No. 14-11363

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

McWANE, INC.,
Defendant-Appellant,

v.

FEDERAL TRADE COMMISSION,
Plaintiff-Appellee.

ON APPEAL FROM THE FEDERAL TRADE COMMISSION

BRIEF FOR AMICUS CURIAE PROFESSORS OF ANTITRUST LAW AND ECONOMICS IN SUPPORT OF DEFENDANT-APPELLANT URGING REVERSAL

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CERTIFICATE OF INTERESTED PERSONS AND CORPORATE DISCLOSURE STATEMENT

In accordance with Fed. R. App. P. 26.1, the undersigned certifies that the undersigned *amici curiae* scholars are not a publicly held corporation. In accordance with 11th Circuit Rule 26.1-1, the undersigned further certifies that the list of persons or entities that have an interest in the outcome of this case is adequately set forth in the opening briefs of the parties.

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STATEMENT OF AMICUS CURIAE INTERESTS[1]

This brief is filed with the consent of all the parties.

Amici Curiae are law professors and economists at U.S. accredited law schools, business schools, and university economics departments who specialize in antitrust law and economics. They share a common view that antitrust law should not penalize vertical agreements unless they are shown to harm competition under this Court's jurisprudence. They are concerned that the decision of the Federal Trade Commission could chill beneficial competition and have adverse effects for consumer welfare.

STATEMENT OF THE ISSUES

1. Whether Complaint Counsel put forth sufficient proof of harm to competition to support a finding of unlawful exclusive dealing by the Commission.
2. Whether the Commission adequately analyzed McWane's procompetitive justifications in light of the modern economic understanding of exclusive dealing.

[1] Under Rule 29(c)(5) of the Federal Rules of Appellate Procedure, amici certify that (1) no party to this action, nor their counsel, authored this brief in whole or in part; (2) no party or party's counsel contributed money to fund preparing or submitting this brief; and (3) no person other than amici curiae contributed money that was intended to fund preparing or submitting this brief.

SUMMARY OF THE ARGUMENT

Unlike in a pre-merger investigation, the Federal Trade Commission ("FTC") did not need to rely on indirect evidence related to market structure to predict the competitive effect of the conduct challenged in this case. McWane's Full Support Program,[2] which gave rise to the Commission's exclusive dealing claim, was fully operational—and had terminated—prior to the proceedings below. Complaint Counsel thus had access to data on *actual* market effects.

But Complaint Counsel did not base its case on such effects, some of which suggested an absence of anticompetitive harm. Instead, Complaint Counsel theorized that McWane's exclusive dealing could have anticompetitively "raised rivals' costs" by holding them below minimum efficient scale, and it relied entirely on a self-serving statement by McWane's chief rival to establish what constitutes such scale in the industry at issue. In addition, Complaint Counsel failed to establish the extent of market foreclosure actually occasioned by McWane's Full Support Program, did not assess the degree to which the program's significant exceptions mitigated its anticompetitive potential, and virtually ignored a compelling procompetitive rationale for McWane's exclusive dealing. In short, Complaint Counsel presented only weak and incomplete indirect evidence in an attempt to prove anticompetitive harm from an exclusive dealing arrangement that

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[2] We use the majority's nomenclature for the purpose of this brief, but make no statement as to whether it is a valid characterization.

had produced actual effects tending to disprove such harm. Sustaining a liability judgment based on so thin a reed would substantially ease the government's burden of proof in exclusive dealing cases.

Exclusive dealing liability should not be so easy to establish. Economics has taught that although exclusive dealing may sometimes occasion anticompetitive harm, several prerequisites must be in place before such harm can occur. Moreover, exclusive dealing can achieve a number of procompetitive benefits and is quite common in highly competitive markets. The published empirical evidence suggests that most instances of exclusive dealing are procompetitive rather than anticompetitive. Antitrust tribunals should therefore take care not to impose liability too easily.

Supreme Court precedents, reflecting economic learning on exclusive dealing, have evolved to make liability more difficult to establish. Whereas exclusive dealing was originally condemned almost *per se*, *Standard Oil of California v. United States*, 337 U.S. 293 (1949) (hereinafter "*Standard Stations*"), the Supreme Court eventually instructed that a reviewing court should make a fuller inquiry into the competitive effect of the challenged exclusive dealing activity. *See Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320, 329 (1961). In *In re Beltone Electronics*, 100 F.T.C. 68 (1982), the FTC followed *Tampa Electric*'s instruction and embraced an economically informed method of analyzing exclusive dealing.

The decision on appeal departs from *Beltone*—which the FTC never even cited—by imposing liability for exclusive dealing without an adequate showing of likely competitive harm. If allowed to stand, the judgment below could condemn or chill a wide range of beneficial exclusive dealing arrangements. We therefore urge reversal to avoid creating new and unwelcome antitrust enforcement risks.

