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Free Riding on Hot Wheels

Victor P. Goldberg*

When warehouse clubs started making inroads into its market, Toys R Us responded with a policy designed to limit the clubs' access to certain toys. The FTC successfully challenged the policy, arguing that TRU had coordinated a horizontal agreement amongst the toy manufacturers to eliminate competition from this new class of competitors.¹ TRU defended itself, invoking the free-rider rationale. This the Commission rejected as pretext. TRU's argument was better than the Commission gave it credit for, but it failed to press its best argument. That failure stems in part from the shortcomings of the standard free rider formulation, and in part from the defendant's need to tailor its arguments to ill-fitting doctrinal constraints. TRU attempted to convince the Commission that its actions were unilateral, within the *Colgate* exception.² Perhaps they were, although the Commission found to the contrary. Regardless, the net result was suppression of an efficiency rationale that emphasized the benefits of cooperation by the toy manufacturers.

In this paper, I will argue that TRU emphasized the wrong free rider problem. Properly framed, the behavior of TRU and the toy companies can be seen as consistent with the efficiency goals of antitrust policy. That a plausible efficiency argument can be

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¹ In the Matter of Toys "R" Us, Docket No. 9278, 1998 FTC Lexis 119. Upheld in *Toys "R" Us v. FTC* 2000 WL 1056235 (7th Cir.). A treble damages case triggered by the Commission's action resulted in a settlement; *In re Toys "R" Us Antitrust Litigation* 191 F.R.D. 347.

² *United States v. Colgate & Co.*, 250 U.S. 300 (1919).

constructed does not mean that the outcome itself was wrong. My narrow focus here is on showing that the standard formulation led to asking the wrong question.

Part I provides a brief overview of the market and TRU's behavior. Part II summarizes the defense's rationale and the Commission's rejection of it. Part III provides an alternative explanation. Part IV concludes.

I. What did TRU do?

When the case was brought, Toys "R" Us was a "category killer," far and away the largest retailer of toys.³ It accounted for about twenty percent of the toys sold at retail in the United States and in a number of markets its share was significantly higher. In Chicago, New York, and Los Angeles its market share exceeded 40%. It faced competition from traditional toy retailers, department stores, and discounters like Wal-mart. In the late 1980's a new retailing innovation, the warehouse club, appeared. Two of the warehouse clubs, Sam's (owned by Wal-mart) and Costco, accounted for over 90% of the sales. Warehouse clubs began to sell toys at prices substantially below TRU's. TRU gross margins were around 30%, while the clubs margins were in the 9-12% range. TRU carried over 11,000 toys (stock keeping units or SKU's) while the clubs' offerings were much more limited (numbering in the low hundreds). The FTC's complaint concerned TRU's response to the perceived threat of increased competition from the warehouse clubs.

TRU adopted and implemented a strategy to prevent the clubs from competing directly against it. The strategy, labeled the “no-identical-items” policy, limited the manufacturers to selling to the clubs only products significantly differentiated from those carried by TRU. Toys were either to be sold in combination packs or redesigned so as to make them visually distinct from items sold at TRU. The FTC concluded that, as a result of this policy, sales through the clubs were substantially less than they would have been but for adoption of this policy by the toy industry. As a consequence, the Commission claimed, consumers ended up paying a higher average price and buying fewer toys than they would have otherwise.

II. The Free Rider Rationale

Assuming that this account is accurate—they attempted to keep toys out of the hands of the clubs and they were in large part successful—can the policy be justified? The defense presented the standard free rider argument blessed by the Supreme Court in *GTE Sylvania*.⁴ If TRU provided services to potential customers and the warehouse clubs could take advantage of these while not paying for them, this would undermine TRU’s incentives to provide such services. The Commission, taking a very narrow view of the scope of the free rider rationale, suggested that toy retailing would not seem a likely candidate.

³ My understanding is that Wal-mart has recently taken over the number one spot.

⁴ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 55 (1977).

Before turning to TRU's specific contentions, it is useful to note that the services that TRU claims are exploited by others are not the "classic" services that the courts have been increasingly willing to protect. Free-riding is most often a problem for manufacturers and distributors of expensive, complex goods. For example, promotion, demonstration, and explanation of complex products are services most vulnerable to free-riders; customers visit the full service retailer to learn about products and then buy them somewhere else. If a product requires installation or extensive service, customers may buy it at a low-cost discount outlet and then take it to the full service dealer for post-sale servicing. The second dealer may incur significant costs to see that it is properly installed, used, and maintained.

