8. Exclusive Dealing

Exclusive dealing is one of the many forms of restrictive practices. Others include resale price maintenance, exclusive territories, tying sales, and the like. Exclusive dealing is probably the least interesting, but it fits into the issue of opportunistic behavior at a fairly basic level so we cover it now.

Exclusive dealing is one of many marketing approaches that a manufacturer can adopt to get its product to the customer. For instance, a manufacturer can own its own stores; it can franchise outlets; or it can distribute its goods through unaffiliated dealers. These unaffiliated dealers can be either exclusive or non-exclusive. Exclusive dealing is usually defined by the situation where the marketing outlet carries only the product of one manufacturer in a particular product type.

For instance, when McDonald's sells only Coca Cola, that is exclusive dealing.[1] Obviously, McD's sells a lot of other stuff, but in the product line of fizzy cola drink it is only Coke. A similar exclusive dealing arrangement was reviewed by the court in the Standard Fashions case. There a women's dress pattern manufacturer signed contracts with department stores which required that they sell only its patterns and not those of competing manufacturers also. The court ruled that this was illegal under Sec 3 of the Clayton Act because it limited competition.

Marvel argues that the Standard Fashion practice was not anti-competitive. The idea is that SF spent resources on developing fashionable clothes. Other pattern manufacturers then "knocked off" these designs. In order to get just compensation for its fashion investment, SF required exclusive dealing. After the court decision it began charging an up-front fee for the right to sell its patterns. This was an alternative way of capturing the investment in fashion design, though not as efficiently as through exclusive dealing.[2]

It is interesting that the Coke case and the Standard Fashion case run in oppose directions. In the case of Coke and McD's, Coke pays. In the case of SF and department stores, the department stores pay. The situations are not identical, because the payment in the SF case occurs when exclusive dealing is outlawed. The payment in the McD's case is precisely part of the exclusive arrangement. McD's gives up something in the arrangement, that is, the option of serving Pepsi lovers what they want. Presumably, the payment by Coke for the exclusive distribution right more than makes up for the loss to Pepsi lovers who also like Big Mac's. However, what does Coke get?

Exclusive dealing in cases other than the Coke/McD example seem to involve a contracting problem where the dealer can act opportunistically against the manufacturer. This was the case in the Standard Fashion case. Department stores carrying the patterns of other manufacturers had the incentive to push the knock off lines because these had higher markup margins. Knock off pattern makers could charge a lower wholesale price because they did not put any money into fashion design.

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[1] When WalMart carries the sports clothes line of Kathy Lee, it is exclusive dealing in the other direction. She sells her clothes only through WalMart. This is an uncommon practice and not likely to survive. Why?

[2] Why?

Other examples include sales expenditures and sales training. Where one manufacturer spends a money on an advertising campaign, dealers can push the lines of other manufacturer using the bait and switch approach. When customers enter the store asking for the product that they have seen on TV, the salesman says, “That’s a good product, but look at this one. It is even better, just not as well known.”

There used to be more exclusive dealing in electronics, appliances, and mattresses than there is today. Much of the change in distribution seems to be attributable to increases in the efficiency of advertising and the chilling effects of antitrust action on all forms of restrictive practices. There is little exclusivity left except for cases where it is voluntary and not universally practiced and in cases where the distribution outlet is a franchise. (Obviously, company owned stores can be exclusive without raising the ire of the antitrust authorities.)[3]

The one example of exclusive dealing that has be studied excessively is the insurance industry. Property and casualty insurance is sold through both exclusive agents and independent agents that sell multiple lines. Another industry where we see both exclusive and non-exclusive sales is the automobile industry.

In insurance there are companies such as State Farm and Allstate that sell through exclusive agents sometimes called direct underwriters. Other firms, such as the Travellers market their insurance through agents who also sell the products of several other companies. These are called Independent Insurance Agents.[4] From time to time a company will switch from using independent agents to direct underwriters.

Grossman and Hart argue that exclusive agents are used to protect the customer base. Marvel argues that exclusive agents are used to protect advertisement investments. Sass and Gisser claim that exclusive agents are used in order to maximize the selling effort of the insurance companies product. All of these arguments make some sense. See Sass and Gisser in particular for a quick run-down on the different ideas. However, it is a bit over cooked.