ARGUMENT

I. Economic Analysis Has Shown that Exclusive Dealing, While Potentially Anticompetitive, is Usually Procompetitive.

Exclusive dealing occurs when one party to a contract agrees to execute transactions of a certain type with only its counterparty. A contract in which a buyer promises to purchase all its requirements of some product from a single seller, for example, is an exclusive dealing contract. *See*, *e.g.*, *Taggart v. Rutledge*, 657 F. Supp. 1420, 1443-45 (D. Mont. 1987). So is an agreement in which an independent retailer, such as a gasoline service station or franchised ice cream shop, commits to distribute only one brand of a product. *See*, *e.g.*, *Standard Stations*, 337 U.S. 293. As these examples demonstrate, exclusive dealing arrangements are ubiquitous.

From an antitrust standpoint, exclusive dealing is a mixed bag. Antitrust law—a "consumer welfare prescription," *Reiter v. Sonotone Corp.*, 442 U.S. 330, 343 (1979)—aims to ensure market competition, which in turn promotes increased

provision of goods and services at lower prices and of higher quality.[3] Most exclusive dealing arrangements facilitate some sort of cost-reduction that intensifies competition among producers and thereby enhances overall market output. Under certain circumstances, however, exclusive dealing arrangements may injure consumers.

A. Exclusive Dealing May Occasion Anticompetitive Harm Under Certain Sets of Circumstances.

Exclusive dealing harms competition when it is used to reduce overall market output or increase prices. Most notably, a dominant firm may employ exclusive dealing arrangements to saddle its rivals with a cost disadvantage that renders them less competitive.[4]

Most markets exhibit economies of scale at certain levels of output. This means that producers operating at lower output levels may often reduce their average costs of production by making additional units. *See* ROBERT S. PINDYCK & DANIEL S. RUBINFELD, MICROECONOMICS 237 (6th ed. 2008). But economies of scale do

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[3] Because modern antitrust equates competition with more goods and services, lower prices, and higher quality, *see* HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 2-5 (2005) (describing output-focused definition of competition), we refer to developments that enhance overall market output as "procompetitive." Those that reduce market output are "anticompetitive." The key consideration is always the effect on overall market output, not the effect on individual competitors within the market.

[4] Exclusive dealing may also reduce price competition in oligopolistic markets. By entering into long-term exclusive dealing arrangements with buyers, sellers in such markets reduce the incidence of competitive bidding and may thereby stabilize oligopolistic pricing. *See* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 437 (3d ed. 2005) (discussing "exclusive dealing as a cartel facilitator"). This potential anticompetitive harm is not at issue in the case at hand.

not go on forever. As the inputs required for continued production get scarcer and more costly, the incremental (or "marginal") cost of producing an additional unit eventually grows so high that the average cost of production begins to rise. The output level at which average production costs are minimized is termed "minimum efficient scale" ("MES"). *See* HAL R. VARIAN, INTERMEDIATE ECONOMICS 428 (1987). A firm that has not yet reached such scale could lower its average cost of production by making more units; upon achieving MES, however, continued growth would not reduce, and would eventually increase, the firm's average production cost. To be as formidable a competitor as possible, then, the firm needs to grow to MES.

In light of this fact, exclusive dealing may offer a way for dominant firms to squelch competition from their smaller rivals. Because a producer cannot profitably expand its output if it cannot find buyers for its wares, a dominant firm may limit its rivals' total output by persuading buyers of its product to purchase exclusively from it. If the dominant firm's exclusive dealing arrangements foreclose a large enough share of available sales outlets, its rivals may not be able to expand their production to the level of MES. If rivals cannot reach that level of production, their per-unit costs will be higher than they otherwise would be. Facing higher costs, rivals become less able to impose pricing discipline on the dominant firm. *See generally* Joshua D. Wright, *Moving Beyond Naïve*

Foreclosure Analysis, 19 GEO. MASON L. REV. 1163, 1166-71 (2012) (discussing economics of market foreclosure). Because the injury to the dominant firm's rivals also results in reduced market output (and higher prices), it constitutes not just a harm to competitors but a harm to *competition itself*.

For such anticompetitive harm to result, at least three circumstances must exist. First, the degree of foreclosure occasioned by the perpetrator's exclusive dealing must be substantial enough to drive (or hold) at least some rivals below MES. *Id*. at 1166 ("A consensus has emerged that a necessary condition for anticompetitive harm arising from allegedly exclusionary agreements is that the contracts foreclose rivals from a share of distribution sufficient to achieve [MES]."). Second, it must be impracticable for foreclosed rivals to bypass the buyers subject to the exclusive dealing arrangements and sell to others by, say, integrating forward into distribution, selling through newly entering distributors, or selling to distributors unaffected by the exclusive deal. Finally, output-reducing exclusive dealing is unlikely absent significant barriers to entry in the producer market. If market power created by foreclosure-inducing exclusive dealing could be easily undermined by new firms entering the producer market in response to supracompetitive prices, producers (who generally have to "pay" something to induce exclusivity) would be unlikely to attempt monopolization via exclusive dealing, and even if they did so, consumer harm would be unlikely.