By contrast, toys are usually simple and inexpensive products. They generally do not require demonstration and do not require significant installation or maintenance. TRU's method of retailing, moreover, is built on the assumption that customers (or perhaps their children) know what they want when they come to the store. TRU does not dispute that it provides no customer services such as product demonstration or installation assistance. There are few if any sales people in a TRU store available to guide or advise shoppers. There was no evidence in the record

that anyone sought demonstration or explanation of a toy product at TRU and then purchased the product at a club.⁵

The defense did not attempt to argue that TRU provided services directly to the consumer. Rather, it argued that TRU provided services to the toy companies. In particular, it identified three activities on which the clubs could have been free riding: local advertising, carrying an inventory of goods early in the year (“dating”), and supporting a full line of products (which included creating hit products). Before considering these in turn, I want to elaborate on the notion that manufacturers buy a package of selling services from retailers. The fact that those services might include installation, demonstration, and other direct contact with end customers is incidental.

A. Provision of retailing services—to manufacturers

Selling goods, especially consumer goods like toys, is an expensive proposition. Manufacturing costs are likely to be substantially less than half the final retail price. The manufacturer must pay for services provided by retailers, wholesalers, their own internal sales staff, television advertising and other services that get the goods from their loading docks into the hands of consumers. Some of the service providers (advertising agencies, for example) are paid directly. Others, notably retailers, are compensated indirectly; typically their payment is contingent on their selling the goods and their “fee” is the

⁵ FTC, 136-37.

difference between the wholesale and retail price.⁶ The indirect form of payment should not disguise the fact that the retailer is providing a valuable, and costly, service and that, as with physical production costs, manufacturers have an incentive to economize.

As a useful analogy, consider the provision of another marketing input—television advertising. The price of a television advertisement depends on the size of the audience and its demographics. Manufacturers pay to get their message to a large number of people, in particular to the right people. The network packages audiences to sell to the manufacturers. Beer producers will concentrate their ads on sporting events and other programming aimed at their target audience, young males. Toy companies will concentrate on Saturday morning cartoons. And so forth.

Just as television networks package audiences for their sponsors, so to do retailers. The retailer is, in effect, providing enhanced shelf space. The value of the shelf space depends on the package of services the retailer offers to the manufacturer. The retailer could generate generic foot traffic (by bringing a lot of sellers to the same location, locating in a densely populated area, hiring entertainment to draw crowds, etc.) or it could engage in activities that would attract a more precisely targeted set of potential customers. A retailer might, at the extreme, provide services limited to promotion of a single brand. Or it might package a set of services aimed at manufacturers of the same, or closely related, products. For example, a retailer might maintain a bridal registry to

⁶ See Goldberg, *The Free Rider Problem, Imperfect Pricing and the Economics of Retailing Services*, *Northwestern University Law Review*, Vol.79 (1984) pp.736-757.

promote sales of fine china, crystal, and similar products.⁷ Or it might establish and maintain an image as a location that carries a wide variety of toys (or books or compact discs or woman's shoes) so that people who show up have a reasonable likelihood of finding what they want. The retailer might provide the "classic" services listed by the FTC, but that would be only one strategy for bringing goods and customers together.

The retailer's indirect compensation complicates things. The manufacturer pays a fee per unit sold, the gross margin, but that is different from the fee per unit of retailing service purchased (which is not observable). So, for example, two retailers might both be buying and selling GI Joes at the same price. However, because one has higher turnover, it might be clearing \$4 per linear foot per month while the other only gets \$1. If the opportunity cost of the former's shelf space were \$3, then the manufacturer's incentive is to cut the effective price it pays to that retailer. It could do so in a number of ways. It could force the retailer to carry more goods than it would otherwise. Or it could limit the retailer's allocation of the "hot sellers." Much of the haggling over the effective price of retailing services will take place in this non-price dimension.

