

## Uneasy Labeling

*Discon, Inc. v. NYNEX Corp.*, 93 F.3d 1055 (2d Cir. 1996), *petition for cert. filed*, 65 U.S.L.W. 3694 (U.S. Apr. 3, 1997) (No. 96-1570).

[E]asy labels do not always supply ready answers.<sup>1</sup>

In antitrust, the initial classification of a challenged business arrangement can make or break a case. Certain types of agreements have been deemed so patently anticompetitive that they are condemned as per se illegal. Agreements that do not fit into per se categories are evaluated under a balancing test, the “rule of reason.” In theory, rule-of-reason analysis requires a careful examination of the competitive impact of a specific agreement; in practice, however, the challenged agreement is rarely struck down.<sup>2</sup>

In *Discon, Inc. v. NYNEX Corp.*,<sup>3</sup> the Second Circuit expressed a legitimate concern that remanding a challenge to a supplier-purchaser agreement for adjudication under the rule of reason might allow a potentially anticompetitive agreement to be upheld without proper scrutiny. But the court’s response—shoehorning a vertical agreement into a category of horizontal restraints traditionally considered per se illegal—establishes a dangerous precedent. The decision further blurs an already fuzzy line between vertical and horizontal restraints, thereby increasing the possibility that agreements that actually promote competition could be wrongly condemned as per se illegal. The unnecessary expansion of the scope of a per se rule means that in future cases, the initial classification of similar agreements could receive even greater emphasis—and carry even higher stakes.

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1. *Broadcast Music, Inc. v. Columbia Broad. Sys. Inc.*, 441 U.S. 1, 9 (1979)

2. This description is necessarily oversimplified. For a helpful—and quite influential—discussion of the precepts underlying rule-of-reason and per se analysis and the major cases that define the relation between these standards, see 7 PHILLIP E. AREEDA, *ANTITRUST LAW* ¶¶ 1500-1510 (1986). Professor Areeda explicitly suggests collapsing the reasonableness-per se distinction into a single inquiry with varying presumptions. *See id.* ¶ 1511; *see also infra* notes 23-29 and accompanying text.

3. 93 F.3d 1055 (2d Cir. 1996), *petition for cert. filed*, 65 U.S.L.W. 3694 (U.S. Apr. 3, 1997) (No. 96-1570). This Case Note focuses on *Discon*’s claims that *NYNEX*’s actions violated section 1 of the Sherman Act, 15 U.S.C. § 1 (1994). It does not examine how the Second Circuit treated *Discon*’s allegations that *NYNEX*’s actions also violated section 2 of the Sherman Act, 15 U.S.C. § 2, as well as several civil provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1962 (1994). *See Discon*, 93 F.3d at 1061-64 (affirming the district court’s dismissal of most of these claims, but reversing and remanding the district court’s dismissal of *Discon*’s conspiracy-to-monopolize claim). Both *Discon* and *NYNEX* filed petitions for certiorari. On the same day that the Supreme Court denied *Discon*’s petition, *see Discon, Inc. v. NYNEX Corp.*, 118 S. Ct. 49 (1997), it requested an opinion from the Solicitor General on issues raised in *NYNEX*’s petition, *see NYNEX Corp. v. Discon, Inc.*, 118 S. Ct. 40 (1997).

## I

Discon, a business that removed obsolete telephone equipment, challenged a decision by NYNEX and its wholly owned subsidiaries to purchase such removal services from Discon's competitor, AT&T Technologies. Discon contended that NYNEX made the arrangement with AT&T Technologies as part of a strategy to increase its profits by exploiting its position as a regulated monopoly.<sup>4</sup> An independent investigation by the Federal Communications Commission (FCC) found that NYNEX replicated the alleged profit-shifting scheme in numerous contexts.<sup>5</sup> The district court, however, granted NYNEX's motion for dismissal on the ground that the complaint failed to specify concerted actions that amounted to an agreement.<sup>6</sup>