B. Exclusive Dealing May Provide a Number of Procompetitive Benefits.

As the prevalence of exclusive dealing arrangements in highly competitive markets suggests, many uses of exclusive dealing strengthen competition and enhance market output. One way they may do so is by eliminating "interbrand free-riding." To win sales from their rivals, producers aim to make their offerings more attractive, often by investing in their distributors. A manufacturer of gasoline, for example, may try to increase its sales by providing the independent retailers that carry its brand with attractive signage, good lighting, and free items for customers (e.g., roadmaps). If such a retailer were also to carry gasoline produced by another manufacturer that did not provide similar retailer investments (and thus bore less cost, permitting it to charge lower wholesale prices), many of the additional sales resulting from the amenities provided by the investing producer would inure to its non-investing, lower-cost rival. By assuring investing producers that their retailer investments will not inure to the benefit of their rivals, exclusive dealing may encourage producers to make consumer-friendly, output-enhancing investments in the distributors that carry their brands. *See generally* Howard P. Marvel, *Exclusive Dealing*, 25 J. L. & ECON. 1, 6-11 (1982); HOVENKAMP, *supra* note 4, at 440.[5]

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[5] *See also* Benjamin Klein & Andres V. Lerner, *The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty*, 74 ANTITRUST L. J. 473

A second way exclusive dealing may enhance competition and benefit consumers is by intensifying competition for distribution. To induce retailer exclusivity and the heightened sales it will generate, producers often lower their wholesale prices in exchange for exclusive dealing. Competition among retailers for customers, then, ensures that those wholesale price-savings are passed on to consumers in the form of lower retail prices. Those lower retail prices, in turn, more than make up for any welfare loss occasioned by reduced consumer choice. By intensifying the competition for access to a retailer, exclusive dealing may therefore confer a net benefit on consumers. *See generally* Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L. J. 433 (2008).

Exclusive dealing may also enhance consumer welfare by reducing the costs associated with uncertain supply and demand. Distributors may find exclusive dealing contracts to be the optimal way to assure a steady source of supply. A gasoline retailer, for example, will want to ensure adequate gasoline supplies for the busy summer months. It could contract in advance to purchase some fixed quantity of gasoline from a producer, but it would run the risk that consumer demand may either soften, leaving it with a glut of gasoline, or spike, leaving it without sufficient gasoline and forcing it to find other suppliers. The retailer's

(2007) (demonstrating that free-riding may occur, and exclusive dealing may thus be warranted, even absent producer investment in distributors).

lowest cost option for assuring an adequate, but not excessive, supply of gasoline may well be to enter a requirements contract under which it promises to buy all its requirements from a single gasoline producer in exchange for that producer's promise to supply all that is required. *See Standard Stations*, 337 U.S. at 306 (exclusive dealing "may assure supply, afford protection against rises in price, enable long-term planning on the basis of known costs, and obviate the expense and risk of storage in the quantity necessary for a commodity having a fluctuating demand"); HOVENKAMP, *supra* note 4, at 439.

On the producer side, exclusive dealing may reduce uncertainty and thereby lower costs (and ultimately prices) by assuring producers of a steady source of demand for their output. A producer that has entered exclusive dealing contracts with a number of distributors can be assured of sales reflective of their collective requirements, a sum that is likely more predictable than is abstract demand for the producer's output. *See Standard Stations*, 337 U.S. at 306-07 (exclusive dealing "may make possible the substantial reduction of selling expenses, give protection against price fluctuations, and—of particular advantage to a newcomer to the field to whom it is important to know what capital expenditures are justified—offer the possibility of a predictable market."); HOVENKAMP, *supra* note 4, at 439-40.

By making it easier for producers to forecast demand for their products, exclusive dealing may encourage producers to expand their productive facilities,

thereby enhancing market output. Consider, for example, a gasoline producer that is deciding whether to build a new refinery and, if so, at what scale. If the producer builds a large and expensive refinery but then encounters soft demand for its output, it may be forced to reduce its gasoline prices to levels that would not permit it to recoup its construction costs. In light of this possibility, the producer may construct a smaller facility or not build at all. This problem may be particularly acute where information about other market participants is poor. For example, if the producer does not know whether competing producers are contemplating new refineries, it may fear excess refining capacity and hold back on expansion. Long-term exclusive dealing contracts guaranteeing demand for its products could alleviate the producer's uncertainty and encourage output expansion. *See generally* HOVENKAMP, *supra* note 4, at 440.

