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Reciprocal Dealing

The practice of reciprocal dealing—buying from one's customers—has only recently come under direct judicial attack.1 Before 1965 only the Federal Trade Commission had concerned itself with reciprocity, and the Commission had characterized it as an unfair trade practice in only three cases.2 Then, in FTC v. Consolidated Foods, the Supreme Court adopted the Commission's view that reciprocity was indeed "one of the congeries of anticompetitive practices at which the antitrust laws are aimed" and, accordingly, disallowed a merger because it posed a threat of reciprocal dealing.3 The Court held that the acquisition by Consolidated Foods, a food processor, wholesaler and retailer, of Gentry, Inc., a manufacturer of dehydrated onion and garlic, violated section 7 of the Clayton Act.4 Competition would be substantially lessened, the Court felt, because the merged firms could now exercise the "mixed threat and lure of reciprocal buying" by inducing food processors that sold to Consolidated to buy from Gentry.5 Gentry, the Court said, would thus be given an unfair competitive advantage. Its competitors would be foreclosed from a substantial part of the dehydrated onion and garlic market, not because Gentry would offer a lower price or better service, but because of

3. FTC v. Consolidated Foods Corp., 380 U.S. 592, 594 (1965), rev'g, 329 F.2d 623 (7th Cir. 1964), rev'd, [1961-1963 Transfer Binder] TRADE REG. REV. ¶ 16,182, at 20,972 (FTC 1962). Reciprocal dealing had been tangentially relevant in three previous lower court decisions. In United States v. E. I. du Pont de Nemours & Co., 126 F. Supp. 235 (N.D. Ill. 1954), rev'd, 353 U.S. 586 (1957), the Government charged that du Pont had used its stock ownership in General Motors to promote reciprocal sales from du Pont to suppliers of General Motors. The district court's dismissal of the Government's complaint was reversed by the Supreme Court, but the Court did not pass judgment on the reciprocity allegation. United States v. National City Lines, Inc. 186 F.2d 562 (7th Cir. 1951), treated as a conspiracy-to-monopolize case, included an example of the use of reciprocity. Firestone, Standard and other producers purchased preferred stock of bus companies under an agreement whereby the bus lines were obligated to purchase their petroleum and tire requirements from the financing producers. Increased use of reciprocity was cited as one of several reasons for condemning a merger under section 7 of the Clayton Act, 15 U.S.C. § 18 (1964), in United States v. Ingersoll-Rand Co., 320 F.2d 599, 524 (3d Cir. 1963).
5. 380 U.S. at 592.
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Consolidated's position as a customer of Gentry's customers. Reciprocity, said the Court, would inject an "irrelevant and alien factor" into the competitive process. Though there was evidence that Consolidated had actually sought to implement a policy of reciprocal dealing, the Court felt that Gentry would obtain an unfair advantage as a result of the merger even if it had not actively pursued that policy. The Court's opinion quoted with approval the Commission's findings that "merely as a result of its connection with Consolidated and without any action on the latter's part, Gentry would have an unfair advantage over competitors enabling it to make sales that otherwise might not have been made." This suggests that "lure" is enough—even potential reciprocity may ban an acquisition. Since conglomerate mergers are becoming increasingly common, it is particularly important to understand the Court's attitude toward reciprocity and its underlying economic theory.

