Can More (Foreclosure) be Less (Harmful)? A Closer Look at Exclusivity Agreements

Ittai Paldor, Hebrew University
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Abstract

Exclusive dealing agreements, agreements whereby a firm commits to purchasing exclusively from or selling exclusively to another firm, have both pro- and anti-competitive effects. Their legality is therefore determined on a case-by-case basis under the rule of reason. Within the framework of the rule of reason, the share of the market foreclosed by the agreements is a key (although in no way the sole) element of the analysis. The prevailing view is that, all else equal, the larger the market share foreclosed – the greater the competitive danger posed by exclusivity. In the following I suggest that a careful examination of basic economic principles leads to a counter-intuitive conclusion: When extremely large market shares are foreclosed, the competitive danger is – paradoxically – reduced. I develop the concept of 'monopoly over monopoly status' to explain why exclusivity agreements foreclosing large market shares are unlikely to produce anti-competitive results. I also suggest a (refutable) presumption of legality for exclusivity agreements foreclosing market shares of 85% and up.
Introduction

Exclusive dealing agreements, agreements whereby a firm commits to purchasing exclusively from or selling exclusively to another firm, are a widespread and long-standing business practice. Such arrangements have conflicting welfare effects: On the one hand, they may generate various cost-savings in production and distribution, which in turn result in lower prices and increased output, undeniably a welfare-enhancing effect. On the other hand, they restrict competitors' access to supply sources or distribution outlets and, if enough outlets are foreclosed, may exclude these competitors from the market altogether. This in turn may enhance or entrench the market power of the party being granted exclusivity, thereby enabling that party to elevate prices and restrict output, resulting in the deadweight loss normally associated with the exertion of market power.

As exclusivity arrangements have both welfare-enhancing and welfare-reducing (anti-competitive) effects, their legality is rightly subject to the rule of reason, according to which their welfare-enhancing effects under the specific market circumstances are balanced against their anti-competitive effects under the same circumstances. If the former outweigh the latter, the arrangement at bar is upheld. If the opposite is the case, the arrangement is struck down.

Prior to the last quarter of the 20th Century courts focused almost solely on the percentage of the market foreclosed when evaluating exclusivity arrangements. Arrangements foreclosing significant market shares were struck down, whereas arrangements foreclosing trivial market

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2 See Section I, below.
4 Standard Oil Company of California v. United States 337 U.S. 293 (1949) [Standard Stations] is regularly cited as the authority under which exclusivity arrangements are subject to the rule of reason. See e.g. "Tying Agreements and Exclusive Dealing Arrangements before the Courts and the FTC" (1955) 55 Colum. L.Rev. 561 ["Tying and Exclusivity"] at n. 15; Jacobson, supra note 1, points out that the issue was initially settled almost quarter of a century earlier in FTC v. Sinclair Refining Co., 261 U.S. 463 (1923) [Sinclair]. But it should be noted that while the court in Sinclair was undoubtedly sympathetic to the contract, the contract at bar had not explicitly prohibited retailers from dealing with competing manufacturers.
shares were allowed. The threshold for condemnation was constantly raised, as theorists identified more and more welfare-enhancing justifications for exclusivity. But until the last quarter of the 20th Century little consideration was given to factors other than the percentage of market foreclosure. In recent years courts have incorporated additional factors into their analysis of exclusivity arrangements. Nonetheless, the percentage of the market foreclosed remains a key element in this analysis.\(^5\)

The importance of the percentage of foreclosure is intuitive: if two of a thousand buyers of equal size commit to purchasing exclusively from a single seller it is hard to see how the seller's competitors might be excluded from the market. If, however, two of three buyers of equal size commit to the same, the seller's competitors may be greatly disadvantaged.\(^6\) In other words, the competitive danger raised by exclusivity arrangements increases as the percentage of the market foreclosed increases. Factors other than the percentage of foreclosure are important, but the competitive danger is directly correlated to the percentage of foreclosure.

The competitive danger associated with exclusivity agreements can thus be viewed as a continuum. At one end are exclusivity commitments granted by firms with trivial market shares, which raise no real competitive concern. At the other extreme are exclusivity commitments granted by firms with significant market shares, which rightly raise concern. This concern may be outweighed by the pro-competitive effects, but it definitely exists. And the larger the foreclosed share, the greater the pro-competitive effects that are required to offset the competitive harm for the agreement to be upheld. And indeed, approvals of exclusivity arrangements in which the foreclosed market share is 100% are essentially nonexistent.\(^7\)

In the following I attempt to challenge the prevailing view according to which the percentage of market foreclosed is a continuum. I show that despite intuition, when exclusivity is granted

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\(^5\) See Section II, below.

\(^6\) The focus on the disadvantage at which competitors are placed in comparison to the incumbent as the key element of the analysis follows the understanding of barriers to entry originating in Joe Bain, *Barriers to New Competition* (Cambridge: Harvard University Press, 1952). On the application of this understanding in the context of exclusivity see references in infra note 32.

\(^7\) See references at infra note 13. Even the court in *Ryko Mfg. Co. v. Eden Servs.*, 823 F.2d 1215 (8th Cir., 1987), a case upholding exclusives, would seem to have been less sympathetic to the exclusives had the market share foreclosed been that extreme: "[W]here the degree of foreclosure caused by the exclusivity is so great that it invariably indicates that the supplier imposing the provisions has substantial market power…” (823 F.2d 1233).
by a firm or firms with large market shares, traditional analysis fails to explain what competitive harm may come from the arrangement. Therefore, although when the percentage of foreclosure is relatively small its anti-competitive impact indeed increases with the percentage of foreclosure, *this is not the case when the percentage of foreclosure is large*. In fact, when the foreclosed outlets comprise a large enough percent of the market, *the large percentage becomes a safeguard against the use of exclusivity to enhance market power*.\(^8\)

The policy implications of the argument developed in this paper are counterintuitive. Exclusivity agreements foreclosing large market shares should be treated *more leniently* than arrangements foreclosing smaller market shares.

The remainder of this paper is structured as follows: Section I reviews the welfare-enhancing justifications for exclusivity and the anti-competitive potential of the practice. Section II surveys the legal treatment of exclusivity and identifies three different periods in the treatment of exclusivity arrangements. While this review largely follows Jacobson's survey,\(^9\) it does dispute his classification of the different periods. Section III begins by exploring the feasibility of anti-competitive uses of exclusivity in the setting of a seller and downstream buyers who are end consumers (IIIA). I then proceed to explore the feasibility of anti-competitive exclusivity arrangements between an upstream seller and downstream purchasers who are *not* end consumers (IIIB). Section IV then considers the implications of the analysis offered in Section III to cases in which the market share foreclosed by exclusivity is extremely large. I develop the concept of 'monopoly over monopoly status' to show that, counter-intuitively, exclusivity is *less* likely to have anti-competitive effects when it forecloses extremely large market shares than when it forecloses medium and large market shares. At the extreme case of 100% of foreclosure the probability of anti-competitiveness is nearly zero. Section V points to several qualifications to the argument pressed in the paper, and considers the policy implications of the analysis. I suggest a refutable presumption of pro-competitiveness for exclusivity arrangements foreclosing market shares of approximately 85% and up of a relevant market.

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\(^8\) The terms 'large' and 'small' are imprecise terms. An accurate quantification of the percentage of foreclosure at which size becomes a safeguard against anti-competitive uses of exclusivity is beyond the scope of this Paper. However, I later discuss some rough approximations (see text accompanying infra notes 120 – 121 and section V, below.

\(^9\) Jacobson, supra note 1 at 314 – 345.
Before proceeding, it is helpful to highlight two preliminary points:

First, exclusive dealing arrangements may be of one of two kinds: they may be exclusive supply agreements, whereby a seller (or sellers) agrees to supply exclusively to a single purchaser;\(^\text{10}\) and they may be exclusive purchasing agreements, whereby a buyer (or buyers) agree to purchase exclusively from a single supplier.\(^\text{11}\) Throughout the remainder of this paper, I normally illustrate the various arguments presented with the more intuitive example of exclusive purchasing agreements. The argument pressed in the paper is not, however, limited to exclusive purchasing agreements. It is equally valid in the setting of exclusive supply agreements. The use of exclusive purchasing arrangements to illustrate the arguments in the paper is done for ease of exposition.

Second, exclusivity arrangements challenged in courts are commonly exclusivity arrangements whereby a firm with significant market power, or a relatively large market share,\(^\text{12}\) is granted exclusivity by downstream or upstream firms.\(^\text{13}\) The concern regularly associated with these agreements is that by foreclosing a large enough number of outlets or

\(^{10}\) See Commission Regulation (EC) 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, L336/21 [BER], Article 1(c).

\(^{11}\) See, e.g., EC Regulation 1984/83 on the Application of Article 85(3) of the Treaty to categories of exclusive purchasing agreements, OJ 1983 L173/5.

\(^{12}\) Market share is regularly used as a proxy for market power, which is more difficult to measure. A famous (and early) articulation of the correlation between size and market power is Justice Douglas' saying: "Size itself is an earmark of monopoly power. For size carries with it an opportunity for abuse" – United States v. Paramount Pictures 334 U.S. 131 at 174 (1948). Even the court in Ryko, supra note 7, one of the leading cases in which size and power were decoupled, acknowledged that there is a correlation between the two (see at 1233). But see Richard A. Posner, Economic Analysis of Law 5th ed. (New York: Aspen Publishers, 1998) at 325 – 328.

