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Rejoinder to Cooper, Froeb, O'Brien, and Vita's Reply

*Ralph A. Winter*

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In this rejoinder, I first respond to the discussion in Cooper, Froeb, O'Brien, and Vita's "Reply to Winter" of a technical point, the relationship between retailer incentives and retailer margins, and then set out our common ground and remaining differences on the broader theme of theory and evidence in vertical restraints cases.<sup>1</sup>

Cooper et al. stated in their original article that a retailer will provide a lower level of effort than is optimal for the manufacturer when the retailer's margin is small relative to the manufacturer's margin. I claimed in my comment on the article that low retail margins do not necessarily lead to inadequate retailer incentives for promotion. One counterexample to Cooper et al.'s general claim is the framework developed in my comment in which a manufacturer and its retailers strike contracts that maximize their joint wealth. Another counterexample is the simple benchmark in which the sales-generating effort by retailers is in effect adding to product quality, in which all consumers have identical preferences for quality, and in which the market structure consists of a monopoly upstream and perfect competition downstream. (Retailers in this setting produce exactly the quality that is optimal for the manufacturer, yet the retailer margin

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1 This article is a rejoinder to J. Cooper, L. Froeb, D. O'Brien, & M. Vita, *Reply to Winter's "Vertical Restraints and Antitrust Policy: A Reaction to Cooper, Froeb, O'Brien, and Vita,"* 2(1) *COMPETITION POL'Y INT'L* 189-193 (Spring 2006). For the original articles, see J. Cooper, L. Froeb, D. O'Brien, & M. Vita, *Vertical Restrictions and Antitrust Policy: What About the Evidence,* 1(2) *COMPETITION POL'Y INT'L* 45-63 (Autumn 2005) and R. Winter, *Vertical Restraints and Antitrust Policy: A Reaction to Cooper, Froeb, O'Brien, and Vita,* 1(2) *COMPETITION POL'Y INT'L* 75-88 (Autumn 2005).

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is zero.) In their reply, however, Cooper et al. provide examples of assumptions under which their claim holds.<sup>2</sup> Low retailer margins may or may not be associated with inadequate retailer incentives. Any attempt to be more precise about the relationship between the retailer margin and the distortion in retailer incentives is perhaps unproductive since both variables are endogenous.

Our differences on this technical detail should not distract the reader from the interesting contributions of Cooper et al. (2005). The most striking of their themes, as summarized in the introduction to the article, is the following statement: “We argue that economic theory actually provides policymakers with very little guidance as to whether vertical restraints are likely to be beneficial or harmful in any particular factual setting.”<sup>3</sup>

This argument is highly provocative to an economist who believes that theory is not just valuable, but essential, in interpreting the facts of a case. Cooper et al. do not suggest that case evidence and economic theory are never reliable of course, but their strong emphasis is on prior evidence on the relative frequency of pro-competitive versus anticompetitive effects of the particular restraint at issue in a case. I defend the opposite position in my comment: the heart of a vertical restraints case is the application of theory to the factual setting of the case. This factual setting includes conventional evidence on market definition and indicators of market power, but what is especially important is case evidence that allows testing of pro-competitive versus anticompetitive theories of the restraint at issue. Some case evidence, in “naked exclusion” cases for example, is consistent with anticompetitive theories. Other case evidence suggests pro-competitive theories are at work.

I exaggerate the difference in our views, however. As in competition policy generally, prior evidence of the type that Cooper et al. emphasize is vital. Its role is in determining where the burden of proof in the court’s assessment of case evidence should lie and in this sense the two kinds of evidence are complementary. In merger analysis, to take an example outside the vertical restraints context, the burden of proof in demonstrating a lessening of competition lies with the plaintiff or government because the overwhelming majority of mergers are pro-competitive. In price-fixing cases, it does not.

Cooper et al.’s review of the evidence on vertical restraints provides support for the position that a strong burden of proof in vertical restraint cases should lie on the side of government intervention, not just on some vertical restraints as it

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2 My description of Cooper et al.’s statement as an “analytical error” was inappropriate. I would have more reasonably indicated that the conditions under which the statement is true are not clearly stated in the article and may well be violated in practice.

3 Cooper et al. (2005), *supra* note 1, at 47.

has since *Sylvania*<sup>4</sup> in 1977 and *State Oil v. Khan*<sup>5</sup> in 1997, but also for minimum resale price maintenance—the most common vertical restraint (when it was legal).<sup>6</sup> A sensible policy, in my view, would allow restraints with purely vertical effects. It is theoretically possible that a monopolist would use resale price maintenance to shift the mix of retail price and service competition to its own benefit and to the detriment of consumers, but (consistent with Cooper et al.'s message) economic theory does not offer a clear delineation of when a purely vertical use of restraints would be anticompetitive. In many cases, the purely vertical use clearly increases welfare.

On the other hand, case studies, which must be considered the essential component of prior empirical evidence, reveal instances where vertical restraints are harmful. Economic theory does, in fact, provide clear guidance as to the impact of restraints with horizontal effects that are exclusionary at the product level (*Nielsen*), exclusionary at the retail level (*Toys "R" Us*), or collusive (*General Electric*).<sup>7</sup> A sensible rule of reason would prohibit restraints that have detrimental horizontal effects, with the burden of proof falling on the government or plaintiff. The details of an optimal rule of reason on vertical restraints would be a challenge, since the dividing line between purely vertical and horizontal effects can be elusive and, as in any area of competition policy, there will be cases on the margin. Economic theory and prior empirical evidence would provide the foundation for designing the rule. Economic theory and case evidence would be the key instruments in applying the rule. ▼

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- 4 *Cont'l T.V. Inc. v GTE Sylvania Inc.*, 433 U.S. 36 (1977), in which the U.S. Supreme Court overruled *U.S. v. Schwinn*, 388 U.S. 365 (1967), as Cooper et al. discuss, and held that non-price vertical restraints were to be judged under a rule of reason, with the burden of proof of adverse competitive effects falling on the plaintiff.
  - 5 *State Oil Company v. Barkat U. Khan*, U.S. 118 S.Ct. 275 (1997), in which the U.S. Supreme Court overruled *Albrecht v. Herald Co.*, 390 U.S. 145 (1968), and decided the vertical maximum price restraints should be judged under a rule of reason.
  - 6 I have previously advocated a policy of per se legality towards restraints that are purely vertical, such as the use of resale price maintenance and territorial restrictions by a monopolist. Cooper et al. note this in footnote 4 of their reply. I have not advocated per se legality of vertical restraints where horizontal effects are involved, as is the case with naked exclusionary restraints or where resale price maintenance facilitates collusive pricing.
  - 7 *Nielsen (Canada (Director of Investigation and Research) v. The D & B Companies of Canada Ltd.* (1995), 64 C.P.R.3d 216 (Comp.Trib. 1995)) is discussed in my comment. *Toys "R" Us v. FTC*, 221 F.3d 928, 937 (7<sup>th</sup> Cir. 2000) and *United States v. General Electric Co.*, 358 F. Supp. 731 (1973) are discussed in F.M. Scherer's comment on Cooper et al. (2005).