6. Id. at 594.
7. Id. at 597. Apparently neither the carrot nor the stick was of much help to Consolidated. Just before the merger in 1951, Gentry held 28 per cent of the dehydrated onion market and 51 per cent of the dehydrated garlic market. Its chief competitor, Basic Vegetables, held 60 per cent and 30 per cent respectively. Seven years after the merger, in 1938, Gentry's percentages were 35 per cent in onions and 59 per cent in garlic, while Basic's were 57 per cent and 50 per cent respectively. During this period the industry output had doubled and Gentry's total share had increased from 32 to 35 per cent. The Court did not consider Gentry's post-acquisition losses in garlic sales significant; but for the "threat and lure" of reciprocity, Gentry's performance might have been even worse.
8. This "lure" theory of reciprocal dealing will be tested in United States v. General Motors Corp., 5 TRADE REG. REP. ¶ 45,053 (Case 1733) (N.D. Ill., Docket Div. 63C80, filed Jan. 14, 1963). In its complaint the Government has alleged that because of General Motors' substantial purchases of transportation service, it has been able to monopolize the market for the sale of locomotives.
10. Judicial reaction to Consolidated has been mixed. In United States v. Penick & Ford, Ltd., 242 F. Supp. 518 (D.N.J. 1965), the district court denied the Government's request for a preliminary injunction enjoining a proposed acquisition by Reynolds Tobacco Co. of Penick, a producer of starch and other corn derivatives. The Government argued that reciprocity would be increased by the proposed merger because starch is the major ingredient for adhesives used in the corrugated box and paper industries from which Reynolds makes substantial purchases. It alleged the existence of reciprocal trading in the cigarette industry and the substantial purchasing power of Reynolds, and urged the court to apply Consolidated. The court concluded that, although possible, it was not a reasonable probability that reciprocity would result from the merger.
11. The second court to consider the application of Consolidated was noticeably more sympathetic. In United States v. General Dynamics Corp., 258 F. Supp. 56 (S.D.N.Y. 1966), the district court held an acquisition by General Dynamics of Liquid Carbonic Corp., then the largest domestic producer of carbon dioxide, to be illegal under section 7 of the Clayton Act.

The academic treatment of reciprocal dealing has also been mixed. Cf. Ferguson, Tying Arrangements and Reciprocity: An Economic Analysis, 30 LAW & CONTEMP. PROBS. 552, 579 (1965) (advocating that there be no antitrust policing of reciprocity); Handler, Emerging Antitrust Issues: Reciprocity, Diversification and Joint Ventures, 49 VA. L.
The emerging law of reciprocity, like that of tie-ins, requirements contracts, and exclusive dealing arrangements, is most easily understood as a concern with foreclosure of competitors from a market. But as the courts have said over and over again, the anti-trust laws are meant to protect competition, not inefficient competitors.\textsuperscript{12} Foreclosure of competitors is economically desirable if achieved only by producing and selling at a lower price. Reciprocal dealing is not an anticompetitive device merely because it may have the effect of injuring competitors but only if it results in restrictions of output or barriers to entry.

The Rationale of the Courts

The courts, the FTC and the Antitrust Division of the Department of Justice have established an irrebuttable presumption that a certain group of business practices, of which reciprocity is the newest member, can be used to create additional monopoly power.\textsuperscript{13} This theory claims that the acquired company can be levered into a monopoly selling position by means of the buying power of the acquiring company. The conglomerate firm is supposed to be able to exert its full buying power on its suppliers, and at the same time to transfer some of this power to its selling subsidiary by forcing these same suppliers to buy from it. Although some commentators have demonstrated the economic impossibility of this bootstrapping in other contexts, the courts and the commission have been oblivious of their work.\textsuperscript{14} Per-
haps it is worth another try, this time in the setting of reciprocal dealing.

A competitive buyer which has no purchasing power will not be able to practice reciprocity at all. Reciprocity would impose an extra cost on the firm’s suppliers—at the very least the cost of making their purchases from a designated source instead of having full freedom of choice. If the buyer lacks market power, there is no reason why suppliers would put up with this extra cost. Rather, they would sell their wares to other purchasers at the going market price.\(^1\)

In Consolidated the Court felt that the buying half of Consolidated-Gentry did in fact have market power, and it built its decision on the theory of market leverage. In this context market leverage is said to be the use of purchasing power to create market power in sales.\(^2\) But economic analysis shows that once a firm has fully exploited its market power in purchasing, it cannot use that power to gain additional profits elsewhere.

