Antitrust

Prof. Barnett

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May 9, 2013

3 Hours

Open Book

Examination Instructions

This exam consists of four Parts. Part I represents 50% of the total grade; Part II represents 30% of the total grade; Part III represents 10% of the total grade; Part IV represents 10% of the total grade.

Please answer the exam questions in chronological order. When answering a question in any individual Part, you may refer to information contained in previous Parts.

YOU MUST STOP WRITING WHEN INSTRUCTED TO DO SO BY THE PROCTOR. FAILURE TO DO SO WILL BE CONSIDERED A BREACH OF ACADEMIC DUTY AND WILL BE REPORTED TO THE DEAN'S OFFICE BY THE PROCTOR.

DO NOT LIFT THIS COVERSHEET UNTIL INSTRUCTED TO DO SO BY THE PROCTOR.
Part I

Joe Smith is the proprietor of Little Lumber, a small family-owned lumberyard that has operated for over 50 years in Tupelo, a small town in a semi-rural area in Kansas. Little Lumber’s customers are a mix of contractors working on large construction projects and homeowners working on smaller do-it-yourself projects. Little Lumber earns the majority of its revenues from sales to contractors, who purchase regularly and in large amounts.

Recently, a national lumber chain store known as “Lumber Depot” opened a location about 30 miles away. Since the opening of Lumber Depot, the contractors have mostly stopped coming to Little Lumber and Joe now primarily sells to homeowners. The contractors say they have no choice: Lumber Depot has a larger selection and lower prices, although it is located farther away and the staff lacks Joe’s encyclopedic knowledge of “all things lumber”.

Aside from Little Lumber and Lumber Depot, there is no other establishment that sells lumber in Tupelo or within 30 miles of the town. Nationally, Lumber Depot and Lumber Mania (the only other national lumber chain store) each represents about 30% of lumber sales in the retail market. The rest of the national retail market consists of small independent lumberyards like Little Lumber. Both Lumber Depot and Lumber Mania are regularly expanding, opening up new locations and increasing market share.

Joe pays a visit to Lumber Depot to see what the competition is offering. He is impressed by the selection and prices but unimpressed by the lack of knowledge of the sales personnel, who can barely tell the difference between pine and oak. Joe notes that Lumber Depot is undertaking two special initiatives.

First, Lumber Depot offers customers a “Loyalty Plan”. The advertisement for the Plan states: “You know our prices at Lumber Depot are unbelievably low. But we can go even lower! Any customer who purchases 100 or more pieces of lumber in a single visit is entitled to a 5% discount on the total price paid for the purchased items. This offer applies to all purchases made in the next 12 months.”

Second, Lumber Depot provides customers with a “Quality Guarantee”. The Quality Guarantee states: “Buy extra lumber for a rainy day while prices are rock bottom! We know storing lumber can be risky—too much moisture or too much sunlight might ruin it. Every time you purchase lumber at Lumber Depot, we automatically add a small surcharge so that we can guarantee that the lumber you purchase will remain in good condition for a period of six months from the date of purchase. That means we will replace at no additional cost any lumber that does not remain in good condition during that period.” Reading the fine print, Joe learns that the surcharge is equal to 1% of the purchase price.

When he gets home, Joe crunches some numbers. Looking at his wholesale costs, he concludes that he could match Lumber Depot’s prices and have just enough money left over to cover
overhead expenses. If he matched Lumber Depot’s discount under the Loyalty Plan, he would have to sell lumber at a loss. Joe says to himself: “I can’t figure it. How can they sell this stuff so cheap? And I didn’t even think about the cost of the Quality Guarantee.”

Joe discovers from a confidential source that Lumber Depot has a “special contract” with Woodchuck Inc., one of the largest wholesale suppliers of lumber. The contract between Woodchuck and Lumber Depot has the following terms:

(i) Lumber Depot agrees to purchase all its lumber requirements exclusively from Woodchuck for a period of 12 months.

(ii) The wholesale price of any lumber item purchased by Lumber Depot from Woodchuck is set equal to the current wholesale price as reported by LumberNews.com, the industry’s leading online trade journal.

(iii) If Lumber Depot purchases more than 10,000 pieces of lumber from Woodchuck, then the wholesale price for all lumber purchased by Lumber Depot from Woodchuck during the term of this contract will be reduced by 10%.

(iv) After one year has elapsed, Woodchuck has the right to renew the contract on the same terms, provided Lumber Depot receives no “economically superior offer” from any other supplier.

Joe calls Woodchuck and asks for the “same deal as Lumber Depot”. The salesperson at Woodchuck replies: “I am not aware of any such arrangement and, even if it did exist, that obviously only makes sense when we sell to places like Lumber Depot or Lumber Mania. We’re happy to sell to you at the current wholesale price as reported in LumberNews.com. But I guess you could get that anywhere – there are lots of other wholesale lumber suppliers, you know.”

You are an Assistant District Attorney responsible for the region in which Tupelo is located. Joe bursts into your office, saying: “Lumber Depot is putting me out of business! Is any of this stuff illegal?” Joe wants to know whether there are any claims you can bring against Lumber Depot or Woodchuck under federal antitrust law. Identify those claims and assess those claims’ likelihood of success.
Exasperated by the situation, Joe joins an online group called “Wooden Blues”, which counsels small-town lumberyard owners. Joe soon learns that he is not alone in his predicament. Throughout rural America, lumber chain stores have diverted significant business from independent lumberyards, which have often been forced into bankruptcy. Joe writes on his blog: “The Main Streets of rural America are being decimated. The once-proud owners of lumberyards are being pushed out of the market by corporate machines with no knowledge of the business and no dedication to service.”