B. TRU's Free Rider Claim

The local advertising rationale has to be stated carefully. The advertisements tell potential customers that if you want to buy X, you can buy it at TRU. If the ads simply get the customers to the TRU outlets, then the effect on the sales of competitors would be

⁷ Indeed, when deciding which retailers would be its distributors, two of the criteria Lenox used were that the distributor maintain a bridal registry and that it carry the china of other brands. See Goldberg,

zero or negative. There would be no free rider problem. TRU's advertising helps local competitors only if customers conclude from the fact that TRU advertised the toy that it is one worth buying from somewhere else. So, if there is free riding on local advertising it must be on this quality certification effect.⁸ The FTC made much of the fact that TRU's local advertising expenditures were roughly the same as the support it received from the toy companies.⁹ The Commission concluded that advertising "was a service the toy *manufacturers* provided for TRU and not the other way around."¹⁰ That is not responsive, since TRU's argument is that the identity of the retail advertiser raises all ships, regardless of who writes the checks for the advertisements. If, because of free riding, TRU's yield on its advertising were less, then it would advertise less, unless the toy companies would increase its compensation for running local advertisements.¹¹

The Commission's description of "dating" is a bit muddy, but the essence of it seems to be that TRU provides warehousing services for goods to be sold in the Christmas season, allowing the manufacturers to spread production evenly over the entire year. However, the Commission argues that TRU is compensated for this, as the manufacturers defer billing. If the Commission has accurately characterized TRU's argument, then there seems little merit to it.

Enforcing Resale Price Maintenance: The FTC Investigation of Lenox, 18 Am. Bus. L. J. 225 (1980).

⁸ TRU's experts provided evidence that an appearance in a TRU catalog resulted in "a large and statistically significant increase in toy sales for both Toys "R" Us and other retailers." Dennis W. Carlton and Hal S. Sider, "Market Power and Vertical Restraints in Retailing: An Analysis of FTC v Toys "R" Us," in Daniel J. Slotte, *The Role of the Academic Economist in Litigation Support* (1999) at 76.

⁹ In 1994, TRU spent nearly \$200 million on advertising and received compensation from manufacturers for all but about \$1 million.

¹⁰ FTC at 52-3 (emphasis in original).

¹¹ TRU presented a related argument, which the Commission ignored. By carrying items during the year, TRU displayed them to customers who might then choose to buy them elsewhere during the peak (Christmas) season. See Carlton and Sider, p. 75.

TRU's argument that it carries a full line of toys and that it is concerned with the clubs cherry-picking the best sellers is a more persuasive argument, especially if TRU is instrumental in promoting the toys to the status of best-seller. The Commission's response was not convincing. It noted that historically when goods were on allocation, TRU received a more than proportionate share. "[L]iberal access to scarce products compensates TRU for its full-line stocking service to the toy industry."¹² In addition, the Commission cites TRU's ability to obtain ex post discounts on slow moving items. The Commission's argument founders on two points. First, it presumes that the compensation is the right amount. But, a priori, we cannot say how much preferential access would be sufficient to compensate TRU for the services provided. Second, even if we could somehow surmount that problem, the argument presupposes that the liberal access TRU enjoyed would continue in a world in which the warehouse clubs thrived. But, if warehouse club's succeed in diverting a significant amount of business from TRU, then its value to the toy companies declines. The toy companies would, therefore, have less incentive to make these in-kind side payments to TRU. The Commission was silent as to how TRU could maintain its superior access to hot-sellers if the warehouse clubs had substantially increased their market share.

III. The Other Free Rider Problem

My argument has two components. First is the antithesis of the free rider problem: unconstrained retailers can cannibalize the sales of others, thereby increasing

the costs to the manufacturer of distributing its goods. Second, the fact that retailers carry multiple brands can be reinterpreted as manufacturers purchasing retailing services collectively. That collective action can result in the reemergence of a second free rider problem. I conclude this section with an important qualifier—the possible efficiencies that might be achieved by containing this free rider problem might well be offset by the principal-agent problem.