Firms with purchasing (monopsony) power maximize profits in a way comparable to those with selling (monopoly) power. The monop-

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\(^2\) If Consolidated’s suppliers for one reason or another prefer Gentry’s competitors, they will not now switch to Gentry unless Consolidated bribes them to do so by paying them more when it purchases from them—if it does not, they will simply sell to others who will pay $1 per unit with no strings attached. It will never be worthwhile for Consolidated to pay its suppliers to buy from Gentry, for by doing so it will always lose at least as much as it will gain. If Consolidated had to pay, say, an extra $.03 per unit to induce its suppliers to buy from Gentry, its gain on Gentry sales could at best recoup the $.03 it expended. If more than a $.03 profit could be made, Gentry’s products could have been profitably sold in the first place simply by lowering the price by $.03.

Of course, if Gentry were able to sell all it could produce at the going price, it would have no incentive to offer a price cut—but in that event there would also be no reason for Consolidated to insist that its suppliers buy reciprocally from it.

When a supplier does buy an undifferentiated product from its customers, it may be doing so simply as a courtesy to them. The result is simply a reallocation, without change in market shares, among the firms in the competitive industry selling the undifferentiated product—that is, some of them will begin selling to different suppliers.

What the critics of conglomerate integration overlook or ignore is the fact that if Consolidated has market power, its business is valuable to the purchasers of dehydrated spices not because it makes these spices but simply because it is a purchaser of substantial size. This would suggest that as far as the suppliers are concerned, the business of one of Consolidated’s large competitors would be equally attractive. Why then is it any less plausible or less economical for, say, Basic Vegetable, Gentry’s primary competitor, to contract for the business of a competitor of Consolidated than for Gentry to “buy” the business of Consolidated after a merger. In either case the true costs involve the foregone return to a particular seller. This is the opportunity cost of not doing business with a supplier. The business is either worth paying for or it is not; and this cost is either less than the cost of a direct price cut by the spice sellers or it is not. The corporate connection of the participants is irrelevant except in terms of the efficiency of internal exchanges as contrasted to market transactions.
elist can control its selling price by restricting output, while the monopsonist can control the price it pays by restricting its purchases. The absolute size of the monopsonist's purchases affects the unit price he will have to pay—the more he wants, the higher the price. Thus before the monopsonist will buy an extra unit, he must reckon as part of its cost the increased price he has to pay on all other units he purchases. His profits will be highest if he continues to purchase units until the total cost of the last unit purchased, including this premium on all other units, just balances the addition to his revenue which the last unit will bring him.17

If the monopsonist has reached this profit-maximizing point, he will have no incentive to promote reciprocal dealing.18 For reciprocal dealing, by imposing extra costs on suppliers, has the same effect as a demand for a lower price by the monopsonist acting solely as a buyer. In both cases, suppliers will only be willing to sell at that lower price a smaller quantity than that which the monopsonist should buy in order to maximize his profits.19 Thus reciprocity cannot be used to lever or create new market power because its use reduces the profitability of monopsony power which already exists.

There is, of course, one sense in which a monopolist or monopsonist can “shift” his market power to another market. But this “transfer” of power is just that—a loss in one market for a gain in another—not, as the Court’s theory presupposes, a simultaneous retention and expansion of market power. Thus Consolidated could induce its suppliers to buy from Gentry, but their price to Consolidated would go up; in

17. For a discussion of how a monopsonist maximizes his profits see LEFTWICH, PRICE SYSTEM AND RESOURCE RELOCATION 278-88 (3d ed. 1966).
18. If for one reason or another a firm is not free to price at the maximizing point on its demand curve, it may be able to use reciprocal dealing to increase profits. See p. 1026-29 infra.
19. The effect of varying this price is to reduce the net revenues generated from the use of the factor. The total scheme will be unprofitable, as these losses will always be at least equal and usually greater than any profit made on the reciprocal sales. This is because the extra costs imposed on suppliers by reciprocal dealing can never be completely recouped by the monopsonist in the form of profits. For example, suppose that Consolidated's suppliers had no use, or only limited use for Gentry's dehydrated herbs, yet were forced by Consolidated to purchase them anyway. The cost imposed on these suppliers would then equal the difference between the sales price of the spices and their zero or limited value to the suppliers. Assume further that the suppliers were just willing to sell 10 units to Consolidated at the price of $1 per unit. If Consolidated conditions its purchase of 10 units on the reciprocal sales of, say, 50 units of Gentry produce at $.05 per unit, and if this $2.50 is a complete loss to the suppliers, they will have to charge Consolidated $1.25 per unit for the 10 units they sell to Consolidated. If the profits to Consolidated through its Gentry sales are greater than the cost to the suppliers, it could have had Gentry sell its products at a price below its competitors' and would have been better off gaining additional sales through this price cut than through reciprocity.
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effect, Consolidated would be paying the suppliers to buy Gentry's products. Nevertheless, it might conceivably choose to do this in order to force Gentry's competitors out of business and thus secure a new monopoly. But even if it were worthwhile for Consolidated to take a short-term loss in order to secure a monopoly position for Gentry, this squeeze could be accomplished by any firm with a deep pocket—whether or not it had market power, and whether or not it used reciprocal dealing.