The insurance business is somewhat unique. Insurance is one of the prototypical U-shaped cost curve businesses. Average cost of insurance falls the more business a company writes because insurance is a pooling phenomenon. The variance of expected loss falls as the sample size increases. On the other hand, insurance is fraught with the potential for managerial shortcoming. Insurance is plagued by the problems of moral hazard and adverse selection.[5] The benefits of growth are offset by the inability to control these contractual problems.

Sass and Gisser make a fundamental assertion which is that the commission rate on insurance policies that goes to the agent falls when companies are able to employ direct underwriters. Their main argument is simple enough. They claim that in order to enjoy maximum sales effort,

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[3] Manufacturer outlets are an increasingly common phenomenon. We will return to this when we study the other forms of the restrictive practices.

[4] Independent Insurance Agents of America is the association. They have a logo with an eagle on the top of an I.

[5] Moral hazard is the situation where the insured party increases the loss (or fakes it) in order to inflate the insurance indemnification. Adverse selection occurs when the insurance company is only able to attract the most risky customers into its pool.

insurance companies will adopt exclusive agents whenever they have enough business to justify this. On the face of it, this seems like a very reasonable proposition. However, it is more problematic to claim that the commission rate falls. The report statistical results which support this proposition.

I have looked at auto dealing in South Carolina. In particular, I have collected data on the extent of exclusive dealing. The following are true: Of the 295 new car dealers in SC in 1993, the average number of manufacturers represented on a lot was 1.25. The average number of makes for each of these manufacturers represented was 1.66. A manufacturer is General Motors. A make is Chevrolet or Buick. Statistically, it is more likely that a car dealer will be exclusive if there are other dealers of the same manufacturer nearby. A dealer is also more likely to be exclusive if it handles more than one make by a manufacturer. For instance, a dealer that handles Chevys and Buicks is less likely to handle Toyotas than is a dealer who only handles Chevys. Dealers that handle high priced cars are less likely to be exclusive. Finally, and most interestingly from the perspective of the Sass and Gisser argument, there is a positive relation between the wholesale-retail price markup and the extent of exclusive dealing. That is, manufacturers with the largest margin between wholesale and retail prices also have the most exclusive dealers.

Antitrust Cases Involving Exclusive Dealing:

Exclusive dealing is controlled by Clayton, Section 3. This Section makes exclusive dealing illegal if the effect of the deal is to substantially lessen competition. As always, the relevant product and geo. market is key in deciding whether there has been a decrease in competition. Whether specific aspects of the deal are bad is frequently the result of being to show interbrand competition.

1. <u>Standard Fashion Co. v. Magrane-Houston Co.</u>, 258 U.S. 346 (1922) (p. 233)

FACTS: Standard had an exclusive deal with Magrane for the sale of patterns. Magrane controlled 40% of the market for sales of patterns. Standard offered favorable terms to Magrane so long as Magrane did not carry any other's patterns or sell below MSRP. Magrane violated contract by selling other's patterns.

ANALYSIS: Court agreed with lower courts that held that in some instances, where the Magrane store is the only one in town, Standard would have a monopoly on the sale of patterns. Thus, the court concluded that the deal was to substantially limit competition. There was apparently no evidence presented of the actual monopoly power.

WHAT YOU NEED TO GET: Product and geographic markets key when evaluating whether something may substantially lessen competition.

2. <u>Tampa Electric Co. v. Nashville Coal Co.</u>, 365 U.S. 320 (1962) (p.236)

FACTS: This case had to do with a requirements contract where one party, here Tampa Electric, agreed to buy all the coal it needed from one supplier for a specified price. Obviously, the cost of coal to Nashville Coal went up to the extent that it was not profitable for Nashville to provide the coal at the specified price. Tampa had to get coal elsewhere and sued Nashville for the difference based on the contract rate ("Contract damages"). Nashville defended by claiming that the contract was illegal under Clayton §3. Both the district court and the appellate court held that the contract was illegal.

ANALYSIS: Again, the key inquiry is the relevant product market, the relevant geographic market, and the amount of competition foreclosed. The Sup.Ct. held that the relevant geo. market was an area spanning more than 10 states. With that size of relevant geographic market, the competition foreclosed was less than 1%. Obviously, for Tampa, a large geographic market is key.

WHAT YOU NEED TO GET: 1) Relevant geo and product market; and 2) how the court can manipulate these factors.