The Second Circuit reversed, finding the meetings between NYNEX and AT&T Technologies alleged in the complaint sufficiently probative of a conspiracy to defeat a motion to dismiss.<sup>7</sup> The court classified the challenged supplier-purchaser arrangement as—in antitrust parlance<sup>8</sup>—a two-party vertical non-price agreement.<sup>9</sup> Such agreements are generally labeled as “exclusive dealerships.”<sup>10</sup> Exclusive dealerships are not per se illegal; they are considered under the rule of reason (and generally upheld as reasonable), because they can promote interbrand competition that may offset the harm they can do to intrabrand competition.<sup>11</sup> But rather than simply remanding the case as an “exclusive dealership” controversy, the court indicated that the

4. See *Discon*, 93 F.3d at 1058. The Second Circuit explained:

MECo, as a non-regulated affiliate of NYNEX, would purchase removal services at inflated prices from AT&T Technologies. These removal services, along with their inflated prices, were then passed on to NYTel, a regulated affiliate of NYNEX. In turn, NYTel was able to overcharge its captive rate-paying customers pursuant to the rate-making process. MECo would then recoup its inflated costs by receiving a secret year-end “rebate” from AT&T Technologies.

*Id.*

5. See *In re New York Tel. Corp.*, 5 F.C.C.R. 866 (1990). Without admitting any wrongdoing, NYNEX's subsidiary NYTel entered into a consent decree in which it agreed to refund over \$35 million to its rate-paying customers for “unreasonable rates reflecting improper capital costs and expense charges.” *In re New York Tel. Corp.*, 5 F.C.C.R. 5892, 5893 (1990).

6. See *Discon, Inc. v. NYNEX Corp.*, No. 90-CV-646A, 1992 WL 193683, at \*5 (W.D.N.Y. June 23, 1992), *aff'd in part and rev'd in part*, 93 F.3d 1055 (2d Cir. 1996), *petition for cert. filed*, 65 U.S.L.W. 3694 (U.S. Apr. 3, 1997) (No. 96-1570).

7. See *Discon*, 93 F.3d at 1059 n.3.

8. Courts presented with a claim under section 1 of the Sherman Act, which outlaws unreasonable restraints of trade, typically begin by classifying the challenged agreement according to the direction of the agreement (horizontal, meaning between competitors, or vertical, meaning along the line of distribution) and the nature of the agreement (price fixing, boycott, market allocation, etc.). Under the traditional model, the “class” into which the challenged practice is placed then determines the “standard” used (per se illegality or rule of reason). See, e.g., *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 721-24 (1988).

9. See *Discon*, 93 F.3d at 1059-60 & n.5 (rejecting Discon's arguments that the agreement was a traditional horizontal restraint of trade or vertical price fixing).

10. *Id.* at 1060-61 (citing *Business Elecs.*, 485 U.S. at 725-31 & n.4; *Oreck Corp. v. Whirlpool Corp.*, 579 F.2d 126 (2d Cir. 1978) (en banc)).

11. See *id.*

arrangement should be characterized instead as a “two-party group boycott.”<sup>12</sup> It then concluded that *Discon* had stated a cause of action “at least” under the rule of reason and “possibly” under the per se rule applied to group boycotts “if the restraint of trade ‘has no purpose except stifling competition.’”<sup>13</sup> This is the first case in which the Second Circuit has suggested that a two-party group boycott could be per se illegal, a change in antitrust law that may have far-reaching implications.

## II

*Discon* distorts modern group boycott doctrine by applying the label to NYNEX’s vertical agreement. Group boycotts generally refer to agreements among horizontal competitors.<sup>14</sup> Twenty years ago, the Second Circuit held that a two-party vertical agreement may be considered a horizontal group boycott (though not a per se illegal boycott) if it sought to disadvantage a competitor of one of the parties.<sup>15</sup> Subsequently, the Supreme Court clearly rejected this reasoning: “[A] restraint is horizontal not because it has horizontal effects but because it is the product of a horizontal agreement.”<sup>16</sup> In *Discon*, the panel relied on the earlier Second Circuit precedent without addressing the apparent contradiction.<sup>17</sup>

