaxations of regulatory barriers to entry, are very likely to be a manifestation of this use of RPM. This seems to have been the case in the Israeli Svirski case, in which a monopolistic manufacturer which had for years been satisfied with vigorous retail-level competition introduced RPM shortly after the introduction of a governmental program to expose the market to importation of the product.

Third, as mentioned earlier, this use of RPM is most likely when there is a single producer – or very few producers – at the outset. As the number of incumbents increase, the loss to the industry from entry decreases, and coordination problems become a more significant obstacle. Situations in which there are a large number of upstream firms at the outset are a harder fit for the hypothesis.

Finally, it should be recalled that one of the advantages of RPM according to the hypothesis is that it results in long-run equilibrium (in which retailers are paid and competition is forestalled). Therefore,

---

76 Nielsen, supra note 21 at 261 – 262.

77 There is value in heightening barriers to entry before potential entrants incur the costs of entry. Once an entrant has incurred (or committed itself to incur) a portion of the sunk costs, these costs are removed from its computation, lowering the probability of successful foreclosure.


79 Although they may fit other anti-competitive hypotheses, such as the manufacturers’ cartel hypothesis.
long-lasting RPM systems, specifically systems in which there seems to be no corresponding service that retailers are expected to provide vis-à-vis consumers is indicative of this use of RPM. For example, the *Standard Fashion*\(^{80}\) case seems to fit the hypothesis. In *Standard Fashion* a manufacturer of patterns for women’s and children’s garments, introduced an RPM system coupled with exclusivity. The contract at bar was one of many Standard Fashion contracts that made no mention of any service retailers were expected to perform;\(^{81}\) other Standard Fashion contracts elaborated on the exclusivity duty but still made no reference to any services to be provided by the retailer;\(^{82}\) and in other contracts Standard Fashion itself was to perform all pre-sale services.\(^{83}\) All of Standard Fashion’s contracts that came before the courts in the course of nearly three decades contained an RPM covenant and an exclusivity covenant, and not one included any consideration for exclusivity other than RPM. The court in *Standard Fashion* summarized its findings as follows:

> The purpose of the whole contract is plainly to sell patterns at a reduced rate to the defendant on the condition that it will resell at the retail prices fixed by the plaintiff, and also refrain from selling the goods of any other pattern manufacturer. The credit extended for one-half the purchase price of the original order for patterns is intended to serve the purpose of holding the defendant to its contract.\(^{84}\)

A comprehensive empirical study examining the prevalence of this anti-competitive use of RPM is beyond the scope of the present paper. The object of this paper is to point to an unnoticed potential anti-competitive use of RPM. But the cases mentioned suggest that the hypothesis is far from a mere academic possibility. As courts begin to devise rules and presumptions for the application of the rule of reason to RPM, it is to be hoped that single-manufacturer-driven RPM systems will not enjoy a

---

\(^{80}\) *Standard Fashion Co. v. Magrane-Houston Co.*, 253 F. 493 (1918) [*Standard Fashion I*].


\(^{83}\) See *Standard Fashion v. Siegel-Cooper Co.*, 30 A.D. 564 at 564 – 568 (1898).

\(^{84}\) *Standard Fashion I* at 496. The credit extended did not, according to the court’s analysis, constitute a benefit to the distributor. (see at 494 – 495). The distributor also paid for the transportation of the products from the manufacturer to the distributor (see at 493). Additionally, there is no record of the manufacturer ever being concerned with any service which the retailer was supposed to provide. On the other hand it seems to have been greatly concerned with the retailer carrying a competing product (see *Standard Fashion Co. v. Magrane-Houston Co.*, 251 F. 559 (1918), *Standard Fashion Co. v. Magrane-Houston Co.*, 259 F. 793 at 793 (1919) specifically at 795. I explain elsewhere why *Standard Fashion* does not fit any of the competing hypotheses for RPM. See Paldor, *supra* note 17 at 207 – 208 & 287 - 291.
presumption of legality. RPM may be extremely harmful to competition even when it is not employed in furtherance of a cartel.