Reciprocal dealing, then, would seem to be impossible for firms without market power and unprofitable for firms with market power. Yet the prevalence of "trade departments" to deal with firms which a conglomerate both sells to and buys from, indicates that the practice is widespread. It remains to be seen just what these firms gain through reciprocity and whether these private gains are offset by social losses— that is whether or not reciprocity is in fact an anti-competitive trade practice.

Reciprocity can be used to increase profits, not by creating new market power, but by enabling the reciprocal dealer to capture all the profits from a position already held. In this maximizing process, reciprocity usually performs the function of an indirect price cut. Price cuts, whether direct or indirect, are certainly not "irrelevant and alien" factors in a market but rather are crucial transmissions in the "central nervous system of the economy." The situations in which reciprocity can be used to increase profits have one thing in common: they all involve some obstacle to complete freedom in pricing. This barrier may result from governmental regulation, a private cartel, or simply the anticipated reaction of participants in the market (price leadership). These uses of reciprocity


21. In fact a conglomerate that buys from its customers usually has less incentive to try to drive out its competitors from the level on which it does not have market power than does a conglomerate in totally different industries. To the extent that a conglomerate with purchasing power ultimately buys back its own products, it will not be interested in creating market power at its selling level. Any additional profits in sales will be lost when it buys from its suppliers at the monopoly price they pass on to it. A monopoly profit can only be gained at one level or the other. See generally Bork, Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception, 22 U. CHI. L. REV. 157 (1954).


can serve both parties to a transaction, whether they be large buyers, small buyers, large sellers or small sellers.

Evasion of Minimum Price Restrictions

Reciprocal dealing is particularly useful for evasion of minimum price restrictions since the apparent price paid for the regulated commodity remains above the legal floor. The seller can charge the minimum allowed price and then purchase from his customers instead of from his usual sources of supply. The substitute for the lower price to the buyer of the regulated commodity is increased sales, perhaps even at an inflated price.

Whether or not a regulated firm should be allowed to reduce its price by means of reciprocal business is a question properly tested by the rules of the regulatory commission, not by the Sherman or the Clayton Act. Since the minimum rate rules are just the sort of rules that would be per se illegal under the anti-trust laws were they set by a private cartel, it is difficult to see how these rules should weigh in an anti-trust case. Their evasion will in most cases promote those same policies which the anti-trust laws are designed to promote.

Reciprocal dealing may also be used as a form of secret price cut by a firm in an oligopolistic industry which wants to steal a share of the market from its competitors without provoking retaliatory price

24. Waugh Equip. Co., 15 F.T.C. 232 (1931) and Mechanical Mfg. Co., 16 F.T.C. 67 (1932) provide examples of the use of reciprocal dealing to secure price rebates in the sale of transportation services. Both involved meat companies selling equipment to railroads favored in the routing of their meat shipments. Both cases had another common element. The sales of railroad equipment were made by related companies the stock of which was owned personally by the officials of the meat companies.

25. Assume, for example, that the Interstate Commerce Commission fixes the lowest rate a railroad can charge at $10 per unit of transportation. At this rate, the railroad finds that it is operating at 50 per cent of capacity. The railroad would like to attract more orders because the cost to it of providing more transportation service on already existing runs is well below the fixed rate. In order to sell more transportation, the railroad must take away business from competitors by lowering its price below $10 per unit. If the ICC will not allow the railroad to reduce its rate directly, the railroad has an incentive to accomplish the price cut indirectly. One way to lower the price is to purchase the products of its customers at prices higher than it would otherwise pay.