A. Cannibalization

Let us assume for the moment that the manufacturer sells through single-brand retailers. The selling efforts of one retailer can affect the selling costs of another retailer, so if the retailers look only to their own costs and benefits, they will ignore the impact of their decisions on the costs of their competitors. If one provides demonstrations, the second can take advantage by selling the product without incurring the costs of demonstration. If the first retailer is not compensated, she would have no incentive to provide demonstrations. This is the standard free rider argument. The manufacturer could cope with this problem by subsidizing the first retailer (e.g., cooperative advertising) or controlling the second retailer by requiring compensation of the first retailer, requiring that it provide service, restricting its freedom to set prices or to determine where it locates, and so forth.

Alternatively, the first retailer's activity could raise the second's costs. So, if retailer A locates near retailer B, it does not take into account the possible adverse effect

¹² FTC at 54.

on B's sales (cannibalization). Unfettered competition between the retailers would result in excessive selling costs. It is not just that B's sales are lower than they would otherwise have been; its costs per sale are higher, and so are A's. This is not just a matter of spreading fixed selling costs over a lower level of sales. Each dollar spent by A on retailing services reduces the productivity of B's retailing services (that is, it raises B's cost curve). If the manufacturer could limit the competition between its retailers, it could reduce the net costs of the retailing services it is purchasing. It would have to balance the gains from increased exposure to its products against the costs of duplicated effort. Assuming that the manufacturing market is tolerably competitive, those savings get passed on to consumers. There is nothing surprising about this; it is a standard result in Hotelling-type models of monopolistic competition.¹³

If vertical integration has no effects on costs, then the manufacturer could simply own the retail outlets and locate and run them optimally. It would internalize the costs and benefits of adding an additional retailer. The restrictions it imposed on its employees would not appear on the antitrust radar screen. Indeed, the notion that a manufacturer might divide its sales force along regional and/or product lines appears so normal that we don't even think twice about it. That a manufacturer might choose to compensate its employed sales people only for sales within their assigned territories will elicit only a yawn from the antitrust authorities. In many instances, however, vertical integration by ownership would be impractical. With integration by contract the manufacturer might

¹³ See Harold Hotelling, Stability in Competition, *The Economic Journal*, Vol. 39, No. 153. (Mar., 1929), pp. 41-57.

want to put the same type of constraints on the dimensions in which retailers carrying its goods can compete.

Thus, there is a nice symmetry between the free rider and cannibalization problems. The former arises from a retailer providing an uncompensated benefit, while the latter arises from a retailer not being responsible for the costs it imposes on others. The manufacturer has to balance the gains from increased exposure against the costs of cannibalization when determining the structure of its retailing network.

B. Collective provision of retail services

Let us now drop the assumption of a single-brand retailer. Each toy manufacturer could maintain its own retailing network, but there are advantages to displaying the toys of a number of manufacturers together. TRU, department stores, and other retailers bring together buyers and sellers of toys. Unlike most of the others, TRU carries only toys. By putting a large number of toys (including the most popular) under one roof, TRU brings to the toys of a number of different toy companies a large number of exposures to people interested in buying toys, a service for which the manufacturers are willing to pay. Once the customer is there, each manufacturer would wish that its products were the only ones available. But to get the customers there in the first place, the manufacturer would want TRU to carry the products of most of its competitors.

To strip the argument to its essentials, let us wash TRU out of the picture. Suppose instead that the toy companies act cooperatively to develop a Joint Retailing Entity (let's call it JRE) in order to reduce their net costs of distribution. Assume further that toy manufacturing is a competitive business so that they are concerned with minimizing costs, not pursuit of oligopolistic profits. This is not an unreasonable assumption given the low level of concentration in the toy business.¹⁴ If all retailing entities were identical, then the JRE must determine the number and location of the outlets. The JRE, just as the individual manufacturer discussed above, must be concerned with balancing the gains of increased coverage against the costs of cannibalization. Even in this simple world, the cost-conscious JRE would restrict the availability of toys to retailers. It would choose to open fewer outlets than if there were unfettered competition between retail outlets. This does not, of course, mean that there would be fewer sales. There would be more. The net average price to consumers would be lower and the sales per outlet higher.