\(^{13}\) This has been the case since the early days of the Sherman Act, 15 U.S.C. §1 (1890). See Re Corning 51 F. 205 (1892) (the firm being granted exclusivity was actually a member of a horizontal combination of several defendants, but a combination formed prior to the enactment of the Sherman Act – 51 F. 207 – 208), United Shoe Machinery Corp. v. United States 258 U.S. 451 (1922) ["United Shoe Machinery"], Lorain Journal Co. v. United States 342 U.S. 143 (1951) [Lorain Journal], FTC v. Motion Pictures Advertising Co. 344 U.S. 392 (1953) [Motion Pictures] (note, however, that the 75% market share was held by 4 companies, which all had exclusivity arrangements in place), Barry Wright Corp. v. ITT Grinnell Corp. 724 F.2d 227 (1983) [Barry Wright], Omega Environmental Inc. v. Gilbarco, Inc., 127 F.3d 1157 (9th Cir., 1997) [Gilbarco], and recently United States v. Microsoft Corp., 87 F. Supp 2d 30 (2000), cert. denied 122 S. Ct 350 (2001) [Microsoft].
supply sources, the dominant firm\textsuperscript{14} enhances its already existing market power.\textsuperscript{15} For ease of exposition, I focus on the extreme case of a monopoly being granted exclusivity by downstream firms. This is again a simplifying tool. Real economic agents are never perfect monopolies in the sense of full control over price and quantity; nor are they ever in a perfectly competitive market. In reality, most economic agents possess some market power.\textsuperscript{16} The analysis does not hinge on the seller being a perfect monopoly in the legal or economic sense. It is equally applicable to a dominant firm (and theoretically even to a firm with no market power at the outset). Similarly to a monopoly, such a firm may attempt to entrench or enhance its market power using exclusive dealing arrangements.

\textsuperscript{14} I use the term ‘dominant firm’ here as a shorthand for a firm with significant market power, even this market power falls short of full control over price and quantity. The term ‘dominant firm’ is widely used by European authorities and scholars following Article 82 (formerly Article 86) of the Consolidated Version of the Treaty Establishing the European Community [2002] O.J.C. 325/33. See e.g. Ky P. Ewing, Jr. Competition Rules for the 21\textsuperscript{st} Century: Principles from America’s Experience, 2\textsuperscript{nd} ed. (Alphen Aan Den Rijn: Kluwer Law International, 2006) at 56 – 60. But the term is also found in writings of American scholars. See, e.g., Alfred E. Kahn, “The Legal and Economic Appraisal of the "New" Sherman and Clayton Acts”, (1954) 63 Yale L.J. 293 at 317 (“Exclusive dealing is anti-competitive when used by dominant firms to ensconce themselves in the market”), and Louis B. Schwartz, ”Potential Impairment of Competition – The Impact of Standard Oil Co. of California v. United States on the Standard of Legality Under the Clayton Act” (1949) 98 U. Penn. L. Rev. 10 at 23.

\textsuperscript{15} See Kahn, \textit{ibid.} at 317 William E. Stockhausen, "The Commercial and Anti-Trust Aspects of Requirements Contracts" (1948) 23 N.Y.U.L. Rev. 412 at 428 – 429; See also references in supra note 13.

\textsuperscript{16} This is known as ‘monopolistic competition’ a concept originally developed by Chamberlin. See Edward Hastings Chamberlin, \textit{The Theory of Monopolistic Competition}, 8\textsuperscript{th} ed., (Cambridge: Harvard University Press, 1962).
I. The Pro- and Anti-competitive Effects of Exclusivity

Exclusivity agreements may achieve a host of welfare-enhancing goals:

First, exclusivity reduces uncertainty and parties' exposure to future fluctuations in supply and demand. Consider, for example, a seller producing a good that is an input used by buyers in the production of some final good. The seller may make sales on the spot market. However, market prices may drop, buyers may divert their demand to the seller's competitors, and so on. In an attempt to (self) insure against such contingencies, the seller may seek a long-term contract with one or more of the buyers. If these buyers agree to purchase all of their future demand (for the duration of the contract) from the seller, sales become less volatile.¹⁷

An element of this explanation that is sometimes overlooked is the ostensible inadequacy of exclusivity to achieve stability.¹⁸ In fact, exclusivity may seem counter-productive in this scenario. If the purchasers' total demand falls for some reason, the seller will not have sold the minimum number of units it needs to sell. On the other hand, if demand increases, the seller will need to increase production so as to meet the increased demand, perhaps to a point at which production is unprofitable.¹⁹ At times, the seller may even be unable to supply all of

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¹⁷ E.g. Stockhausen, supra note 15 at 413 – 415, Harlan M. Blake and William K. Jones, "Toward a Three-Dimensional Antitrust Policy" (1965) 65 Colum. L.R. 422 at 440 (discussing full vertical integration, where this advantage is more pronounced), Schwartz, supra note 14 at 12 (focusing on a variation of this explanation: "…a constant supply at a definite price without the financial burden of a large inventory").

¹⁸ This is, of course, not always overlooked. See e.g. Philip Areeda, Louis Kaplow, Aaron Edlin, Antitrust Analysis – Problems, Text, and Cases, 6th ed. (New York: Aspen Publishers, 2004) at 654-655. The problem of fluctuations in buyers' demand is implicitly dealt with, when the authors describe the setting as one in which users have 'fairly stable requirements'. The problem explicitly addressed by the authors is closely related to the one described here, namely the problem of opportunistic behavior that may occur if price and quantity are not stipulated in the contract. See also Victor P. Goldberg, "Quantity and Price Adjustment in Long-term Contracts: A Case Study of Petroleum Coke" (1987) 30 J.L. & Econ. 369. Similarly, Stockhausen, ibid. at 412, also acknowledges that "the amount may be indefinite and in fact may be zero" but unlike Areeda, Kaplow and Edlin does not incorporate this into his analysis.

¹⁹ This may occur if there are diseconomies of scale in production, which can be expected to be the case at least at some point of the production function. The production function may also be such that production at the given point is profitable, but nonetheless less profitable than production of smaller scale. See generally Dennis W. Carlton & Jeffrey M. Perloff, Modern Industrial Organization, 4th ed. (Boston, San Francisco, New York: Pearson-Addison Wesley, 2005) at 35 – 44.
the buyers' demand. Ostensibly, therefore, exclusivity is a cumbersome way of reducing volatility. A long-term contract stipulating price and quantity for the duration of the contract is both straightforward and more effective in reducing volatility. However, in real-life settings exclusivity may be a workable proxy for specified quantities. Although the seller may prefer a firm commitment to specified prices and quantities, and although such agreements are sometimes struck,20 buyers may be reluctant to make such a commitment because they themselves do not know, at the time the contract is struck, the precise quantities they will need. Thus, they may be more inclined to commit to purchasing whatever quantities they may need from the seller than to commit to a fixed number of units, especially when the contract is of greater length. On the seller's side, although this guarantee may be less appealing than a firm commitment, it is nonetheless of value, specifically if the buyers' demand is relatively stable.21 Exclusivity may thus be a real-life proxy for firm quantity-price commitments as a means to decrease volatility and uncertainty.

A second welfare-enhancing use of exclusivity is as a means to verify that products have originated from a specific manufacturer. This may be important when the manufacturer assumes post-sale duties, such as warranties, maintenance or service, vis-à-vis end consumers. Under such circumstances, exclusivity acts as a verification measure (to the manufacturer) that products sold by the specific retailer originated from the manufacturer.22

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20 See e.g. Barry Wright, supra note 13, Magnus Petroleum Comp. and. Marpat Corp. v. Skelly Oil. Comp. 599 F.2d 196 (7th Cir., 1979) [Magnus].

21 See Areeda, Kaplow & Edlin, supra note 18 at 654, Stockhausen, supra note 15 at 414.

22 Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 at 55 n. 23 (1977) Richard M. Steuer, "Exclusive Dealing in Distribution" (1983) 69 Cornell L.Rev. 101 at 131 – 132. Note, however, that both the court in GTE Sylvania and Steuer, cite Susser v. Carvel Corp., 323 F.2d 505 at 516 (2nd Cir., 1964), cert. denied 381 U.S 125 (1965) and thus seem to focus more on the way the dealer handles the product (the quality and functioning of which the manufacturer has guaranteed) than on the identification of its origin. There are, of course, additional ways in which the manufacturer can verify the origin of a product, the most obvious of which is by applying a trademark or logo to the product. However, trademark law is aimed at preventing consumers', not producers', confusion as to origin – see Robert M. Merges, Peter S. Menell, Mark A. Lemley, Intellectual Property in the New Technological Age 3rd ed. (New York: Aspen Publishers, 2003) at 529 – 534 and at 621 – 625; see also AMF Incorporated v. Sleekcraft Boats 599 F.2d 341 (9th Cir., 1979). Origin-verifiability for the producer is merely a beneficial byproduct of the prevention of consumer confusion, which (along with the more recently recognized goal of dilution-prevention) is the aim of trademark law. Therefore, trademark law may not adequately address the manufacturer's concern (for example, if consumers are entirely indifferent as to the origin
A third use of exclusivity is as a means to eliminate the danger of inter-brand free riding, thus facilitating investment in distribution of the product. Exclusivity is necessary, in this setting, when the manufacturer considers it profitable to bear the costs of certain retail-level services, either by lowering the wholesale price of the product to retailers who undertake to perform such services, or by paying retailers directly for the provision of these services. For example, a manufacturer may be willing to train a retailer's sales personnel at its own expense. But if competing manufacturers can free ride on these services, the manufacturer may find it unprofitable to fund these services. To overcome this problem, the manufacturer may demand that retailers for whom the services are provided (or funded) remain exclusive to the manufacturer, thus eliminating the free rider problem.


24 For examples of different ways in which the manufacturer may incur the costs of these services see Martin B. Glauser Dodge Co. v. Chrysler Corp., 570 F.2d 72 at Part III & at 76 – 77 (3rd Cir., 1977) cert. denied 436 U.S. 913 (198), Coleman Motor Co v. Chrysler Corp. 525 F.2d 1338 especially at 1341 – 1342 (3rd Cir., 1975), Mt. Lebanon Motors v. Chrysler Corp. 283 F. Supp 453 (1968) at 457.

25 A closely related question is why retailers – who accrue the additional profits from the sale of all brands – will not spontaneously provide the services, obviating the need for remuneration in the first place. But retailers face an analogous free-riding problem, known as the intra-brand free riding problem. Additionally, their profit-margin, or their return on the investment, may be different from the manufacturer's, thus making the investment unprofitable at their level. The intra-brand free rider problem may be overcome with the reverse exclusivity provision, namely exclusive supply, whereby the manufacturer commits to selling exclusively to a single (service providing) retailer (William Noel Keyes, "Exclusive Foreign Distributor Agreements – Are They Illegal?" (1953) 41 Cal. L. Rev. 439). Intra-brand free riding can also be overcome by assigning exclusive territories to retailers or – according to traditional antitrust analysis – by imposing a price minimum on retailers. See W.S. Bowman, “The Prerequisites and Effects of Resale Price Maintenance” (1955) 22 U. Chicago L. Rev. 825; Ward S. Bowman “Resale Price Maintenance – A Monopoly Problem” (1952) 25 J. Bus. 141 at 151; Lester Telser, “Why Should Manufacturers Want Fair Trade” (1960) 3 J.L. & Econ. 86; Leegin Creative Leather Products, Inc. v. PSKS, Inc. 1275 S. Ct. 2705 (2007). On the incentive alignment when profit margins are different see Benjamin Klein & Joshua D. Wright, “The Economics of slotting Contracts” (2007) 50 J. L. & Econ 421.