Exclusive dealing may be particularly helpful for encouraging the production of "systems" involving multiple disparate components. Many systems utilize multiple parts that are similar in design, have comparable fixed costs of production,[6] and are used together but not in fixed proportions. A home plumbing system, for example, involves pipes, joints, and valves of multiple shapes and

[6] Fixed costs are those whose magnitude does not vary with the number of units produced. Suppose, for example, that production of a part involves pouring molten metal into a die of a certain shape. The cost of the metal is "variable" because it will grow as more units are produced. The die's production cost, which is the same regardless of the number of units ultimately produced, is "fixed."

sizes. The parts are manufactured using comparable technologies and therefore have similar fixed costs of production. The parts are used together, but some parts are utilized and replaced more frequently than others. There are also economies in distributing and producing the products together: consumers will benefit if they can purchase all their plumbing parts from a single distributor, and distributors can reduce transaction costs (and thus charge lower prices) if they acquire all complementary parts from a single producer. Both consumers, who need easy access to multiple complementary parts, and producers, who will find each part to be more highly valued if its complements are easy to obtain, benefit from having all parts readily available. Taken together, these facts suggest that efficiencies may result when the same producer provides all the parts in the system.

But a producer that provides the full line of complementary parts will incur costs that makers of a narrower line of parts may avoid. Because the fixed cost of producing each of the various parts is similar but the incidence of their usage varies, a producer that makes only frequently used parts will have lower average per-unit costs than will a producer that makes the full line of parts.[7] Facing lower costs, the partial line producer—which benefits from the full line maker's

[7] For example, if it costs $10,000 to cast the die for a single part and $1 for the materials and labor used in producing one unit of that part, the producer's average cost will be $2 if it makes 10,000 units [($10,000 fixed cost + $10,000 variable cost)/10,000 units produced], but $11 if it makes only 1,000 units [($10,000 fixed cost + $1,000 variable cost)/1,000 units]. A partial line producer making only popular parts would have lower average per-unit costs than would a full-line producer making numerous unpopular, but essential, parts.

production of obscure parts—could charge lower prices on the narrower line of parts it makes. But if the partial line producer undersells and thus wins business from the full line producer on popular parts, the full line producer may be weakened or go out of business, making obscure parts less readily available. Such a development would injure not just the full line producer but also both consumers, who need easy access to obscure parts, and partial line producers, whose products will be valued less if the full line of complementary parts is less readily available.

To protect itself *and* avoid the consumer harm that will result if the system it makes becomes less valuable, a system producer will want to avoid "cherry-picking" by partial line producers. It could do so by utilizing a form of exclusive dealing in which it requires distributors of its parts to carry only its parts, not those of partial line producers who are ultimately free-riding on its full line production.

* * * *

In sum, exclusive dealing may enhance consumer welfare by reducing interbrand free-riding, intensifying competition for distribution, cutting costs by guaranteeing sources of supply for distributors and demand for producers, and eliminating value-destructive cherry-picking by producers of partial lines of system components. Given that exclusive dealing has these many procompetitive uses and is likely to occasion anticompetitive harm in only a narrow set of circumstances, it should come as no surprise that empirical studies generally find most instances of

exclusive dealing to enhance, rather than reduce, competition. *See* Jan B. Heide, et al., *Exclusive Dealing and Business Efficiency: Evidence from Industry Practice*, 41 J. L. & ECON. 387, 387 (1998) (finding that "firms are more likely to use exclusive dealing when there is a potential that other manufacturers can free ride on the services they provide" and that "when manufacturers are concerned about the costs that exclusive dealing imposes on end customers, such arrangements are less likely"); Tim R. Sass, *The Competitive Effects of Exclusive Dealing: Evidence from the U.S. Beer Industry*, 23 INT'L J. INDUS. ORG. 203 (2005) (concluding that exclusive dealing in the beer market increases market output); James C. Cooper et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639, 658 (2005) (observing that although "some studies find evidence consistent with both pro- and anticompetitive effects . . . virtually no studies claim to have identified instances where vertical practices were likely to have harmed competition"); Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy in* HANDBOOK OF ANTITRUST ECONOMICS 391 (Paolo Buccirossi ed., 2008) ("[I]t appears that when manufacturers choose to impose restraints, not only do they make themselves better off but they also typically allow consumers to benefit from higher quality products and better service provision"); Daniel O'Brien, *The Antitrust Treatment of Vertical Restraints: Beyond the Possibility Theorems in* THE PROS AND CONS OF

VERTICAL RESTRAINTS 40, 72-73 (2008) (observing that "with few exceptions, the literature does not support the view that [vertical restraints] are used for anticompetitive reasons").

II. In Light of Economic Learning, the Legal Standards Governing Exclusive Dealing Have Liberalized So That Antitrust Liability Is Properly Imposed Only Upon Proof That an Instance of Exclusive Dealing Threatens Net Harm to Competition, Not Merely Harm to a Competitor.

Given economic analysis showing that (1) anticompetitive harm from exclusive dealing can occur only under rarely existent conditions,[8] (2) procompetitive uses of exclusive dealing are quite common, and (3) most instances of exclusive dealing enhance, rather than reduce, market output, exclusive dealing doctrine has evolved to impose liability only upon proof of net harm to competition.[9] Both Supreme Court and FTC precedents require such proof.