26. Since the price reduction results in a more efficient use of existing transportation resources, it is to this extent pro-competitive, rather than anti-competitive.

On the other hand, those firms to which the railroad can sell at a lower price by giving rebates in its purchases may obtain a competitive advantage in their sales to the railroad. If General Motors, for instance, is a substantial purchaser of railroad transportation and at the same time sells locomotives to the railroads through its electromotive division, the railroad may be induced to buy GM's diesels even though they are not as good as its competitors' simply because GM is able to provide a technique for evading ICC minimum price regulations. In this sense the conglomerate's unique position may be a happenstance that infuses "an irrelevant and alien factor" into the competitive process. Were such reciprocal arrangements unique to GM, competitors of GM's electromotive division might be foreclosed even though they make a better diesel. See note 8 supra.
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cuts. This use of reciprocity does indeed foreclose competitors, but only those that continue to set prices at "oligopolistic" levels above marginal cost. In this regard the only advantage that the conglomerate firm has is that it can make secret price cuts. If its competitors reduced their price to marginal cost this advantage would be lost. Movement away from prices inflated by cartels and oligopolies obviously involves a movement toward the desired competitive solution and should not be prohibited.

Cost-Justified Price Cuts

The Robinson-Patman Act imposes a form of price regulation on all suppliers to intermediate purchasers.\(^{27}\) The act may result in artificial price restraints because mere differences in price are considered prima facie evidence of illegal discrimination.\(^{28}\) Although this presumption may be rebutted by proof of a cost justification, such a showing may be difficult and expensive to make.\(^{29}\) To avoid the risk of litigation, a firm may decide to charge a uniform price, even though it can supply certain of its customers more cheaply than others. To avoid losing those customers that can be supplied more cheaply, the seller can accept reciprocal sales from those customers instead of from its customary suppliers.

Use of reciprocal dealing to sell at cost-justified prices clearly promotes competition for it allows the manufacturer to set prices closer to his cost.

Non Cost-Justified Price Discriminations

Because reciprocal dealing eliminates the threat of arbitrage\(^{30}\) between its customers or suppliers, a firm may use such dealing to exploit fully its existing market power.\(^{31}\) In fact reciprocity is useful for con-

\(^{28}\) Id. § 13(b).

\(^{30}\) "Arbitrage" is the term given to the process of trading a good which is being sold or purchased at different prices in different markets. In the cases of price discrimination in the sales of a commodity, it is the resale from a buyer in a lower priced market to a buyer in a higher priced market. In the case of price discrimination in the purchase of a commodity, it is the sale from a lower priced seller to a higher priced seller for resale to the buyer. The effect of arbitrage is to render impossible the use of varying prices.

\(^{31}\) J. Robinson, The Economics of Imperfect Competition 224 (1933). For the explanation of the parallel case of the use of the tie-in contract as a means of price discrim-
ducting price discrimination successfully in purchases as well as in sales. The monopsony buyer can discriminate in its purchases if its suppliers have differing elasticities of supply, while the monopoly seller can discriminate in sales if its buyers have differing elasticities of demand. For either to be successful, the firms which are paid or charged different prices for the same product must be kept separate from each other; arbitrage between sellers or buyers must be prevented. Thus reciprocal dealing on the buying side does for a monopsonistic buyer just what it does for a monopolistic seller. It maximizes the return of those who are able to utilize it for purposes of price discrimination.

32. Regular counting devices for determining rentals and tie-in contracts for sales can also be used for the same purpose.

33. Elasticity of supply refers to the slope of the supply curve. At any point on the supply curve, it measures the ratio between the change in quantity supplied and the corresponding change in price offered.

34. Elasticity of demand is the counterpart of elasticity of supply. It measures at any point on the demand curve the ratio between the change in quantity purchased and the corresponding change in price charged.