A fourth advantage, closely related to the previous one, is the inducement of retail-level selling efforts. By signing an exclusivity agreement the retailer links its fate to that of the manufacturer's. It thus guarantees that it will make a genuine effort to promote the brand and ensure its success. This commitment is of value even if the manufacturer is not concerned with inter-brand free riding.

Finally, exclusivity may be a way to economize on transaction costs. Sales on the spot market invariably require ongoing negotiations. When exclusivity is agreed to, parties need not renegotiate continuously. This advantage is distinct from the first advantage of reducing volatility. Even if market prices are expected \textit{ex ante} to remain unchanged for the duration of the contract, thus eliminating volatility, reducing the number of transactions conducted nonetheless reduces total expenditures on negotiations.

Notwithstanding its output-enhancing functions, exclusivity may also be used anti-competitively. This use is probably the most intuitive use of exclusivity. Exclusivity contracts

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27 See William B. Lockhart & Howard R. Sacks, "The Relevance of Economic Factors in Determining Whether Exclusive Arrangements Violate Section 3 of the Clayton Act" (1952) 65 Harv. L. Rev. 913 at 935. Keyes, supra note 25 at 441. A prominent real-life example of this use of exclusivity can be found in \textit{Joyce Beverages v. royal Crown Cola Co.}, 515 F. 2d 835 (5th Cir., 1975), \textit{cert. denied} 424 U.S. 934 (1976). See also Robert H. Bork, \textit{The Antitrust Paradox} (New York: The Free Press, 1978) at 306 – 307. See also Areeda, Kaplow, and Edlin, supra note 18 at 655, pointing to some concern with the possible divergence between the manufacturer's interest and the social interest, but pointing to two cases in which the pro-competitive benefits of exclusivity seem the strongest.

28 See \textit{Joyce Beverages}, \textit{ibid.}, \textit{Submeyer v. Coca-Cola Co.}, 515 F.2d 835 (1975), Steuer, supra note 22 at 124 – 126. Marvel, supra note 23 argues that this is not a viable explanation for exclusivity (see at 2 & 4 - 5).

29 Bork, supra note 27 at 309, Stockhausen, supra note 15 at 414. Kaplow and Edlin question the need for exclusivity to achieve this goal. They point to fact that a simple pattern of regular repeated purchases from the seller would tend to produce the same savings (Areeda, Kaplow, and Edlin, \textit{supra} note 18 at 655).

30 The simple version of the argument, according to which a smaller number of negotiations reduces total transaction costs ignores the fact that when a contract is struck for a longer period of time, the number of contingencies that must be resolved is greater, as is the level of uncertainty. Thus, negotiations for long-term contracts can be expected to be lengthier and more costly than spot contracts (for a formal model incorporating this consideration see See also P. Bolton & M. Whinston, "Incomplete Contracts, Vertical Integration, and Supply Assurance" (1993) 60 Rev. Econ. Studies 121). Similarly, future disagreements on addressing contingencies that arise, which the parties did not fully consider or specify at the time of signing, can be expected to be higher in long term contracts. The cost savings associated with long-term contracts are thus more accurately described as the difference between the savings attributed to the smaller number of negotiations and the added cost of dealing (both \textit{ex ante} and \textit{ex post}) with additional and less certain contingencies.
may exclude a competitor or competitors, thus enhancing or entrenching a firm's market power. For simplicity, we may again think of exclusive purchasing arrangements. By signing such exclusivity agreements with retailers, the upstream firm denies its competitors access to distribution outlets. These competitors must consequently either distribute their product through outlets that have not signed exclusivity agreements with the incumbent, or induce independent entry into distribution. If the foreclosed outlets are the more efficient outlets - the ones at the more desirable locations and so on - the firm granted exclusivity gains an inherent advantage over its competitors. The cost disadvantage of these competitors allows the incumbent to profitably elevate prices.

As mentioned, this use of exclusives is probably the most intuitive use. However, its viability has been largely questioned in the literature. A closer look at the challenges to this use is undertaken in the third Section of this Paper. Before reviewing the arguments made in connection with the likeliness of exclusion as a result of exclusivity agreements, I briefly review the development of the legal standard applied to such arrangements.

A variation of this explanation is offered in David Gilo, "Retail Competition Percolating Through to Suppliers, and Using Vertical Integration, Vertical Restraints, and Tying to Stop it" (2003) 20 Yale Journal on Regulation 25. According to the hypothesis developed there, exclusivity may be one means through which an upstream firm with market power overcomes what is referred to as the 'commitment paradox'. Essentially, through exclusivity the firm is able to assure its downstream buyer that it will not offer a hidden concession to the buyer's competitor (see at 54 – 57). However, in contrast to traditional analysis, the motivation for the exclusivity arrangement is not to enhance the downstream firm's market power, but rather to allow the upstream firm – the firm granting exclusivity – to exploit its market power and charge supra-competitive wholesale prices. I do not discuss this function separately because despite the different motivation, the end result is similar for purposes of the present analysis.

II. The Legal Treatment of Exclusivity

The legal treatment of exclusivity agreements can be roughly divided into three periods. \(^{33}\) The first period started in 1890, with the enactment of the Sherman Act, and ended in 1914 with the enactment of the Clayton Act. \(^{34}\) Between 1890 and 1914, courts refrained almost entirely from interfering with exclusivity arrangements. With few exceptions, U.S. courts followed the example set by English courts, and upheld exclusivity arrangements as 'partial restraints of trade'. \(^{35}\) The most well known of these cases was the Pullman case, \(^{36}\) in which the court refused to strike down an agreement granting the Pullman company the exclusive right to furnish sleeping cars for all passenger trains controlled by the Chicago, St. Louis & New Orleans Railroad Company for a period of 15 years. \(^{37}\) The agreement, which was one of a series of agreements Pullman had with various railroad companies, \(^{38}\) ultimately enabled Pullman to sustain its monopoly for nearly half a century. \(^{39}\) The second period started in 1914, with the enactment of the Clayton Act. The Clayton Act was aimed at strengthening antitrust enforcement, which was thought to be lacking under the Sherman Act. \(^{40}\) Certain practices were therefore explicitly prohibited. Among these was

\(^{33}\) Jacobson, supra note 1 at 314 – 334, identifies four different periods in the legal treatment of exclusivity agreements. Jacobson divides the third period discussed below into two different periods – before the mid 1990s and since the mid 1990. I explain below (infra note 76) why I consider these two periods to be one.


\(^{35}\) Jacobson, supra note 1 at 314 – 316.


\(^{37}\) 139 U.S. 83 – 84.

\(^{38}\) For some of the other agreements see, Whitwell v. Continental Tobacco Co., et al., 125 F. 454 (1903), Donovan v. Pennsylvania Comp. 199 U.S. 279 (1905), The State of Ohio Ex. Rel. Sheets, Attorney General v. The Union Depot Co. 71 Ohio St. 379 (1905). For a list of additional state cases see Jacobson, supra note 1 at n. 15 – 16.


\(^{40}\) For a summary of the legislative history of the Clayton Act see Lockhart & Sacks, supra note 27 at 934 – 935. See also Schwartz, supra note 14 at 10, "Tying and Exclusivity", supra note 4 at 562.
exclusivity, which Section 3 of the *Clayton Act* condemned whenever its effect "may be to substantially lessen competition or tend to create a monopoly in any line of commerce". Courts were quick to follow the explicit Congressional condemnation of exclusivity, and exclusivity agreements were soon struck down regardless of the justifications for the practice. The first case in which the Supreme Court found an agreement to be in violation of Section 3 of the *Clayton Act* was the *Standard Fashion* case, a ruling subsequently condemned extensively in academic writings. A week later, in *United Shoe*, the court struck down exclusivity clauses it had upheld twice in the preceding decade under the *Sherman Act*. In both these cases the court seemed to apply a rule of *per se* illegality to the practice, as it conducted no analysis of the effects of the exclusivity commitment on market performance. But the court soon clarified that the practice was not subject to *per se* condemnation in *Sinclair*. Subsequent to this clarification, lower courts began focusing on the market shares of the contracting parties, striking down exclusivity clauses that resulted in foreclosure of a significant market share and upholding exclusivity arrangements signed by firms with insignificant market shares.

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41 The change in the standard of review was noticed almost immediately. See *Note, "The Legality of Contracts of Sale which Prevent the Purchaser-Retailer from Handling Goods of the Wholesaler's Competitors"* (1916) 30 Harvard L. Rev. 72 at 73. See also Jacobson, supra note 1 at 317 – 323.

42 *Standard Fashion Co. v. Magrane-Houston Co.* 258 U.S. 346 (1922). The appeal to the Supreme Court was the culmination of lengthy litigation, in the course of which lower courts repeatedly found the arrangement to be in violation of Section 3. See *Standard Fashion Co. v. Magrane-Houston Co.*, 253 F. 493 (1918), *Standard Fashion Co. v. Magrane-Houston Co.*, 251 F. 559 (1918), *Standard Fashion Co. v. Magrane-Houston Co.*, 259 F. 793 at 793 (1919).


44 *United Shoe Machinery*, supra note 13.

45 *United States v. Winslow* 227 U.S. 202 (1913) (technically considering only the agreement forming United Shoe Machinery, not the exclusivity covenant) and *United States v. United Shoe Machinery Co.* 247 U.S. 32 (1918) (which, although decided after the enactment of the *Clayton Act*, pertained to offenses that had been committed prior to its enactment).

46 See Jacobson, supra note 1 at 318 - 319.

47 *Sinclair*, supra note 4.