Toy outlets are not, of course, homogeneous. The marketing channels include toy superstores (like TRU), department stores, traditional discounters, specialty stores, warehouse clubs, and now the internet. The heterogeneity makes the picture richer and more complex, but the cannibalization problem remains. Instead of being concerned only with the number of outlets and their location, the JRE now must worry about the mix. A warehouse club might carry some segments of the product line without adversely affecting the sales of the remainder. However, if warehouse clubs had unrestricted access

¹⁴ The top ten firms have less than 50% of the toy market (excluding video games); see FTC, p. 3; the HHI is under 800; see Carlton and Sider, p. 70.

to the hot toys, their increased sales could increase the selling costs of the superstores. The gains from the increased sales through the warehouse clubs could be more than offset by the decrease in sales from the superstores. Moreover, if the warehouse clubs cannot carry hot toys, those interested in hot toys are more likely to patronize the superstores, and, while there, the likelihood that they would buy other toys would be enhanced. This spillover effect is likely too diffuse for the individual toy company, but for the group it could be significant. If the warehouse clubs carry the hot toys, their promotional value is lost and the net selling costs of toys could increase.

The behavior of Wal-mart vis a vis its Sam's Club warehouse stores is consistent with this explanation. Sam's Clubs are virtually always located near or adjacent to a Wal-mart. Wal-mart imposed on itself a policy similar to TRU's, allowing very few of the toy items stocked by Wal-mart to be carried by Sam's.¹⁵ The common ownership allowed Wal-mart to internalize the balancing of the gains from increased exposure against the costs of cannibalization and it appears to have come to roughly the same conclusion as TRU. TRU's experts explain Wal-mart's policy as a response to the potential free riding on Wal-mart's promotional efforts.¹⁶ I believe that the cannibalization explanation works better. The "quality certification" story is more convincing for TRU than it is for Wal-mart.

Sam's had systematically lower markups than Wal-mart. If customers coming to Wal-mart could get the identical items in the adjacent building at a lower price, many

¹⁵ Carlton and Sider, p. 77.

¹⁶ Carlton and Sider, p. 77-78.

would choose to do so. That might sound good for consumers, but it is likely that Wal-mart would find its sales revenues no longer adequate to justify the amount of shelf space allocated to selling toys. If it could limit Sam's to carrying toys that did not compete directly with those carried by Wal-mart, then the segmentation can enable it to engage in a bit of price discrimination. Wal-mart internalized the costs of cannibalization and apparently it concluded that the profit maximizing strategy would be to sell only a few toys through its warehouse outlet, toys that would not adversely affect the sales through its primary outlet.

Unlike Wal-mart, TRU cannot internalize the costs. This explanation suggests that the toy companies, and their customers as a group, would be better off if somehow the companies could commit to not opening (or at least restricting) the warehouse marketing channel.¹⁷ The free rider problem has resurfaced, but in a new guise. Each toy company is better off if they all keep their hot-selling toys out of the hands of the warehouse clubs. But each has the incentive to cheat. The costs of diverting the sales of one firm from the superstores are spread over all the toy companies, while the benefits are captured exclusively by the single cheater. If the toy companies cannot coordinate their behavior, each will have an incentive to sell through the clubs, thereby raising for all the selling costs of the JRE. The crucial point is that the toy companies are buying a collective input, and that containing their incentive to free ride will be in their (and their customers') long-term interest.

¹⁷ Of course, a subset of customers, those who patronize the clubs, would be better off.

Given the relatively low level of concentration in the toy industry, it is hardly surprising that the problem would not be resolved by spontaneous independent action. The no-identical-items policy would be one possible solution to their problem. There are many other possible solutions. For example, the manufacturers could hire a specialist (like Nielsen's) to monitor the sales through the clubs and then allocate shelf space in the JRE inversely to the club sales. Or TRU could monitor the sales itself, rewarding those who restricted warehouse sales with more (or higher valued) shelf space. TRU could have adopted such a policy unilaterally. Indeed, a core element of its defense was an attempt to show that it had acted unilaterally. Whether the behavior comports with some legal definition of unilateral behavior does not matter analytically. The basic point is that joint benefits can be derived from collective action; however, private benefits can be obtained at the expense of the group and there will be incentives to develop mechanisms to constrain the mutually detrimental behavior. The behavior of the parties might look like the behavior of participants in a classic cartel, but that similarity should not obscure the fact that the function is completely different. So, for example, if Mattel shipped some Barbie dolls to Costco, it would not be surprising to find some smoking guns in the files—TRU would attempt to dissuade Mattel, perhaps threatening some sanctions (slow shipping, a smaller shipment of hot sellers), and it would probably field complaints from Hasbro and others.¹⁸ Antitrust cases are built on inferences from such behavior, even though the motives and effects of the behavior were benign.