35. See note 24 supra. Unless the markets can be segregated, the customers (suppliers) who are paying more (getting less) will buy from (sell to) the customers (suppliers) who are paying less (getting more) rather than from the monopolist (monopsonist) that is trying to sell to (buy from) each of them at different prices.

The monopoly seller can successfully discriminate through reciprocity by charging the highest possible price to all buyers and then lowering it to those who would refuse to pay it—those with more elastic demands—by accepting reciprocal sales from them at inflated prices. For example, suppose the monopolist could sell to buyer X at $5 per unit and to buyer Y at $15 per unit. If this price differential were paid directly, firm Y would soon be buying from X rather than from the monopolist. If instead the monopolist charges both $15 per unit, and then buys enough from X so as to in effect give him a $10 per unit rebate, he can obtain maximum profits and eliminate arbitrage.

The use of reciprocal dealing by a discriminating monopsonist is the exact counterpart of its use by the monopolist where the discrimination is in the price paid for a product rather than in the price received for it. Assume a monopsonist, A, that can buy from firm X at $5 per unit and from Y at $15 per unit. If this differential were paid directly, firm X would sell to Y rather than to A. If instead, A pays both firms $15 per unit and conditions purchases from X on Y's acceptance of reciprocal sales from A at a price gauged effectively to reduce the purchase price from X to $5 per unit, the monopsonist maximizes return and curtails arbitrage.


Reciprocity may also enable the monopolistic seller or the monopsonistic purchaser to practice what is known as "perfect price discrimination" or multi-part pricing. This is the process of not only separating each supplier or buyer into a separate "market" for pricing purposes but also discriminating in the price paid to each seller or charged to each buyer, for each unit. In its simplest form, perfect price discrimination is achieved if each unit of a product is purchased at its minimum supply price or sold at its maximum sales price. The market power necessary to conduct perfect price discrimination successfully is very great; probably the only firms capable of doing so are the single buyer and seller.

Perfect price discrimination is conducted by means of the "all or nothing" offer. For the monopsonist, the all or nothing offer puts to sellers the choice of accepting the monopsonist's offer to purchase stated amounts at stated prices or not selling to the monopsonist at all. As used by the monopolist, the choice put to buyers is to purchase the product in stated amounts at stated prices or not to purchase at all. Again reciprocal dealing is used to avoid arbitrage.
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The net effect on output resulting from the use of price discrimination, whether in sales or purchases, will depend on the relative sensitivity of sales to price change in the higher and lower priced markets and on the relative size of these markets. If the manufacturer sells at two prices and is forced to adopt a single price, output may be expanded or contracted. Discrimination is not necessarily output restricting. Only if most of the monopoly revenue is obtained from large sales in the lower price market would the elimination of price discrimination lead to lower average price. Even after careful analysis the predicted output effect can represent no more than an informed guess. It has been persuasively argued that this uncertainty, together with extraordinary difficulties and costs in trying to discover and ban instances of price discrimination, make the endeavor to do so a wasteful, if not futile, one. Thus even in this most suspect of all its uses—that of fully exploiting existing market power—reciprocal dealing should probably be permitted.

Yet the judicial treatment of reciprocal dealing suggests just the opposite result—that it is destined for per se illegality under the heavy hand of the market leverage theory. This single-minded concept is based on a misconception of the purposes for which reciprocal dealing may be utilized. Given the present state of economic knowledge, these uses suggest that a rule of per se legality, not illegality, should govern the practice of reciprocal dealing.

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Perfect price discrimination by a monopsonist is discussed in Robinson, supra note 25, at 225. See also Boulding, The Concept of Economic Surplus, 35 AM. ECON. REV. 851 (1945).


37. See P. Samuelson, Foundations of Economic Analysis 42-45 (1947); Robinson, supra note 25, at 188-95.


39. Quality control is another possible function of reciprocal dealing when a seller is rebuying his own processed products. In a tie-in case the Supreme Court has not looked upon this argument with favor, however. See International Salt Co. v. United States, 332 U.S. 392, 397-98 (1947). But see Dehydrating Process Co. v. A. O. Smith Corp., 292 F.2d 653 (1st Cir. 1961).

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