48 See Jacobson, supra note 1 at 319 – 320 and references at nn. 52 – 54.
Approximately quarter of a century later the legality of exclusivity arrangements was again questioned, due to a ruling that applied a *per se* illegality rule to tie-in arrangements. As both tie-ins and exclusivity are prohibited by Section 3 of the *Clayton Act*, the ruling finding tie-ins to be *per se* illegal could have been interpreted to apply to exclusivity as well, or at least could have affected the legal treatment of exclusivity. The Supreme Court was again called upon to decide on the rule applicable to exclusivity. In the landmark *Standard Stations* case, the court reaffirmed that exclusivity arrangements, as opposed to tying arrangements, were not to be judged under the *per se* illegality rule. However, complex economic investigations would not be required: exclusivity arrangements foreclosing "a substantial share of the line of commerce affected" would be condemned under Section 3 of the *Clayton Act*. A 'substantial' market share meant any share that was nontrivial, and even foreclosure of relatively small market shares was enough for striking down an agreement. Soon after, the "substantial foreclosure" test, or the quantitative substantiality test, was adopted for analysis under the *Sherman Act* prohibitions on monopolization and restraints of trade as well. Pro-competitive justifications for exclusivity were considered only if the

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50 See e.g. "Tying and Exclusivity", supra note 4 at 561 – 562 (notes 13 – 15 and accompanying text).

51 *Standard Stations*, supra note 4.

52 337 U.S. 314. See also *United States v. Richfield Oil Corp.*, 99 F. Supp. 280 (S.D. Cal. 1951), aff’d 343 U.S. 922 (1952) [*Richfield Oil Corp*], *Fashion Originators Guild v. FTC* 312 U.S. 457 at 465 (1941). The court's reasoning in *International Salt*, supra note 49 suggests the same, although the case at bar was one of tie-ins, not of exclusivity. See 332 U.S. 396. On the analogy between the legal treatment of both practices see Schwartz, supra note 14 at 11 – 12.

53 E.g. *Standard Stations*, supra note 4. See generally "Tying and Exclusivity", supra note 4 at 561. Although the quote refers directly to tying arrangements, the author clarifies that this account holds relevant to the analysis of exclusivity agreements. But further in the article a more nuanced approach to exclusivity arrangements is identified (see at 563). A different analysis of the cases as conforming to the notion of 'workable competition' can be found in Kahn, supra note 14 at 313 – 315 and 319 – 322. The author admits, however, that although the decisions *can* be explained by the 'workable competition' idea, the actual reasoning of the courts suggests that any foreclosure of a "not insubstantial" market share is enough for condemnation (see at 314 – 315).

54 Jacobson, supra note 1 at 320.

55 *Lorain Journal*, supra note 13 (*Sherman Act* §2), *FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966) (*Sherman Act* §1), *Richfield Oil Corp.*, supra note 52 (*Sherman Act* §1 (but not §2) and §3 of the *Clayton Act* with respect to the relevance of intent), *Motion Pictures*, supra note 13 (technically discussing §5 of the *Federal Trade Commission Act* 15 U.S.C. § 45, but stipulating that the contracts were in violation of both the monopolization
foreclosed market share was not substantial. Blake and Jones, summarizing the case-law at the time, pointed out:

"It might be argued that exclusive dealing arrangements have compensating advantages...This is a good basis for upholding exclusive dealing arrangements when they do not threaten to impede entry;"\textsuperscript{56}

By the end of the second period, in 1961, it was well established that exclusivity arrangements foreclosing a substantial market share, taken to mean any nontrivial market share, were illegal. Exclusivity agreements foreclosing insignificant market shares were upheld.

The \textit{Tampa Electric} Ruling, delivered in 1961,\textsuperscript{57} marks the beginning of the third period.\textsuperscript{58} In \textit{Tampa Electric} the court emphasized that

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56 Blake & Jones, supra note 17 at 445 – 446 (emphasis added). Interestingly, the authors claim that this is what the court did in \textit{Tampa Electric v. Nashville Coal Co.}, 365 U.S. 320 (1961) [\textit{Tampa Electric}] as well. But subsequent writings view \textit{Tampa Electric} as the cornerstone of the full-blown rule of reason analysis, whereby pro- and anti-competitive effects are balanced. Although a similar outcome may have been reached under the then-prevailing approach, as market shares in \textit{Tampa Electric} were indeed not extremely significant, the case nonetheless resembles a different approach.

57 \textit{Tampa Electric}, ibid.

58 Jacobson classifies \textit{Tampa Electric} as part of the second period, and the FTC's decision in \textit{Beltone electronics Corp.}, 100 F.T.C. 68 (1982) as the mark of the beginning of the third period (Jacobson, supra note 1 at 322 & 323), rejecting the traditional classification according to which \textit{Tampa Electric} marks the beginning of the full-blown rule of reason analysis (see, e.g. Steuer, supra note 22 at 107 – 108, \textit{Roland Machinery Co. v. Dresser Industries Inc.}, 749 F.2d 380 (7th Cir., 1984) [\textit{Roland Machinery}]). I prefer the traditional classification to Jacobson's because cases following \textit{Tampa Electric}, although undoubtedly placing great weight on the substantiality of foreclosure, were generally careful to apply a more comprehensive analysis of the effects of
\end{footnotesize}
"[t]o determine substantiality in a given case, it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area, and the probable immediate and future effects which preemption of that share of the market might have on effective competition therein. It follows that a mere showing that the contract itself involves a substantial number of dollars is ordinarily of little consequence".\(^{59}\)

The court in *Tampa Electric* did not stipulate that market share was of no importance. In fact, substantiality of the foreclosed share of the market was explicitly incorporated as the third element of the three-part test to be applied before harm to competition could be found.\(^{60}\) The importance of the *Tampa Electric* ruling is that it refused to consider market share as the sole determinant of the legality of exclusivity arrangements. Instead, a substantial market share was regarded a necessary but insufficient condition for the condemnation of exclusivity arrangements. *Tampa Electric* did not result in an immediate shift to a full blown rule of reason analysis. Lower court's focus on market share was not abandoned. But *Tampa Electric* did alter lower courts' perception of what constituted innocuous foreclosure. The percentage of foreclosure at which condemnation ensued was steadily raised, and higher and higher levels of foreclosure

\(^{59}\) 365 U.S. 329. Emphasis added.

\(^{60}\) 365 U.S. 328.
were permitted. While at the time of Tampa Electric foreclosure of even 6% of the relevant market was considered enough for condemnation,\(^61\) and in one extreme case even foreclosure of 1.6% of the relevant market resulted in condemnation\(^62\) gradually a 40% market share became the threshold for condemnation,\(^63\) and some later courts have even applied a 45% – 50% threshold.\(^64\)

Eventually, the myopic focus on market share alone was abandoned. Courts began to ask whether foreclosure, of whatever magnitude, did in fact have an exclusionary effect.\(^65\) In Roland Machinery\(^66\) the court upheld an exclusivity arrangement\(^67\) foreclosing a significant share of the relevant market because the plaintiff had not offered proof of a probable anti-competitive effect.\(^68\) In Ryko\(^69\) the court noted the level of distribution that was foreclosed

\(^61\) Standard Stations, supra note 4, although concern was also expressed with similar practices by other dominant firms.

\(^62\) The most extensively criticized of the rulings that condemned foreclosure of small market shares is Brown Shoe Co., Inc. v. United States, 370 U.S. 294 (1962). While the case was technically a case of a vertical merger, not an exclusivity agreement, the concern was of foreclosure, and the analysis was "consistent with prior precedent" (Blake & Jones, supra note 17 at 454. See generally at 453 – 456). For an account of the different rulings in different contexts see Kahn, supra note 14.


\(^64\) Microsoft, supra note 13.

\(^65\) See e.g. Barry Wright, supra note 13, Jefferson Parish, supra note 49, Sulmeyer, supra note 28 (considering, inter alia, the question of de facto exclusivity and finding the jury's conclusion of no exclusionary effect sustainable), Joyce Beverages, supra note 27. For a survey of recent cases and courts' focus on actual effects see Jacobson and Sher, supra note 39 at 793 - 798.

\(^66\) Roland Machinery, supra note 58.

\(^67\) I use the term "arrangement and not "agreement" intentionally, because the court grappled with the question of whether an actual agreement existed. But its conclusion is not based on the distinction ("Actually, it is not important whether Dresser's antipathy to nonexclusive dealing was secret. ….", ibid. 749 F.2d 393).

\(^68\) Such proof requires proof of two issues: one is that at least one significant competitor is likely to be kept out of the market due to the exclusives. The other is that the result of this exclusion is likely to be a raise in prices above the competitive level (749 F.2d 394).

\(^69\) Supra note 7.
and the duration and scope of the agreements and refused to condemn the arrangement.\textsuperscript{70} In \textit{New York News}\textsuperscript{71} the court upheld exclusivity agreements which undoubtedly covered a significant market share (although the precise share was not pinpointed mainly due to plaintiffs' failure to adequately define the market)\textsuperscript{72} because, \textit{inter alia}, there had been "no showing that interbrand competition ha[d] been significantly limited or that entrance into the newspaper publishing market ha[d] been foreclosed".\textsuperscript{73} And in \textit{Paddock Publications} judge Easterbrook emphasized that competition for exclusives was in itself a form of competition to be protected by antitrust laws,\textsuperscript{74} despite the end result which may seem like a foreclosed market.

In \textit{Gilbarco}\textsuperscript{75} a dominant producer (Gilbarco) refused to deal with Omega, a distributor who would not deal exclusively with Gilbarco. Gilbarco was the market leader with a 55\% market share, and its policy of refusing to deal with distributors who were not exclusive to its brand foreclosed 38\% of the market. The court emphasized the availability of alternative distribution channels, the short duration of the exclusivity contract and its easy terminability. It consequently refused to strike down the agreement.