Read literally, the *Discon* court’s characterization of a group boycott as a vertical agreement that seeks to disadvantage a horizontal competitor could swallow up the exclusive dealership category. The court, however, emphasized

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12. *Id.* at 1060-61. Group boycotts (also called concerted refusals to deal) generally involve collective activity among a group of horizontal competitors to inhibit the competitive vitality of another competitor. The doctrine’s applicability to vertical agreements stems from *Klor’s, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959), which classified an agreement among several manufacturers and distributors not to sell to a retailer as a group boycott. But *Klor’s* specifically excluded vertical agreements that, like NYNEX’s, are made between just two parties. *See id.* at 212.

13. *Discon*, 93 F.3d at 1061 (quoting *Oreck*, 579 F.2d at 131 (quoting *White Motor Co v United States*, 372 U.S. 253, 263 (1963))). The quotation with which the *Discon* court concluded highlights the extent to which the court distorted precedent by taking it out of context. The full sentence in *Oreck* is “Horizontal restraints alone have been characterized as ‘naked restraints of trade with no purpose except stifling competition’; and, therefore, *per se* violations of the Sherman Act.” 579 F.2d at 131 (citation omitted). *Oreck* goes on to distinguish the vertical agreement at issue in the case from such horizontal restraints and to hold that vertical agreements, even if classified as two-party group boycotts, must be evaluated under the rule of reason. *See id.* The *Discon* court thus goes beyond *Oreck* in categorizing the NYNEX agreement as potentially per se illegal. *See Discon*, 93 F.3d at 1061.

14. *See supra* note 12. Not all group boycotts are per se illegal, however. *See infra* note 27

15. *See Oreck*, 579 F.2d at 131-32 & n.6; *see also supra* note 13.

16. *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 730 n.4 (1988)

17. *See Discon*, 93 F.3d at 1060-61 (citing *Oreck*, 579 F.2d at 131-32 & n.6). Elsewhere in its opinion, the *Discon* court accurately cited *Business Electronics* as holding that the only vertical agreements that are per se illegal are those that fix prices. *See id.* at 1059 (citing *Business Elecs.*, 485 U.S. at 724). Rather than confronting directly the implications of *Business Electronics*, the *Discon* court pointed to cases from other circuits that have treated two-party vertical agreements as horizontal group boycotts on grounds similar to those used in *Oreck*. *See id.* at 1061 (citing cases). All of the cases cited from other circuits were decided before *Business Electronics*. The law in this area remains unsettled. *See, e.g.*, James F. Rill, *Recent Developments in Antitrust Enforcement*, in 38TH ANNUAL ANTITRUST LAW INSTITUTE 685, 721-27 (PLI Corp. L. & Prac. Course Handbook Series No. B-988, 1997).

that “*in general*” two-firm vertical agreements should be scrutinized as exclusive dealerships and reaffirmed that in the “vast majority of cases” such agreements have both a “pro-competitive intent and effect.”<sup>18</sup> Yet it did not provide any criteria to distinguish two-party group boycotts from exclusive dealerships. In its petition for certiorari, NYNEX seized on the court’s observation that in this case “no such pro-competitive rationale appear[ed] on the face of the complaint,”<sup>19</sup> to contend that *Discon* established an “entirely unsatisfactory and unpredictable rule of law” under which a jilted supplier could have a court strike down a perfectly reasonable supplier-purchaser agreement simply by drafting a complaint that failed to mention a procompetitive justification.<sup>20</sup> Amicus briefs supporting NYNEX’s petition echoed these concerns and predicted a flood of frivolous suits.<sup>21</sup>

NYNEX and the amici are partly right and partly wrong. The *Discon* panel was well aware that courts must be careful when classifying complicated arrangements. It began its analysis by noting that one of the “primary difficulties” in antitrust law is that the initial categorization of an agreement into the “rigid legal taxonomy” employed in cases is “often outcome-determinative. Under one category, the arrangement may be *per se* illegal, while under another, it may be found permissible under the rule of reason.”<sup>22</sup>