[8] Moreover, such harm tends to be self-correcting. *See* Frank H. Easterbrook, *The Limits of Antitrust*, 62 TEX. L. REV. 1, 2 (1984) ("Monopoly prices eventually attract entry.").

[9] Three provisions of the Sherman and Clayton Acts may reach exclusive dealing arrangements. See 15 U.S.C. § 1 (prohibiting agreements that unreasonably restraint trade); 15 U.S.C. § 2 (prohibiting monopolization, attempted monopolization, and conspiracies to monopolize); 15 U.S.C. § 14 (forbidding sales conditioned on not purchasing the goods of a rival seller, where the effect of such a commitment "may be to substantially lessen competition or tend to create a monopoly ...."). Regardless of the specific statutory provision invoked, courts assessing exclusive dealing now focus primarily on a single matter: whether the arrangement at issue "is unreasonably anticompetitive." *See* Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L. J. 311, 327 (2002) (describing convergence of liability standards under Sherman Act Section 1 and Clayton Act Section 3).

A. Supreme Court Precedents Have Evolved to Require Proof of Harm to the Competitive Process, Not Merely Harm to a Competitor.

In one of its early exclusive dealing decisions, *Standard Stations*, 337 U.S. 293, the U.S. Supreme Court focused on whether the defendant's exclusive dealing arrangements caused harm to its competitors, not to competition itself. The Court further suggested that market foreclosure is a sufficient, not merely a necessary, condition to antitrust liability. Subsequent Supreme Court decisions have clarified both that harm to competition is a prerequisite to liability for exclusive dealing and that market foreclosure generally will not, by itself, create antitrust liability.

The exclusive dealing in *Standard Stations* involved requirements by a gasoline producer that the independent retailers selling its brand carry its fuel exclusively. *Id*. at 295-96. Such arrangements, which helped combat the sort of interbrand free-riding discussed above, were common in the gasoline industry. *Id*. at 314. Finding that the defendant's exclusive dealing arrangements foreclosed its rivals from 6.7 percent of available distribution outlets, the district court imposed antitrust liability. It barred evidence concerning "the economic merits or demerits of the present system," and refused to consider whether the number of dealers had increased or decreased since the exclusive dealing contracts had come into existence. *Id*. at 298. In affirming the district court, the Supreme Court appeared to endorse a rule of *per se* liability for exclusive dealing arrangements foreclosing

a "substantial" percentage of sales opportunities for the defendant's rivals. *See* HOVENKAMP, *supra* note 4, at 441.

A dozen years later, the Supreme Court rethought that "quantitative foreclosure" approach. In *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961), the Court reversed a decision condemning an arrangement in which a Florida utility had promised to purchase its coal exclusively from a single producer for a 20-year period. The key part of the *Tampa Electric* decision was the Court's ruling on how to define the relevant market, a ruling that reduced the foreclosure occasioned by the challenged arrangement to an insubstantial percentage (less than one percent). *Id*. at 329-33. That ruling was enough to warrant reversing the lower court's decision. In a bit of influential dicta, however, the Court ventured beyond the market definition issue and asserted that the mere *quantity* of sales opportunities foreclosed by an exclusive dealing arrangement should not determine the arrangement's legality. Rather, a reviewing court should inquire further into the *competitive effect* of the exclusive dealing arrangement—i.e., whether it enhances or reduces market output from what it otherwise would be. The Court explained:

> To determine substantiality [of market foreclosure] 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*.

Id. at 329 (emphasis added).

Tampa Electric's effects-based, "qualitative foreclosure" approach[10] properly reflects economic insights about exclusive dealing's ability to enhance market output even when it forecloses sales opportunities for a defendant's rivals. The Court's emphasis on the competitive effects of foreclosure suggests that a court assessing the legality of an exclusive dealing arrangement should first consider, in addition to any evidence on the degree of foreclosure, whether the arrangement at issue occasioned an actual change in market output—i.e., a significant change in the number of units sold, their quality, or the prices charged. If the evidence on that question is indeterminate, then the court should consider, at a minimum:

- what is minimum efficient scale in the industry at issue, and whether the foreclosure occasioned by the arrangement threatens to drive or hold a rival below that level of output;

[10] Commentators generally refer to the approach prescribed in *Tampa Electric* as a "qualitative," as opposed to "quantitative," foreclosure approach because the Court there clarified that the percentage of sales opportunities foreclosed by an exclusive dealing arrangement, while relevant, is not the touchstone for liability. *See* Jacobson, *supra* note 9, at 322. Instead, liability should turn on the arrangement's actual or likely effect on competition—i.e., on market output.

- how easy it is to enter the relevant production and distribution markets;[11] and
- the likelihood that the challenged arrangement creates procompetitive benefits by reducing interbrand free-riding, intensifying competition for distribution, cutting costs by guaranteeing demand for producers or supply for distributors, or eliminating value-destructive cherry-picking by producers of partial lines of system components.