At least since \textit{Gilbarco}

"…courts, for the most part, have demanded rigorous proof of the relevant market in which market power is assessed; have required plaintiffs to distinguish exclusive dealing contracts won through aggressive competition from those that are profitable only because of their negative effect on rivals; and have extended consideration to proffered efficiency justifications. The focus on true market power in these cases is not attributable to a concern that market power in the abstract, unrelated to the challenged conduct, is harmful (although that is often true). The concern is instead that creating a or increasing market power through

\textsuperscript{70} 823 F.2d 1234 – 1235.
\textsuperscript{72} 366 F.Supp. 678.
\textsuperscript{73} 366 F.Supp. 679. This was only one reason for rejecting the argument. The main argument for rejecting the plaintiffs' contention was that they lacked standing to sue (366 F. Supp. 677 – 678). As previously noted, the court also pointed out that the plaintiffs had failed to adequately define the market (678).
\textsuperscript{75} \textit{Gilbarco}, supra note 13.
exclusive dealing is the means by which the defendant is likely to increase prices, restrict output, reduce quality, slow innovation, or otherwise harm consumers".  

The most famous case in recent years is the Microsoft case, in which the court engaged in an elaborate analysis of the effect that a series of arrangements between Microsoft and independent entities had on Netscape's ability to compete effectively in the Internet browser market. Emphasis was given not only to the share of the foreclosed distribution outlets, but also to the relative efficacy of these outlets. Ultimately, the court was willing to condemn exclusivity arrangements even when the 40%-50% foreclosure usually required was not met. Other cases too demonstrate an emphasis on the real effect of the arrangements on market structure and performance.

Two last notes are important with respect to the different Acts governing exclusivity arrangements and the nature of the arrangements.

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76 Jacobson, supra note 1 at 328. Jacobson considers Gilbarco to be the inception of a fourth period, a period in which courts are firmly committed to a full-blown rule of reason analysis. I do not challenge Jacobson's point, but as the preceding survey shows, the courts commitment to a real rule of reason analysis can be found in quite a few rulings that preceded Gilbarco. As Judge Posner wrote in 1984 in Roland Machinery, supra note 58:

"Although the Supreme Court has not decided an exclusive-dealing case in many years, it now appears most unlikely that such agreements, whether challenged under section 3 of the Clayton Act or section 1 of the Sherman Act, will be judged by the simple and strict test of Standard Stations. They will be judged under the Rule of Reason, and thus condemned only if found to restrain trade unreasonably" (749 F.2d 393). Gilbarco is, in my view, but one point in the long period beginning in Tampa Electric, which resulted in a gradual shift from a technical focus on the substantiality of foreclosure to a full-blown rule of reason. In fact, the gradual shift from a myopic focus on the foreclosed market share began even before Tampa Electric. Lockhart & Sacks, supra note 27 at 915 – 916, 919, 923 – 929 & 935 - 940 (see also "Tying and Exclusivity", supra note 4 at 563, Kahn, supra note 14 at 308, 315, Schwartz, supra note 14 at 25 – 26). The different classification is not, however, a crucial element of my main argument in this paper.

77 Microsoft, supra note 13.

78 253 F.3d 70.

79 E.g. Avery Dennison Corp. v. Acco Brands, Inc., 2000-1 Trade Cases (CCH) 72,882 (barriers to entry discussed even though defendant had a 75 percent market share, concluding that there was a likelihood of consumer harm), Louisa Coca Cola Bottling Co. v. Pepsi-Cola Metropolitan Bottling Co., 94 F. Supp. 2d 804 (1999) (concluding that the harm to the competitor was the result of hard competition, not of harm to competition itself. See also analysis at 816), United States v. Visa USA, Inc., 163 F. Supp. 2d 322 (S.D.N.Y., 2001), aff'd United States v. Visa USA, Inc. et al. 344 F. 3d 229 (2nd Cir., 2003) [Visa] (analyzing only under the Sherman Act).
First, as mentioned, although originally *Clayton Act* §3 was intended to apply a different (more strict) standard than *Sherman Act* §1 and §2 to exclusivity, analysis under the Acts eventually converged. The analysis under the two Acts has remained identical, despite the changes in the substance of the analysis itself. Although exclusivity arrangements are now scrutinized differently than they were in the 1950s, the standard is similar regardless of which article is cited by the plaintiff.

Second, the prohibition on exclusivity encompasses not only exclusivity that takes the form of an explicit contractual commitment not to deal with competitors. *Clayton Act* §3, *Sherman Act* §1, and *Sherman Act* §2 all apply to agreements that include some kind of (financial) inducement to exclusivity, even if dealing with competitors is not nominally prohibited. Thus, for example, loyalty discounts and rebate systems that induce *de facto* exclusivity, and all other arrangements which have the *de facto* effect of exclusivity are also under the purview of the antitrust prohibitions. Similarly, an agreement for the employment of technological measures that will make a competitor's product less accessible may also be prohibited by the antitrust laws.

In summary, contemporary antitrust doctrine has shifted away from a myopic focus on the percentage of the foreclosed market, and now gives weight to additional factors in assessing the anti-competitive potential of exclusivity arrangements. Notwithstanding this shift, market share remains a key component in the analysis of exclusivity arrangements. And exclusivity arrangements foreclosing extremely large market shares are routinely condemned. It is thus important to explore whether or not there are instances in which the link between (foreclosed) market share and the competitive danger becomes not only rough, but in fact nonexistent. Section IV suggests that there are such cases. Before developing this argument, it is helpful to first explore the economic understanding of the anti-competitive potential of exclusivity. This is undertaken in the next Section.

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80 See supra notes 40 – 55 and accompanying text.

81 Hovenkamp, supra note 3 at #1800c4, *Roland Machinery* supra note 58 at 393, Bork, supra note 27 at 299, Jacobson, supra note 1 at 327.

82 With respect to §3 of the *Clayton Act* this is explicit in the language of the Act itself.

83 *Tampa Electric*, supra note 56, Lockhart & Sacks, supra note 27 at 919 – 920 (citing cases of different incentives created for exclusivity).


85 *Microsoft*, supra note 13.

86 See references in supra notes 7, 12, and 13.
III. Challenges to the Anti-competitive Explanation for Exclusivity

The anti-competitive potential of exclusivity is somewhat more complex than it may seem at first blush. Early writings of members of the 'Chicago school' argued that exclusivity is unlikely to be used to forestall competition. These writings did not challenge the idea that foreclosure of outlets may impede entry. But the fact that exclusivity is a voluntary transaction (between the party granting exclusivity and the party being granted exclusivity) provides a natural check on anti-competitive uses of exclusivity. Since it is a voluntary transaction, exclusivity can generally be assumed to be Pareto efficient (from the contracting parties' perspective), which implies that both parties are better off as a result of the agreement, or – at the minimum – that one party is made better off and the other no worse off. An analysis of both parties' incentives initially led to the conclusion that rational profit-maximizing firms will never use exclusivity to forestall competition. Later writings refined this conclusion, and identified circumstances under which the use of exclusivity to eliminate competition is theoretically compelling. To expose these results, I begin with the simple setting of a seller being granted exclusivity by end consumers. Next, the analysis is extended to a seller and buyers who are not end consumers.

A. A Seller and Purchasers who are End Consumers

First, consider the setting of a seller who sells to end consumers. Posner\textsuperscript{87} and Bork\textsuperscript{88} make the point that in this setting an agreement to exclude competition is highly unlikely. Buyers are adversely affected by the preservation (or establishment) of a monopoly. They will be charged higher prices than they would have been charged had competition prevailed. Knowing this, they will be reluctant to participate in a scheme to preserve or establish a monopoly at the seller's level, unless they are compensated in full for their prospective losses. Put differently, they will demand to receive the full value of the monopoly overcharge before they sign exclusivity agreements with the to-be monopolist. This in turn implies that the seller's prospective gains from the preservation of the monopoly will all be dissipated in the form of payment to customers, making the scheme unprofitable for the seller. Posner


\textsuperscript{88} Bork, supra note 27.
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.” And Bork argues that ”[t]he truth appears to be that there has never been a case in which exclusive dealing or requirements contracts were shown to injure competition... there is every reason to believe that exclusive dealing and requirements contracts have no purpose or effect other than the creation of efficiency.”

Later writings on exclusivity have explained why this analysis may not hold. Aghion and Bolton, in a seminal paper, show that customers may be induced to participate in a monopoly-creating scheme without being compensated in full for their losses. The seller may thus be able to extract part, and in fact even all, of the monopoly rents by signing exclusivity contracts with enough buyers so as to exclude competitors. The intuition underlying Aghion and Bolton's analysis is that if a seller need not foreclose all of the existing retail outlets in order to preempt entry, a buyers' collective action problem emerges. Even if it is in their best interest as a whole to withhold their consent to the foreclosure scheme, buyers may ultimately participate in it for a price that fails to compensate them for their future losses. Consider, for example, an industry in which recovering the fixed costs of production requires servicing at least 25% of the market. A seller can thus drive out all potential competitors by signing exclusivity contracts with only 75.1% of the buyers. As a whole, buyers are best off if none of them signs exclusivity agreements with a seller, and competition between four sellers is allowed to drives prices down. But a single seller may offer buyers some inducement to sign exclusivity contracts. Buyers realize that if three quarters of them sign such contracts, they will all face a monopolistic seller and will ultimately be forced to pay the monopoly price. Knowing this, each individual buyer will prefer to sign an exclusivity contract in return for any payment, however trivial, rather than ultimately paying the monopoly price for no compensation at all. Thus, not only can the seller acquire a monopoly position by

89 Posner, supra note 87 at 205.
90 Ibid. at 309.
92 For a less formal exposition of this result see Louis Kaplow, "Extension of Monopoly Power Through Leverage" (1985) 85 Colum. L. Rev. 515 at 532.
93 On the concept of 'fixed costs' see Carlton & Perloff, supra note 19 at 29 – 33; on the concept of 'minimum efficient scale' [of production] see at 41 – 42.
compensating only three quarters of the buyers for their future losses, it can in fact offer even these buyers less than full compensation. A 'race to the bottom' among buyers will result in enough buyers agreeing to exclusivity even if they are not fully compensated for future losses, for fear of facing the same result with no remuneration at all.\footnote{I use the term 'race to the bottom' rather than 'competition' to describe buyers' conduct. The reason is that the end result is worse (from the buyers' perspective) than under competition. Under competition, buyers – at least those who ultimately sign exclusivity agreements – will receive their marginal cost, namely their future added costs of purchasing from a monopoly. In the setting described here, buyers will receive a sum lower than their marginal cost. The intuition behind this result is that, as pointed out by Aghion and Bolton, in the setting of monopoly-securing exclusivity buyers' conduct creates a negative externality on other buyers. The collective action problem ultimately causes buyers to receive less than they would have received under competition.}