While the characterization of the behavior of TRU and the toy companies as unilateral or otherwise does not matter analytically, it does matter in practice. There is a

¹⁸ For examples of communication about cheating, see FTC, pp. 44-48.

lot of bad precedent out there and the prudent defense lawyer must steer clear.¹⁹ If my explanation is correct, and if the defense had attempted to make the argument, that might well have hurt its chances. This is particularly unfortunate since the best source for empirical work on distribution arrangements is antitrust litigation, and the defense lawyer's incentives are to blockade one of the more attractive research paths.

C. The Principal-Agent Proviso

TRU was not a jointly owned entity. It had its own interests, which were not entirely consistent with those of the manufacturers. And its market share, while not overwhelming, was high enough to warrant going beyond a per se legality standard. One might even argue that it was positioned to create a dynamic inefficiency. If the warehouse clubs were permitted to grow without restriction, the manufacturers as a group might eventually have been better off. However, if the growth of warehouse clubs adversely affected the value of TRU's dedicated assets, it might oppose expansion of the warehouse marketing channel (unless it could exact compensation). TRU could prevent the spread of the superior (by assumption) retailing technology by refusing to deal with any manufacturer who did not adopt the no-identical-items policy. The collective action problem in this instance would prevent the appearance of a more efficient system. In effect, there is a principal-agent problem. The manufacturers are principals with an

¹⁹ See, for example, *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959), cited with some reluctance by the FTC (p. 58) and *United States v. General Motors Corp.*, 384 U.S. 127 (1966), cited with approval (p. 90). *Interstate Circuit, Inc. v. U.S.* 306 U.S. 208 (1939), the poster child for inferring conspiracy is extensively cited in the TRU opinion (pp. 76-85). For a persuasive debunking, see Butz and Kleit, *Are Vertical Restraints Pro- or Anticompetitive? Lessons From Interstate Circuit*, 44 *J. Law & Econ* 131-159 (2001).

interest in a common property asset and TRU, their agent, manages that asset in a manner not entirely consistent with the principal's desires.

IV. Concluding Remarks

The antitrust analysis of distribution arrangements is in a rut. Despite liberalizing decisions like *GTE Sylvania*²⁰ and *Sharp*,²¹ there is a pecking order of acceptable explanations exemplified by the Commission's decision in *Toys R Us*. If the behavior in question is ancillary to the provision of services to customers, then it presumably falls within the *GTE Sylvania* rule. If the behavior is ancillary to the provision of services to manufacturers, then there is more skepticism, if not outright hostility; still, arguments of that sort can win, especially if it is plausible that non-favored retailers could be free riding on local advertising. If the behavior in question cannot be shoe-horned into these two categories, then the defendant is at risk. That legal framework has had a stifling effect on scholarship. Would-be experts for the plaintiffs have no reason to expand the range of acceptable arrangements and would-be experts for the defense are reluctant to have published work suggesting that behavior that looks cartel-like might turn out to be efficient.

My purpose here is not to judge whether the FTC's bottom line was correct. I don't think the opinion, as long as it is, has enough relevant information to make that judgment. My intent is to broaden the analysis by emphasizing the wide range of benign

²⁰ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 55 (1977).

²¹ *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 735 (1988).

or beneficial explanations for restraints—horizontal or vertical—in the distribution chain. The consumer-services rationale should be recognized as a subcategory of the manufacturer-services explanation. The indirect compensation of retailers should not obscure the fact that the manufacturers pay for the service. Even if the only service retailers provide is bringing undifferentiated foot traffic to a manufacturer’s product, producers might find it efficient to impose restrictions on the marketing channels. Most products are sold through retailers carrying a range of products of different manufacturers so that, in effect, the manufacturers are jointly purchasing retailing services. A number of trade practices that have raised antitrust concerns might plausibly be directed at assuring the provision of the right mix of selling inputs and assuring that the manufacturers pay their fair share. The manufacturers will be concerned with the allocation of costs and with policing behavior that would raise the costs of the group as a whole. Arguably, TRU’s policy was aimed at solving that problem.