B. The FTC's *Beltone* Decision Properly Endorsed an Exclusive Dealing Rule of Reason Based on Actual or Likely Competitive Effect, Not Mere Harm to a Competitor.

The FTC endorsed an economically informed rule of reason for exclusive dealing in *In re Beltone Electronics*, 100 F.T.C. 68 (1982). Beltone, a hearing aid manufacturer, required its distributors to handle its brand exclusively. *Id*. at 176-77. The Administrative Law Judge ("ALJ") found that "independent hearing aid dealers [were] the principal source through which consumers obtain[ed] hearing aids," *id*. at 136, and concluded that "Beltone's practices violate[d] the central policy of the antitrust laws by having the tendency and capacity to foreclose Beltone's competitors from selling to authorized dealers…." *Id*. at 142. Reversing the ALJ, the FTC reasoned that more than mere market foreclosure is required to

[11] If entry into the production market is easy, exclusive dealing cannot monopolize the market. If entry into the distribution market is easy, a rival of the producer imposing exclusive dealing should be able to find alternative distributors.

establish antitrust liability based on exclusive dealing. *Id*. at 204 (foreclosure is "only one of several variables to be weighed"). The Commission acknowledged that *Tampa Electric* had expanded the relevant inquiry to consider more than the percentage of market foreclosure, *id*. at 201, and it observed that the Supreme Court's most recent decision on vertical restraints of trade, *Continental T.V., Inc. v. GTE-Sylvania, Inc.*, 433 U.S. 46 (1977), had prescribed a full-blown rule of reason for evaluating non-price, intrabrand restraints. *See Beltone*, 100 F.T.C. at 177, 192-93. Correctly inferring an effort by the Supreme Court to bring the law of vertical restraints in line with economic learning, the Commission prescribed an exclusive dealing rule of reason that closely tracks the economic analysis summarized above:

> [A] proper analysis of exclusive dealing arrangements should take into account market definition, the amount of foreclosure in the relevant markets, the duration of the contracts, the extent to which entry is deterred, and the reasonable justifications, if any, for the exclusivity.

Id. at 204.

Applying that rule, the FTC concluded that Complaint Counsel had not established that Beltone's exclusive dealing was anticompetitive. First, the Commission concluded that harm to competition had not been established, despite the market foreclosure found by the ALJ, because "other firms ha[d] recently entered the market or grown vigorously." *Id*. at 210. Moreover, Beltone

demonstrated a procompetitive benefit stemming from its exclusive dealing: the arrangement enabled a program in which Beltone would generate leads from potential hearing aid customers and pass them along to its distributors without fear that the distributors would then direct the customers to a different, higher margin brand. *Id*. at 216 ("[T]o the extent that [Beltone] seeks to protect its investment in lead-promoting activity . . . , the restrictions in question have a rational and efficient connection to that objective."). Thus, the Commission reasoned that exclusive dealing should pass muster, despite some apparent foreclosure, when actual market experience shows continued competition through entry and the exclusive dealing facilitates some sort of output enhancement.[12]

III. The Decision Below Failed to Follow Prevailing Standards, Imposing Liability Without Proof of a Net Harm to Competition.

When challenging exclusive dealing, the government bears the burden of articulating a theory of harm to *competition* (not merely to a competitor) and then proving actual or likely anticompetitive effect. *United States v. Microsoft Corp.*, 253 F.3d 34, 58-59 (D.C. Cir. 2001). In the proceedings below, Complaint Counsel identified a theory as to how McWane's Full Support Program could have occasioned harm to competition, but it failed to prove the actual or likely occurrence of such harm. Even if Complaint Counsel had met its prima facie

[12] The Commission's opinion below did not cite *Beltone*.

burden, the Commission failed to take proper account of the procompetitive justifications for McWane's conduct.

A. The Commission Did Not Require the Proof Necessary to Determine Actual or Likely Anticompetitive Harm.

The anticompetitive theory upon which Complaint Counsel relied was that McWane's Full Support Program denied Star the sales opportunities necessary to achieve MES and thereby raised its costs. (Dissent at 24). By increasing Star's costs, Complaint Counsel theorized, McWane could prevent Star from underselling it, thereby maintaining its power over price. While this theory is consistent with the economic understanding of exclusive dealing, theory alone is not enough. Complaint Counsel also bore the burden of proving that the theoretical harms it identified had actually materialized or were likely to do so. *Microsoft*, 253 F.3d at 58-59.