The upshot of these analyses is that, at least when there is a collective action problem among buyers, the anti-competitive potential of exclusivity arrangements exists. But contrary to intuition, this is not because both buyers and the seller are better off. In fact, while the seller is better off as a result of the exclusives, buyers as a whole are made worse off as a result. It is the collective action problem among buyers that allows this result.\footnote{This analysis ignores competition among potential sellers to become the monopoly, or 'competition for the market'. Such competition may counter the collective action problem at the buyers' level, and result in sellers offering larger payments for exclusivity (see e.g. Paddock Publications, supra note 74. But see Nielsen supra note 74). At the extreme, sellers may share all of their prospective rents with downstream buyers. But even under such circumstances, only two thirds of buyers will be compensated for their prospected losses. More importantly, in real-life settings the tension between sellers' competition and buyers' collective action problem may result in some midway equilibrium in which buyers are under-compensated, albeit less so than under no competition among sellers. Finally, one can think of a great many circumstances in which there is no competition, or little competition, among sellers to become the monopoly. For example, if there is only one seller who is capable of serving the whole market.}

\section*{B. A Seller and Customers who are not End Consumers}

The analysis becomes somewhat more complicated when the parties to the arrangement are not sellers (or a seller) and end consumers, but rather two firms active at different stages in the chain of production. Here, both parties may be made better off by eliminating competition at one level so as to enlarge total industry rents. For example, retailers may grant exclusivity to a single manufacturer, thereby eliminating upstream competition and allowing the manufacturer to elevate prices (and reduce output) to the monopoly level. End consumers will be charged higher prices and the excess of monopoly rents will be shared with retailers by the
monopolistic manufacturer, making both parties (to the exclusivity arrangement) better off. The result here is different from the result in the setting of buyers who are end consumers. The relationship between a seller and end consumers is a zero-sum game in terms of profit. Any additional dollar accruing to the monopoly is invariably a dollar out of buyers' pockets, so that there is no scope for a mutually beneficial arrangement to exclude competition. But when a seller and retailers are concerned, end consumers may be charged higher prices, which are then shared between the parties. Thus, it would seem that in this setting there may be scope for a mutually beneficial arrangement to preserve or create a monopoly. However, well established economic principles seem to imply that here too there can be no scope for a mutually beneficial arrangement. To understand why, it is necessary to explore two economic principles – the 'one monopoly markup' and the 'double marginalization' problem.

**B(1). The 'One Monopoly Markup'**

Economic theory shows that absent some external constraints on the ability to set price and quantity freely (for example price regulation), a single producer in the chain of production has nothing to gain from monopolizing an additional link in the chain of production. For a given product there is one – and only one - optimal monopoly price, and a corresponding (single) optimal quantity. Price and quantity are a derivative of the demand for the end product, and a single monopoly in the chain of production can capture all of the rents regardless of where in the chain of production it is active. The formal exposition of this proposition can be found elsewhere. In the present context, it is sufficient to illustrate the one monopoly markup argument with an example. Consider a manufacturer who is the sole producer of both jars and lids. The cost of producing a jar is $1, and the cost of producing a lid is also $1. As a monopolist, the producer sets the price of a jar at $3 and the price of a lid at, $3, for a total of $6 which we assume to be the profit maximizing monopoly price for a jar and a lid. Suppose now, that competition emerges in the production of lids, causing the

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96 A formal model illustrating this argument is developed in Ittai Paldor, "RPM as an Exclusionary Practice" [forthcoming, 2009, Antitrust Bulletin].

97 The one monopoly markup idea was originally developed in W.S. Bowman, "Tying Arrangements and the Leverage Problem" (1957) 67 Yale L.J. 19. On the case of price regulation see at 22 – 23.

market price of lids to drop to $1. Rather than struggle to remain a monopoly in the production of lids, the incumbent can simply charge $5 for jars. Consumers' demand for the end product – a jar and a lid – has not changed, and a price of $6 for the product will still result in the optimal (monopoly) quantity being cleared by the market. Competition in the production of lids will keep the price of lids down, disallowing any lid manufacturer to charge a higher price for lids, and all supra-competitive rents will accrue to the incumbent through the price of jars. It follows, that nothing is gained from monopolizing more than one link in the chain of production. A monopoly over a single link in the chain of production is enough to extract all rents from the end product. As Bowman puts it: "a monopoly of bolts if nuts are competitive is as good as a monopoly of bolts and nuts".99

The analysis is equally valid if there are more than two links in the chain of production to monopolize. Consider, for example, a windshield wiper producer. Let it be assumed that this producer has an unchallenged monopoly in the production of wipers, for example because it is the only licensed producer of such wipers. The marginal cost of a set of wipers is $2. Demand for a car is such that the monopoly price for a car (which includes a set of wipers) is $5,000. Let us further assume that there are 10 components in a car, and each of the other 9 component costs $100 to produce. If all other links in the chain of production are perfectly competitive, each of these producers will charge $100 for its component (otherwise one of its competitors will supply the component for less). The wiper-producer will accrue all supra-competitive rents, or $4,100 for each set of wipers.100 Each link in the chain of production will earn zero economic profit, exactly covering the cost of production,101 and all economic profit will be captured by the windshield wiper producer. This example demonstrates that even if there are several links in the chain of production, and even if the monopoly is held in a seemingly insignificant link in the chain of production, a monopolist cannot increase its profits by monopolizing an additional link in the chain of production. There is one monopoly

99 Bowman, supra note 97 at n. 9.

100 Put differently, the quantity of cars will be set at the point where the marginal revenue from selling a car equals the marginal cost of producing a car, or $902 in this example. Regardless of which producer is the monopolist, total quantity will remain the same. See generally Posner, supra note 12 at 295 – 308 (ch. 9).

101 Economic profit is distinct from accounting profit. No economic profit does not imply no profit in the traditional (accounting) sense. On economic profit and accounting profit see Trebilcock et al., The Law And Economics Of Canadian Competition Policy (Toronto: University of Toronto Press, 2002) at 56.
markup, and there are no additional rents to be gained by monopolizing more than one link in the chain of production.

B(2). The Double Marginalization Problem

The double marginalization problem is closely related to the 'one monopoly markup'. According to the double marginalization observation, a firm with market power loses from the establishment of an additional monopoly in the chain of production. The reason for this stems directly from the 'one monopoly markup' analysis. As the previous analysis shows, there is only one monopoly markup in every chain of production. If the firm is the only monopoly in the chain of production, it will accrue all of the monopoly rents. If a second monopoly is established, it will regard the price at which it purchases its input (from the first monopoly) as part of its marginal cost, and – equating marginal cost to marginal revenue – will further raise the price, resulting in a suboptimal quantity of the end product being sold.¹⁰²

A slight variation of the previous jar-lid example may be used to illustrate this. Suppose that in the previous example, at the monopoly price of $6 per jar and lid, the market clears 100 units of the product. Total revenue is thus $600. Production costs are $1 per jar and $1 per lid for a total of $200, and monopoly profits total at $400 ($600-$200). Suppose now that there is a single producer of jars and a single producer of lids, who purchases jars from the first producer, produces lids, and sells the final product to consumers. If the jar producer charges $5 for the jar, the lid producer will add this to the production cost of lids ($1), for a total marginal cost of $6 for jar and lid. Being a monopoly itself, it will then equate its own marginal cost ($6) to marginal revenue and further raise the price of the end product to, say, $7. The price increase (from $6 to $7) will naturally result in smaller quantities of the product, say 75 units, being cleared by the market. Total revenue is now $525 ($7*75) instead of $600, and the joint profits total $325 ($525-$200).¹⁰³ Regardless of how these $325 are

¹⁰³ This numeric example may seem artificially designed to achieve the desired result. If, for example the market clears 86 units of the product at $7, total profit will have increased to from $400 to $402 ($7*86) - $200. And profits will have increased by even more if the market clears more than 86 units. But if that were the case, the original monopoly price would have been $7 and not $6. If the original monopoly price is assumed to have been the profit-maximizing price, a second markup necessarily results in smaller overall profit. For a formal illustration see Spengler, ibid.
divided between the two monopolies, each would have been better off being the sole monopoly in the chain of production.

If transaction costs are not prohibitive, the two monopolies can be expected to negotiate a division of the single markup between them. In the previous example they will agree to charge $6 for the jar and lid, and split the excess of the one markup over the double markup ($400 - $325 = $75), so as to leave at least one of them better off than under the double markup. But although negotiations indeed yield a better outcome than the double markup, each of the monopolists is nonetheless worse off than as the sole monopoly, in which case it will accrue the full monopoly profit. Negotiations can, at best, result in a single monopoly markup being split between the monopolies, with no additional deadweight loss. But a single monopoly is still more profitable, and a single monopolist should be reluctant to allow, certainly facilitate, an additional monopolist in the chain of production.

The examples used here to illustrate the double marginalization and the 'one monopoly markup' may seem over-simplistic because they correspond to situations in which the number of units of the input (windshield wipers) and the number of units of the final good (cars) are identical: the production of one unit of the end product requires one unit of input. When the input is an input that does not fit this paradigmatic case, for example when the input is a fixed input which can be used for a varying number of units of the final product (say a license), there may seem to be scope for a second markup. This is not the case. A (monopolistic) supplier of an input can use various mechanisms to extract the profits earned by its downstream counterpart on a per-unit basis. Most obviously, it can charge a price for the input that is calculated to equal the total profit from selling units. Alternatively, it can charge a royalty payment – a percent of all profits or sales. A commonly used mechanism


105 If negotiations over the share of the rents granted to each of the economic agents are prohibitively costly, or otherwise fail, the problem may result in no production at all as in the 'tragedy of the anti-commons'. See Michael A. Heller, "The Tragedy of the Anticommons: Property in the Transition from Marx to Markets" (1998) 111 Harv. L. Rev. 621. This tragedy of the anti-commons is in fact an extreme case of the double marginalization problem.

