

WSGR ALERT

MARCH 2010

FTC CONSENT DECREE BARS TRANSITIONS OPTICAL FROM ENTERING INTO EXCLUSIVE DEALING AGREEMENTS WITH DOWNSTREAM CUSTOMERS

Continuing its recent focus on business practices that have the effect of helping dominant firms maintain their market position against competitors, the Federal Trade Commission (FTC) last week announced it had entered into a settlement with Transitions Optical, the leading provider of photochromic treatments for corrective eyeglasses in the United States. The FTC alleged that Transitions had maintained its monopoly power by engaging in exclusionary conduct since 1999, such as entering into exclusive dealing agreements or de facto exclusive dealing agreements that foreclosed its rivals from critical channels of distribution and deterred potential rivals from entering the market. When read in conjunction with the FTC's complaint against Intel, the Transitions consent decree signals a cautionary note that firms with significant market shares must tread carefully when designing business strategies in response to potential competitive threats. Terminating relations with customers who do business with rivals and requiring customers to enter into exclusive deals raise red flags in today's antitrust environment.

Background

Because the FTC's investigation is confidential, the facts surrounding Transitions' conduct are necessarily limited to information as disclosed and authored by the FTC. Transitions allegedly has possessed more than an 80 percent share of the relevant market for the development, manufacture, and sale of photochromic treatments for

corrective ophthalmic lenses in the United States since 2005 (its market share was as high as 85 percent in 2008). This market is allegedly characterized by high barriers to entry, including substantial requirements for: product-development costs and capital requirements, intellectual property rights, and regulatory requirements.

When selecting corrective ophthalmic lenses for an eyeglass frame, consumers have the option of purchasing photochromic lenses or ophthalmic lenses that have been treated to protect the wearer from UV radiation. Transitions produces the photochromic treatment, which it applies to lenses it purchases from lens manufacturers known as "lens casters." The lens casters then purchase the treated lenses back from Transitions for resale. Lens casters may resell the photochromic lenses to either wholesale optical laboratories (wholesale labs) or optical retailers.

Wholesale labs sell corrective ophthalmic lenses set in eyeglass frames to eye-care practitioners. Retailers, on the other hand, are vertically integrated, offering both laboratory and eye-care practitioner services. Such retailers can influence the prescribing behavior of hundreds of eye-care practitioners and are allegedly the most efficient means for promoting and selling photochromic lenses to consumers. The complaint alleges that Transitions engaged in exclusionary conduct at every level of the distribution chain. In 1999, a firm introduced a plastic photochromic lens that allegedly was a direct

competitive threat to Transitions' photochromic lens. After a lens caster began selling the competing lens, Transitions terminated the lens caster. Similarly, when another lens caster developed its own photochromic treatment to apply to its own lenses, Transitions terminated the lens caster. Transitions entered into exclusive agreements with other lens casters, announced a policy to deal only with lens casters that sold its lenses on an exclusive basis, and threatened to terminate lens casters that did not want to sell its lenses on an exclusive basis. According to the FTC, because of Transitions' course of conduct, even lens casters that did not sign exclusive agreements had a clear understanding that they could not sell or promote a competing photochromic lens without being terminated by Transitions.

Transitions also allegedly induced retailers not to sell competing lenses with lump-sum, up-front payments or rebates in exchange for "long-term" exclusive agreements that were not easily terminable. The FTC's consent decree material does not identify the duration of the agreements. In addition, Transitions allegedly compensated labs to promote Transitions lenses as the preferred photochromic lens in exchange for rebates or other consideration. And because many of these agreements were conditioned upon the customer purchasing most or all of its total ophthalmic lens requirements from Transitions and no other supplier offered a comprehensive line of ophthalmic lenses, the complaint alleges that these discounts acted as an entry barrier whereby entrants would

Continued on page 2...

FTC Consent Decree Bars Transitions Optical . . .

Continued from page 1...

be deterred from entering without a comparable offering of lenses to compete with Transitions. The complaint alleged that Transitions' exclusionary practices were coercive because following termination, a customer could lose up to 40 percent of its overall profits and the ability to sell both clear and photochromic lenses produced by Transitions, which many retailers and wholesale labs prefer.