Complaint Counsel produced no direct evidence that could discharge its burden. Unlike in a pre-merger investigation, the situation here afforded Complaint Counsel an opportunity to gather data on *actual* competitive effect. Information was available on conditions in the relevant market during and after the life of the challenged policy, so Complaint Counsel could have compared "actual prices and industry output during the relevant time period against an estimate of the prices and output that would have occurred during the relevant time period had McWane not engaged in the challenged conduct." Dissenting Statement of Commissioner

Joshua D. Wright, *In the Matter of McWane, Inc. et al.*, Docket No. 9351 at 5 n.10 (Feb. 6, 2014) (hereinafter "Dissent"). There is, however, no evidence in the record showing that McWane's conduct actually raised prices or lowered output in the domestic iron pipe fittings ("DIPF") market. (Dissent at 5). On the contrary, the record's direct evidence shows an *absence* of anticompetitive effect: Star grew in market share at exactly the same rate when the restraint was in place and during the period following the restraint. (Dissent at 45).

Complaint Counsel's indirect evidence was similarly deficient. Complaint Counsel, in attempting to prove its theory that McWane's Full Support Program prevented Star from achieving MES and thereby raised its costs, equated MES with the level of sales sufficient to warrant foundry ownership. (Dissent at 28-29). But, as Complaint Counsel freely admitted, the only record evidence supporting such a definition of MES was Star's unsupported assertion that its costs would have been lower had it owned its foundry. (Dissent at 28-30).

Such self-serving testimony should be deemed insufficient in light of *actual market evidence* showing that foundry ownership is not necessary to be a formidable competitor in the iron pipe fittings industry. Sigma, a major competitor in the worldwide iron pipe fittings market, operates on a "virtual manufacturing" model where it owns no foundries. (Dissent at 31). Instead, Sigma sources production to independent foundries and relies on its own employees for know-

how and quality control. (Dissent at 31). Despite not owning its foundries, Sigma has grown quickly to become the second-leading supplier of fittings in the United States. (Dissent at 31). This evidence strongly suggests that MES does *not* equate to the level of sales required for economical foundry ownership. If self-serving statements by put-upon competitors can overcome this sort of hard market evidence, then "proving" anticompetitive harm from exclusive dealing will become an easy matter indeed.

Complaint Counsel never even established the degree of market foreclosure actually occasioned by McWane's Full Support Program. (Dissent at 37-38). The appropriate measure in assessing foreclosure is the volume of rival sales that did not occur, but would have absent the challenged exclusive dealing. To calculate that figure, the Commission simply took "the sum of the market shares of distributors that are 'subject' in some way to the Full Support Program." (Dissent at 38). That approach overstates the degree of foreclosure here for two reasons. First, it fails to account for the significant volume of sales made to McWane's rivals under the exceptions contained in the Full Support Program; Complaint Counsel simply ignored those sales. (Dissent at 40-41). Second, the measure fails to account for the fact that most sales of McWane fittings to distributors subject to the Full Support Program would have occurred anyway. Such "non-contestable" sales were in no way "foreclosed" by McWane's exclusive dealing arrangements.

(Dissent at 38-40). The Commission's overly simplistic assessment of foreclosure makes it far too easy to establish a high foreclosure percentage in exclusive dealing cases.

Finally, the Commission failed to give appropriate consideration to Star's actual entry into the DIPF market. Star broke into the DIPF market in the fall of 2009, selling nearly $300,000 of fittings to 29 customers through year's end, "despite having projected no sales of domestic-only DIPF for that year." (Rosch at 3). In 2010 alone, Star made sales worth $6.5 million to 132 customers, and its share doubled to "almost 10% in 2011." Statement of Commissioner J. Thomas Rosch, Dissenting in Part to the Opinion of the Commission on Complaint Counsel's and Respondent's Motions for Summary Decision, at 4 (Aug. 9, 2012) (Doc. 184) (hereinafter "Rosch"); Initial Decision of Chief Administrative Law Judge D. Michael Chappell, *In the Matter of McWane, Inc.*, No. 9351, at 374 (May 8, 2013) (Doc. 264) (hereinafter "ALJ"). Such evidence suggests McWane's exclusive dealing did not have the anticompetitive effect alleged. *See Beltone*, 100 F.T.C. at 210 (reversing ALJ's liability determination in exclusive dealing case where "other firms ha[d] recently entered the market or grown vigorously").

B. The Commission Gave Short Shrift to Procompetitive Benefits Occasioned by McWane's Full Support Program.

McWane set forth two procompetitive justifications for its Full Support Program. The Program was necessary, it maintained, to preserve the last

remaining domestic foundry committed to producing a full line of DIPF, and to prevent Star from cherry-picking high-volume, low-cost fittings. The Commission analyzed those justifications in isolation, and without considering their interaction in light of the unique characteristics of the DIPF market. Opinion of the Commission, *In the Matter of McWane, Inc.*, FTC Docket No. 9351 (Jan. 30, 2014) (Doc. 289, 290), at 30-32 (hereinafter "Decision"). A more holistic analysis would have shown that Star's production and sale of only the highest-margin fittings—a likely outcome absent McWane's Full Support Program—threatened to disrupt the supply chain and injure consumers. McWane's Full Support Program, a form of "full-line forcing" in which a distributor is required to carry the complete line of a producer's wares, may well have been the optimal means of preventing consumer harm from cherry-picking.