Joe decides to take some initiative. Together with about 50 owners of independent lumberyards in Kansas and some neighboring states, Joe forms the Independent Lumberyards Association, known as “ILA”. In the aggregate, the ILA members are responsible for approximately 40% of all lumber sales in the areas in which the members operate. Lumber Depot and Lumber Mania, plus a few independent lumber retailers who chose not to join the ILA, are responsible for the remainder of lumber sales in those areas.

ILA elects to undertake two tasks.

First, ILA will provide its members with instructional seminars to improve members’ skills in “salesmanship, including discounting, rebates, loyalty programs, and other promotional strategies.” At the seminars, members are encouraged to “feel free to discuss what you’ve tried out, what’s worked, what’s flopped. Together we can identify the right promotional strategy for the unique needs of your small business.” ILA will also periodically survey members concerning their promotional strategies and then distribute data to ILA members on the most and least successful strategies, but without identifying any particular member by name or location.

Second, ILA will collectively negotiate with, and purchase lumber from, wholesale lumber suppliers on behalf of its members and then resell to its members the lumber at the wholesale cost plus a small administrative fee. ILA expects that it can significantly lower members’ wholesale lumber costs.

ILA’s charter provides that any lumberyard may join ILA so long as the applicant: (i) is located no closer than 30 miles from the location of any existing ILA member; and (ii) “meets the required threshold of lumber-related knowledge and dedication to service”. The charter also provides that membership in ILA “will not be understood to confer any managerial or other authority of ILA or any member thereof over the business or other activities of any ILA member.”

Shortly after formation of the ILA, Lumber Depot sends a letter to ILA, requesting membership in ILA. ILA sends back a letter to Lumber Depot stating: “We appreciate your interest in joining our organization. However, we have concluded that your enterprise does not meet the minimum
knowledge and dedication to service requirements that must be satisfied for membership in our organization.”

You are counsel to Lumber Depot. The CEO of Lumber Depot is incensed after having been denied membership in ILA. He asks you to draft a memo identifying any claims Lumber Depot could bring against ILA or any of its members under federal antitrust law. Identify those claims and assess those claims’ likelihood of success.

Part III

A few months later, Joe calls a meeting of all members of the ILA. He says: “Our situation is still not good. We continue to lose ground to Lumber Depot and Lumber Mania. Some of our members are close to insolvency. The reason is simple: the big guys’ product is cheaper and their stores are, well, bigger. There is only one solution: merger.” The next day ILA issues a press release announcing an agreement among its members to dissolve ILA and merge into a single corporation, Nice Lumber Co. Thereafter each ILA member firm will become a division of Nice Lumber Co. After its formation, Nice Lumber will be the largest lumber retailer in the geographic area covered by ILA members, constituting approximately 40% of all lumber sales, as compared to approximately 30% each for Lumber Depot and Lumber Mania. A handful of independent lumber retailers will remain in a few localities.

You are a lawyer at the Federal Trade Commission. Your boss has asked you to prepare a memo analyzing whether the FTC should take any action under federal antitrust law to block the proposed formation of Nice Lumber Co. Please advise.

Part IV

Joe, now the CEO of Nice Lumber Co., decides to embark on an ambitious plan to reinvigorate the new firm’s business. The plan has three components: (i) “go national” – that is, expand nationally; (ii) “go unique” – that is, promote “Nice” as a distinctive and high-quality brand of lumber that cannot be found at a lumber chain store; and (iii) “go DIY” – that is, concentrate on supplying lumber to “do-it-yourselfers” who value the customized service of an independent lumberyard. Speaking to the Nice Lumber board of directors, Joe says: “At best, we can match the big guys on price. But I want to win, not tie. To do that, we need to beat them on branding and service.”

To achieve expansion rapidly, Nice decides to partner with existing independent lumberyards in other states to act as retailers for Nice-branded lumber. Nice enters into a partnership agreement with each independent lumberyard, which includes the following terms:
(i) Nice will not supply Nice-branded lumber to any other retailer within 30 miles of the retailer-partner’s location.

(ii) The retailer-partner will not sell any Nice-branded lumber below the price to be stipulated by Nice on an ongoing basis.

(iii) The retailer-partner will make good faith efforts to advertise the Nice brand and to hire personnel with sufficient knowledge of lumber products and a dedication to the highest level of customer service.

Many retailers sign up for the partnership program and, just as Joe had hoped, enjoy success as a “DIY” center. Nice enters into a partnership agreement with Julie’s Woodshop, an independent lumberyard in Los Angeles. Julie is excited to join the “Nice” revolution in lumber marketing, promotes the brand in the local press and even hires a specially-trained expert to provide customers with free “lumber consultations”. There is a Lumber Mania location a few miles away from Julie’s Woodshop.

To her dismay, Julie has lots of customers who come in for lumber consultations but never make a purchase. After a few months of poor sales, Julie fires the lumber expert and reduces prices to match Lumber Mania on comparable products. Sales immediately increase. Nice learns of this pricing change and notifies Julie that it is terminating their partnership.

You are a litigator in Los Angeles. Julie wants to know whether she can bring any claims against Nice under federal antitrust law. Identify those claims and assess those claims’ likelihood of success.