FTC Analysis

The FTC applied the rule of reason analysis to weigh the harms against the benefits to competition resulting from Transitions' conduct and found that Transitions had violated Section 5 of the FTC Act. The FTC began by noting that Transitions allegedly was able to foreclose at least 80 percent of the upstream lens casters' business and 40 percent of the downstream distribution channels from its competitors, which led to a presumption of anticompetitive harm. The 40 percent foreclosure effect is comparable to the threshold noted by the D.C. Circuit against Microsoft in *United States v. Microsoft Corp.* However, the D.C. Circuit added that exclusive distribution agreements are commonplace in the market, and that courts should be wary of chilling what is assumed to be efficient business conduct by imposing the risk of an antitrust lawsuit on a firm for entering into such an agreement, no matter how negligible the effect, simply because it has market power.¹

After finding a presumption of competitive harm, the FTC cited several anticompetitive effects resulting from Transitions' conduct, including its refusal to supply private-label photochromic lenses to the United States market even though it provided such lenses in other markets at a lower price. However, the FTC did not state that Transitions' conduct actually caused higher prices or reduced output, opting instead to allege that the

exclusionary prices "likely" increased prices and reduced output.

The FTC rejected the proposition that Transitions' agreements with customers were reasonably necessary to achieve procompetitive benefits such as preventing interbrand free-riding or protecting intellectual property. The rationale was that because Transitions' promotions were brand-specific, though they might enhance interest in photochromic lenses generally, free-riding would be limited. Moreover, Transitions did not offer substantial technical assistance or share intellectual property with customers. Unfortunately, the FTC's consent decree material does not provide extensive detail on the business justifications advanced by Transitions, and does not elaborate on either why the justifications were rejected or why the justifications were outweighed by the alleged harm.

Consent Decree

The consent decree settling the *Transitions* case permits Transitions to continue to offer volume discounts based on cost differences and other discounts to "meet competition." Transitions also may provide payments to its customers so long as the funds are used solely for the manufacture, promotion, or sales of Transitions lenses. The consent decree includes, however, significant restrictions on Transitions' sales and marketing activities:

Restrictions Effective for 20 Years

- Prohibiting Transitions from adopting any agreement or policy that includes any requirement that a customer limit or refuse to deal with Transitions' competitors or treat Transitions favorably
- Permitting Transitions to enter into exclusive agreements with downstream

customers such as retailers and wholesale labs only if certain "safeguards" are met, such as not offering lump-sum payments to downstream customers in exchange for exclusivity

- Requiring Transitions to permit customers to sell competing brands of photochromic treatment
- Prohibiting Transitions from discriminating or retaliating against customers for engaging in the research and development, manufacture, purchase, or promotion of competing photochromic lenses

Restrictions Effective for 10 Years

- Prohibiting Transitions from offering its customers so-called "loyalty discounts" or "market share discounts," discounts based on the quantity of Transitions lenses the customer purchases as a percentage of its total photochromic lens requirements
- Prohibiting Transitions from retroactively offering customers discounts once the customers' Transitions lens purchases meet a designated threshold
- Prohibiting Transitions from offering bundled discounts to customers who purchase greater than one line of Transitions lenses

Conclusion

The *Transitions* case suggests the following:

- For a firm with a large share of the market, terminating (or threatening to terminate) dealings with customers who purchase from rivals or entering into exclusive arrangements with customers can place the firm in a uniquely perilous situation that may subject it to antitrust scrutiny by government agencies.

¹ *United States v. Microsoft Corp.*, 253 F.3d 346, 366 (D.C. Cir. 2001). In this case, the plaintiffs demonstrated a presumption of competitive harm by showing that Microsoft had substantially foreclosed Netscape, a competitor, from roughly 40 percent of the most efficient downstream distribution channels.

Continued on page 3...

FTC Consent Decree Bars Transitions Optical . . .

Continued from page 2...

- An agreement not rising to the level of complete exclusivity with customers may be analyzed as a de facto exclusive dealing agreement if it is sufficiently long-term, difficult to terminate, and forecloses competitors from a substantial percentage of distribution channels.
- If a firm has market power, in certain circumstances a plaintiff may be able to sustain the burden of showing anticompetitive harm under exclusive dealing by demonstrating that the dominant firm has foreclosed as little as 40 percent of the most efficient distribution channels.
- Loyalty discounts or other payments to customers offered to those who purchase all or most of their total ophthalmic lens requirements from a supplier can constitute de facto exclusive dealing agreements.
- The bona fides of the business justifications for exclusive dealing arrangements will be strictly scrutinized.

Exclusive agreements with customers and the offering of payment transfers to customers through discounts, rebates, or marketing payments present challenging antitrust problems. Such problems can be managed, however, through the implementation of an antitrust compliance program maintained by both inside and outside counsel.

For more information about the FTC's consent decree with Transitions, please contact Renata Hesse, Chul Pak, or another member of Wilson Sonsini Goodrich & Rosati's antitrust practice.



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