In light of various statutory, regulatory, and contract requirements calling for the use of domestically produced supplies, buyers of pipe fittings have an interest in assuring a ready, domestically produced supply of all complementary fittings. McWane produced such a full line at its domestic foundry. Because fixed costs are similar for both rarely used and popular fittings, McWane's average production cost for a rarely used fitting [i.e., (fixed costs + variable costs)/number of units produced] was higher than its average cost for an oft-used part. *See supra* note 7. That meant that if McWane charged similar prices for technologically similar

parts—a pricing practice purchasers often expect—it needed to "subsidize" production of rarely-used fittings with margins earned on often-used parts. An equally efficient producer of only popular fittings would not have to engage in such "cross-subsidization" to finance the production of rarely used parts and would be able to sell its popular fittings at a lower price. But if too many buyers purchased their often-used fittings from the partial line producer, McWane could no longer afford to produce rarely used parts, and gaps in product availability would result.[13] That would be bad for buyers.

Buyers, though, were facing a prisoner's dilemma. If they all (or a substantial portion of them) continued to buy both obscure and popular fittings from McWane, they would be better off because a full line of domestically produced fittings would remain available. Individually, however, each buyer could benefit from purchasing

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[13] The Commission maintained that if other producers started underselling McWane on popular parts, McWane could reduce its price to meet theirs and then set a separate price for low-volume parts, where that price was high enough to cover the fixed costs of producing those parts. (Decision at 32). But McWane may have had good business reasons to prefer a cross-subsidization strategy to such a separate pricing approach. First, consumers may have been put off by having to pay substantially higher prices for technologically similar obscure parts. McWane had an interest in preserving its buyers' goodwill. In addition, a cross-subsidization strategy may have provided greater certainty than separate pricing and thereby reduced McWane's costs. When deciding whether to incur the fixed costs necessary to produce an obscure part, a business planner does not know how many of those units it will eventually sell and thus how to price the units to ensure coverage of fixed costs. If it sets the price too low, it will not recoup its fixed costs; if it prices too high, it will encourage substitution away from the unit. Production of the part will involve less business risk if the producer can recoup its costs in a manner that is more predictable—i.e., by collecting a small increment on parts whose demand is more predictable. If production risk is lower, production is more likely to occur. Thus, the sort of cross-subsidization via full-line forcing that McWane implemented may encourage greater production.

its popular fittings from a lower-cost, partial line producer and relying on other purchasers to buy enough popular McWane fittings to finance production of the more obscure parts. Given the individual incentives of buyers, McWane stood to lose so many sales of popular parts that it could no longer afford to produce more obscure parts. While this would not be the optimal outcome for buyers as a group, it may have been the dominant strategy given each individual buyer's incentive to free-ride on others.

McWane's Full Support Program offered a solution to this problem. By requiring buyers of its fittings to refrain from handling those of other producers, McWane could prevent the sort of cherry-picking that would have rendered its production of obscure parts uneconomical. Because consumers, distributors, and even other producers of DIPF all benefit from continued production of a full line of fittings, McWane's Full Support Program was far from an unreasonable form of competition. On the contrary, it was output-enhancing and thus procompetitive.[14]

Thus, the FTC not only failed to require adequate prima facie evidence of anticompetitive harm, it also gave short shrift to an important procompetitive

[14] In addition to preventing value-reducing free-riding by partial line producers, full-line forcing of the sort implemented here may prevent buyer hold-up in markets in which high-volume, low-cost products are sold alongside low-volume, high-cost complements. For example, distributors could have held-up McWane in negotiations for DIPF knowing that McWane needed contracts for high-volume, low-cost fittings in order to keep its foundries running.

benefit of exclusive dealing. Affirmance of the judgment below would wrongly call into questions all sorts of procompetitive full line forcing arrangements.

CONCLUSION

For the foregoing reasons the Federal Trade Commission's ruling should be reversed.

Respectfully submitted,

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CERTIFICATE OF COMPLAINCE

In accordance with Rules 32(a)(7)(B) and (C) of the Federal Rules of Appellate Procedure and Circuit Rule 32(a), the undersigned certifies that the accompanying brief has been prepared using 14-point typeface, proportionally spaced, with serifs. According to the word processing system used to prepare the brief, Microsoft Office Word 2010, the brief contains 6,944 words, exclusive of the table of contents, table of authorities, attorney identification, and certificates of service and compliance.

Dated: July 7, 2014

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CERTIFICATE OF SERVICE

I hereby certify that the foregoing amicus curiae brief was electronically submitted on July 7, 2014, to the Office of the Clerk for the United States Court of Appeals for the Eleventh Circuit via the court's CM/ECF system, which will generate and send by e-mail a Notice of Docket Activity to all CM/ECF registered attorneys participating in this case. Counsel for appellants and appellees are registered CM/ECF users.

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