106 See e.g. Principe v. McDonalds Corp. 631 F.2d 303 (4th Cir., 1980) [McDonalds].

107 For an analysis of such a mechanism as the equivalent of a differentiated per-unit pricing scheme see Gerald R. Gibbons, "Field Restrictions in Patent Transactions: Economic Discrimination and Restraint of Competition" (1966) 66 Colum. L. Rev. 423 at 427 – 430. See also Tirole, supra note 98 at 172.
is a franchise fee,\textsuperscript{108} but there are additional mechanisms an upstream monopoly can use to extract rents when the ratio of input-units to final-product units is not one to one.\textsuperscript{109} A discussion of these mechanisms, generally referred to as two-part tariffs,\textsuperscript{110} is beyond the scope of the present paper. For present purposes it is enough to note that the analysis does not change if the ratio of units of input to units of the end product is not one to one.\textsuperscript{111}

In summary, the upshot of the 'one monopoly markup' is that a monopoly in one link in the chain of production has little to gain from monopolizing an additional link in the chain of production. The upshot of the double marginalization problem is that a monopoly in the chain of production should be reluctant to facilitate monopolization of another link in the chain of production. While this itself does not imply that exclusivity can never be anti-competitive, it has important implications for the understanding of when exclusivity is unlikely to have an effect.

\textsuperscript{108} McDonalds, supra note 106. While the first part of the franchise payment was a fixed sum, the second part of the payment was a percentage of gross receipts. See also Ungar v. Dunkin’ Donuts of America 531 F.2d 1211 (3rd Cir., 1976). While the case focuses on the alleged harm to Dunkin’ Donuts’ franchisees, the description of the arrangement between Dunkin’ Donuts’ and suppliers of signs and equipment (1215 – 1216) conforms precisely to this analysis.

\textsuperscript{109} See Bowman’s analogy between tie-ins and a technological device metering the use of the (fixed input) product, e.g. a copying machine, in the context of price discrimination (Bowman, supra note 97 at 23 – 24).

\textsuperscript{110} Tirole, supra note 98 at 176 – 177.

\textsuperscript{111} This issue should not be confused with the problem of input substitution, which arises when units of a different input can be used to substitute for units of the specific producer’s input (Tirole, \textit{ibid} at 179 – 180), although a two part-tariff is a possible mechanism for overcoming the problem of partial input substitution.
IV. 'Monopoly over Monopoly Status' – The Natural Check on Anti-competitive Exclusivity

Consider the extreme case of a monopoly being granted exclusivity. The upshot of the preceding analyses is that there can be no anti-competitive motivation for the exclusivity agreement, because nothing is to be gained by monopolizing an additional link in the chain of production. The motivation for the exclusivity covenant cannot therefore be that the monopolist is trying to exclude its contractual counterpart's competitors so as to monopolize an additional link in the chain of production. And even if for some reason it is motivated by a desire to monopolize an additional link, no additional deadweight loss will arise from this monopolization. Ultimately, price (and quantity) will be set at the profit maximizing level, namely at the same level at which they would have been set had only one link been monopolized.

Now, consider the extreme case of a monopoly granting exclusivity. Again, there can be no anti-competitive motivation. The upshot of the double marginalization problem is that a retailer, wholesaler, or manufacturer, are adversely affected by the enhancement of their contractual counterpart's market power. And as a result, the analysis is similar to that of end consumers granting exclusivity. Although collective action problems may cause them to grant exclusivity to their own detriment, absent such problems – as in the case of a monopoly granting exclusivity to a buyer or seller – there is no scope for anti-competitive exclusivity. Our intuition regarding the importance of market share in assessing the anti-competitive potential of exclusivity arrangements can now be reconsidered in light of the preceding analysis. A monopoly granting exclusivity to a seller or buyer is, counter-intuitively, a case which should seemingly raise no competitive concern, even though it results in foreclosure of 100%, undoubtedly a significant market share. The same case can, of course, be made for a monopsony granting exclusivity to a seller or buyer. In these settings Bork's stipulation that "there is every reason to believe that exclusive dealing and requirements contracts have no purpose or effect other than the creation of efficiency"112 seems convincing.

The cases of a monopoly and a monopsony granting exclusivity are not the only cases to which the preceding analysis is applicable. There are other cases in which there is no collective action problem among the firm or firms granting exclusivity. This is the case, for

112 Bork, supra note 27 at 309.
example, in an industry in which foreclosing the market requires foreclosing all existing outlets. As no single outlet is redundant, there is no collective action problem. If this seems an extreme case, consider the case of an industry with 10 retailers each of which holds a 10% market share, and in which an upstream enterprise is viable if it serves 8%, 9%, or 10% of the market. There is again no collective action problem. No single retailer faces the risk of ultimately facing a monopoly if it does not grant. These situations can be thought of as situations of ‘monopoly over monopoly status’. A firm granting exclusivity has the power to confer the monopoly status on its contractual counterpart or withhold this status from its contractual counterpart. It can thus be expected to extract all rents from the party being granted the monopoly status, if indeed the agreement enhances market power to any extent. There is a natural check on the anti-competitive potential of exclusivity, and it must therefore be motivated by efficiency justifications.

The general point is that when the market share foreclosed by exclusivity arrangements is relatively large, the anti-competitive concern is lessened as the foreclosed market share increases. Traditional analysis, according to which the competitive danger increases as the foreclosed market share increases is correct for small and medium market shares. But when the foreclosed market share is relatively large, the competitive danger is reduced as the foreclosed market share increases. Thus, while foreclosure of 50% should indeed, all else equal, be scrutinized more carefully than foreclosure of 40%, foreclosure of 100% should raise less concern than foreclosure of 90%.

A precise quantification of the percentage at which more foreclosure raises less concern is not undertaken here. The precise percentage depends largely on the industry cost-structure of both the link in the chain of production granting exclusivity and the link in the chain of production being granted exclusivity, other barriers to entry, profit-margins, and so on.

The general point is that the probability of competitive harm as a function of the percentage of the market foreclosed is not a linear increasing function, as it is currently thought to be, but rather one that initially increases and – beyond some threshold – begins to decline. This is illustrated in figure I, in which the vertical axis denotes the probability of (competitive) harm.

113 ‘Monopoly over monopoly status’ does not necessarily require a monopoly in the relevant product or geographic market. For example, if there is a retailer who has a 5% market-share but whose location or reputation is such that visibility in its establishment are essential to the success of the product, it has a ‘monopoly over monopoly status’, and exclusivity arrangements have no anti-competitive potential.
(PH) as a function of the market share foreclosed by exclusivity (MS), measured on the horizontal axis.

While traditional analysis holds, at times implicitly, that the function is an inclining one, the argument pressed in this paper suggests that it is in fact a concave function. At small market shares it indeed inclines in a manner no different from the manner traditional analysis suggests. But when the (foreclosed) market share becomes larger, the probability that exclusivity is being used to achieve exclusion declines, as depicted by the dotted line. And at the extreme case of 100% of foreclosure the anti-competitive potential is not at its highest, but rather zero.

This analysis is uni-dimensional, in the sense that it captures only the probability of competitive harm as a function of the foreclosed market share, ignoring other factors that have an impact both on the probability of competitive harm and on the correlation between (foreclosed) market share and the probability of competitive harm.
One extremely important factor is the industry's concentration ratio.\footnote{There are different measures of concentration ratio in an industry, which attempt to incorporate the relative size of the larger firms. The two most commonly used indices are the four-firm concentration ratio (CR4) and the Herfindahl-Hirschman Index (HHI). But there are also others. For a survey of these see B. Curry and K. D. George, "Industrial Concentration: A Survey" (1983) 31 J. of Indust. Econ. 203 at 204 – 210. The CR4 is but one instance of the general CRK test, which takes the form of $\text{CRK} = \sum_{i=1}^{K} F_i^2$. As Curry & George note, values of 3 – 8 are usually employed. For a less formal description of the two most common indices and a discussion of their shortcomings and relative advantages see Hovenkamp, supra note 63 at 456 – 463.} Greater concentration means that the average size of each firm is larger. This implies that for a given foreclosure rate necessary for the elimination of competition, the probability of anti-competitive exclusivity is \textit{smaller} because there is more likely to be a single firm (or even more than one firm) that has a 'monopoly over monopoly status'. For example, in an industry in which forestalling competition requires foreclosure of 51%, anti-competitive foreclosure is more likely to occur if there are 100 retailers (with equal market shares) than if there are 4 retailers (with equal market shares), and \textit{impossible} if there are 2 retailers with a market share of 50% each.\footnote{Technically, the slope of the curved line is steeper and its starting point is further to the left the larger the concentration in the industry. Consider, for example, the difference between the probability of harm in an industry with 100 retailers of equal size, denoted by the dotted line $C1$ in the following graph, and the probability of harm in an industry with 10 retailers of equal size, denoted by the dotted line $C2$ in the following graph:}

Another important factor, closely related to the previous one, focuses not on the number of firms in the market, but rather on the \textit{distribution} of size among these firms.\footnote{The HHI incorporates the distribution of size among the firms, but the CR4 does not.} This is important because for any given concentration ratio, the more uniform the distribution of market shares among the larger firms in the industry, the more likely it is that a number of them will be redundant for a foreclosure scheme. All else equal, this increases the probability
of anti-competitive exclusivity. Put differently, the more evenly distributed market shares are, the more probable anti-competitive exclusivity is.\textsuperscript{117} In an industry with four competitors, each of which has a 25\% market share, anti-competitive exclusivity is far more likely than in an industry with four competitors, three of which have a 10\% market share and one of whom holds 70\% of the market.\textsuperscript{118}

The point is, therefore, that for small and medium market shares the competitive danger posed by exclusivity agreements raises as the foreclosed market share increases; but for relatively large market shares, the danger decreases as the foreclosed market share increases. Just as exclusivity arrangements foreclosing small market shares are considered presumptively benign, so should exclusivity agreements foreclosing extreme market shares.

The prevalent view according to which the competitive danger increases as the foreclosed market share increases,\textsuperscript{119} is simply wrong. Counter-intuitively, the percentage of foreclosure should be presumed benign not only at extremely small market shares, but also at extremely large market shares.

A precise quantification of the term 'extremely large foreclosure' is not undertaken in this paper. Such quantification is infeasible as a practical matter. As mentioned, the anti-competitive potential of exclusivity arrangements is a function of numerous factors, of which market share is only one. Just as the question of what percentage of foreclosure should be set as the lower threshold for raising antitrust concern is one with no accurate answer, so is the question of what level of foreclosure reduces the antitrust concern. The important point is that

\textsuperscript{117} A good measurement of the differentiation in market shares among firms is the Hannah and Kay index (see Curry & George, supra note 114 at 208). As the HK index increases, the probability of foreclosure at any given market share decreases, which will have the same effect on the dotted curve as an increase in the industry's concentration rate (see figure II, supra note 115).

\textsuperscript{118} As mentioned, it may be inaccurate to label the two industries as industries with similar concentration ratios, because most concentration indices incorporate differences in market shares into the measurement of concentration. But this is not always the case (as in CRK indices). Even when it is the case, it is helpful to decouple the measurement of the number of firms from the measurement of the market-share differentiation for current purposes. The most intuitive index for these purposes is the HK index (\textit{ibid}).

the almost categorical condemnation of foreclosure of large market shares through exclusivity\textsuperscript{120} is unjustified. And counter-intuitively, it is in these kinds of arrangements that there is a natural check on anti-competitive uses of exclusivity agreements. At least when foreclosure of, say, 85\% and up is considered, exclusivity is far more likely to be benign than it is to be anti-competitive.

As mentioned, other factors too impact the likelihood of anti-competitive effects. The cost-structure in the industry, other barriers to entry (regulation, industry-specific sunk costs, etc.),\textsuperscript{121} the length of the exclusivity covenant and the ease of termination of the contract are all important. And of course, once the anti-competitive potential has been assessed, it needs to be balanced against the pro-competitive attributes of exclusivity under the specific market circumstances. The important point is that within this framework, the foreclosure of larger market shares is not necessarily more dangerous, from a competitive perspective, than foreclosure of smaller market shares. And when the foreclosed market share is large enough so that no collective action problem exists, the possibility of anti-competitive foreclosure is completely negated.

\textsuperscript{120} See supra note13.

\textsuperscript{121} On industry-specific sunk costs and barriers to entry see Carlton & Perloff, supra note 19 at 29 & 73 – 82.
V. Conclusion

The argument pressed in this paper is not that exclusivity arrangements should be *per se* legal. They may indeed be used to eliminate competition, and thereby enhance the market power of the party being granted exclusivity. But within the framework of the rule of reason, courts should be mindful of the fact that exclusion of competitors through exclusivity agreements is unlikely not only when the foreclosed market share is relatively small, but also when the foreclosed market share is extremely large. Antitrust authorities are generally reluctant to condemn exclusivity arrangements foreclosing market shares of less than 40% - 50%. Exclusivity arrangements with a foreclosure effect that falls below this threshold are presumed benign. And in recent years, parties to exclusivity arrangements foreclosing market share of less than 40% have even begun to use the foreclosing effect as a *defense* in courts. The argument developed in this paper is that the almost automatic condemnation (by courts) of exclusivity arrangements foreclosing large market shares is, although intuitive, unjustified. Counter-intuitively, foreclosure of market shares of approximately 85% and up should be presumed benign. Notwithstanding other important elements of the analysis, enforcement should focus on exclusivity arrangements foreclosing market shares of 40% - 85%.

I do not suggest an irrefutable presumption of legality for exclusivity arrangements foreclosing large market shares. There are several reasons why the presumption should be refutable.

First, the 85% figure is a reasonable figure and is an important workable rule of thumb, but it is not the result of precise calculations. And in this sense, the choice between using 85% and 80% as the threshold for no condemnation is arbitrary. This is not a qualification to the setting of the threshold itself. The setting of workable number values for different purposes is in no way foreign to antitrust analysis. Most figures used by antitrust practitioners (and theorists) are the product of an underlying theory that is inaccurate in the same sense. For

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122 See supra notes 63 – 64 and accompanying text.
123 See Visa, supra note 79, Jacobson, supra note 1 at 343 – 344. In The European Union, vertical arrangements, including exclusive supply agreements, between undertakings neither of which has a market share of 30% enjoy a Block Exemption from the application of the prohibitions contained in Article 81 of the Treaty of Rome, the equivalent of Section 1 of the Sherman Act. See BER, supra note 10 at Article 1 Paragraphs 8, 9 and Article 3.
124 See references in supra note 7, 12, and 13.
example, in the context of product market definition the test adopted by the Department of Justice and Federal Trade Commission is the 'hypothetical monopoly test', which seeks to determine the profitability of a "small but significant non-transitory increase in price" [SSNIP]. The "small but significant' element of this test is generally translated to mean a 5% - 10% increase in price.\footnote{U.S., Department of Justice and the Federal Trade Commission, \textit{Horizontal Merger Guidelines} (2 April 1992), revised April 8, 1997 online: \url{http://www.usdoj.gov/atr/public/guidelines/horiz_book/11.html} ch. 1.11} This figure is also arbitrary in the above sense. An 11% price increase may similarly be considered small.\footnote{And indeed, the FTC and DOJ reserve the right to use a different figure: "However, what constitutes a "small but significant and nontransitory" increase in price will depend on the nature of the industry, and the Agency at times may use a price increase that is larger or smaller than five percent" (\textit{ibid}).} Similarly, the HHI test mentioned earlier is used to assess the probable effects of horizontal mergers on market concentration. Within the framework of the HHI the government sets general standards: it considers markets in which the post-merger HHI is less than 1000 to be un-concentrated, markets in which the post merger HHIs are between 1000 – 1800 to be moderately concentrated, and markets in which post-merger HHIs are above 1800 to be highly concentrated.\footnote{\textit{Horizontal Merger Guidelines}, supra note 125 at 1.5} This classification itself is arbitrary in the sense mentioned above. Again, one could just as easily have supported a stipulation of 1900 as the upper boundary of moderately concentrated markets. The government also considers a 100 HHI point increase in a moderately concentrated market and a 50 HHI point increase in a highly concentrated market to be likely to create an anti-competitive effect, again an arbitrary decision. Different market shares are also used in attempted monopolization and in illegal monopolization cases under §2 of the \textit{Sherman Act}. Finally, in the present context of exclusivity arrangements the 40%-50% threshold for condemnation is no more compelling than a 35% one.

Thus, the setting of an 85% threshold is not itself objectionable. But as it is inaccurate, it should be regarded as a rule of thumb, not as a threshold giving rise to an irrefutable
presumption of legality. Industries may well exist in which a collective action problem is faced even when the foreclosed market share reaches levels of 90% and higher.

A second reason why the threshold should not be considered conclusive is that actual foreclosure levels are not necessarily indicative of the foreclosure levels that are required for the elimination of competition. Consider, for example, an industry in which foreclosure of 92% is observed. The industry may theoretically be one in which the elimination of competition requires the foreclosure of only 65%, an industry in which the presumption of pro-competitiveness should not be invoked. It is of course unclear why exclusivity arrangements would be struck with 92% of the market if 65% are enough to foreclose the market, but it is not impossible. This too is not a major qualification to the presumption. Like any agreement, an exclusivity arrangement is not a costless endeavor, and parties observed signing such arrangements can be assumed to have done so for a reason. When the elimination of competition is the goal of these arrangements they can generally be expected to foreclose the necessary market share, not excessive market shares. Thus, while not impossible that in an attempt to conceal the true nature of the arrangement or for some other reason exclusivity arrangements foreclosing a large market share are not indicative of a real need for such widespread exclusivity, as a practical matter it seems reasonable to assume that a genuine business justification underlies exclusivity arrangements foreclosing large market shares and consequently to infer that such arrangements are pro-competitive. But since theoretically this may not be the case, the presumption should be refutable.

Melamed, supra note 32 at 376, points to the inflexibility that has resulted from the focus on the lower threshold in the present context: "...[A]lthough rules of thumb like a specified percent foreclosure test are not unrelated to the competition issues raised by exclusive dealing agreements, they are often too wooden and inflexible to provide a sound basis for decision".

Of course, there may be cases in which collective action problems exist even when the elimination of competition requires foreclosure of 99%. Theoretically, if each of 100 retailers holds a 1% market share, the collective action problem will prevail even if the elimination of competition requires foreclosure of 99%. But as a practical matter this seems like an unrealistic qualification: if any of the retailers holds a market share that is even marginally greater (say, 1.01%), the collective action problem will be 'naturally' eliminated and there will be a natural check on anti-competitive exclusivity. Additionally, hold-out problems and transaction costs make it far more difficult to achieve foreclosure under these circumstances.

Note, in this context, that once the monopoly has been secured by virtue of the 65% foreclosure, additional outlets have little reason to resist an offer to sign exclusivity agreements, at least in terms of enhancement of monopoly power.
Finally, exclusivity arrangements foreclosing large market shares may have adverse long-run effects on the structure of the industry. As shown here, they are unlikely to directly enhance the market power of the firm being granted exclusivity. But they may cause competitors of the firm being granted exclusivity to exit the market. Although, as explained, it is unlikely that the firm(s) granting exclusivity will facilitate this if it enhances the market power of the firm being granted exclusivity, as this generally works to the detriment of the firm(s) granting exclusivity, I show elsewhere that a mutually beneficial exclusivity arrangement may nonetheless be possible due to an externality problem that is not directly related to the enhancement of market power.\textsuperscript{131} Exploring this possibility is beyond the scope of the present analysis, as it does not have to do with the core anti-competitive concern regularly considered within the framework of the rule of reason. But it is another reason why plaintiffs should be allowed to produce evidence of potentially anti-competitive outcomes of exclusivity arrangements.

Notwithstanding its proposed refutability, exclusivity arrangements foreclosing large market shares should, counter-intuitively, enjoy a presumption of pro-competitiveness. At extremely large foreclosed market shares the probability that exclusivity arrangements are being used to an anti-competitive end decreases, and it becomes far more likely that there intended and actual effect is welfare enhancing. As a workable figure, it seems reasonable to set foreclosure of 85% as a threshold that invokes this presumption. Despite intuition, enforcement efforts are best directed at exclusivity arrangements foreclosing market shares ranging between 40% - 45% and 80% - 85%.

\textsuperscript{131} [Author name deleted for anonymity], "When should we care? Anti-competitive Effects with no 'Real' Foreclosure" (available on SSRN).