The *Discon* court’s concerns about classification mirrored those generally expressed by courts considering agreements that fall into traditionally *per se* illegal categories. The Supreme Court has explained that, as with any bright line rule, the “match between the presumed and the actual [under the *per se* rule] is imperfect.”<sup>23</sup> Indeed, the Court has maintained that a certain degree of overbreadth must be “tolerated” for the sake of business certainty and litigation efficiency.<sup>24</sup> In recent years, however, the Court has been increasingly forthright about the dangers of mechanically condemning complex agreements that literally fit within a *per se* illegal category. In *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc. (BMI)*,<sup>25</sup> the Court acknowledged that a challenged blanket licensing agreement “involve[d]

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18. *Discon*, 93 F.3d at 1061.

19. *Id.* Since one does not generally expect a complaint to detail possible defenses, it is surprising that the court suggests the absence of a procompetitive rationale to be significant.

20. See Petition for a Writ of Certiorari at 12-13, *Discon* (No. 96-1570). The Second Circuit acknowledged that some courts will be “reluctant” to apply the group-boycott rule to a two-party agreement because such agreements “will often resemble” exclusive dealerships. *Discon*, 93 F.3d at 1061. Thus, as NYNEX pointed out, the court seemed to have been “uneasily aware” that its rule might reach further than it intended. Petition for a Writ of Certiorari at 12.

21. See Motion of the Association of the Bar of the City of New York for Leave To File Brief as Amicus Curiae and Brief Amicus Curiae in Support of the Petitioners at 4-5; Motion for Leave To File Brief Amicus Curiae and Brief of Consumers Electronics Manufacturers Association as Amicus Curiae in Support of Petitioners at 9-12. Practically speaking, however, truly frivolous suits would probably fail for lack of antitrust standing or injury.

22. *Discon*, 93 F.3d at 1058-59.

23. *Arizona v. Maricopa County Med. Soc’y*, 457 U.S. 332, 344 (1982).

24. *Id.*

25. 441 U.S. 1 (1979).

'price fixing' in a literal sense."<sup>26</sup> Yet, the Court turned the per se rule on its head, requiring that courts take at least a quick look at possible procompetitive justifications to determine whether a given agreement should be evaluated under the rule of reason before classifying the agreement in a per se illegal category.<sup>27</sup> The label itself ceased to be determinative.

*BMI* recognized that classifying an agreement into a category deemed per se illegal risks condemning an agreement that is actually procompetitive. In *Discon*, the Second Circuit expressed the opposite concern, that classifying an agreement into a category that the court (mis)identified as "presumptively legal" risks upholding an agreement that is actually anticompetitive.<sup>28</sup> As a matter of law, the *Discon* court's fears were misplaced. The rule of reason is not a rule of per se legality; the test demands a nuanced evaluation of the competitive pros and cons of a specific agreement. But as a purely descriptive statement, the court's characterization of exclusive dealerships as presumptively legal was fairly accurate. The rule of reason almost always yields a pro-defendant outcome.<sup>29</sup>

Thus, when the *Discon* court was faced with an agreement that it feared might be anticompetitive, it apparently believed that it needed to pull the agreement out of the "exclusive dealership" category. To justify this move, it invoked language from *BMI* about the dangers of over-literality: "[E]asy

26. *Id.* at 9.

27. *See id.* The Court explained:

As generally used in the antitrust field, "price fixing" is a shorthand way of describing certain categories of business behavior to which the *per se* rule has been held applicable. Literalness is overly simplistic and often overbroad. Thus it is necessary to characterize the challenged conduct as falling within or without that category of behavior to which we apply the label "*per se* price fixing."

*Id.* Following *BMI*, the Supreme Court has chipped away at other per se rules. For example, not all literal "group boycotts" merit per se invalidation; instead, certain characteristics should be used to identify collective activity where there is a considerable "likelihood of predominately anticompetitive consequences." *Northwest Wholesale Stationers, Inc v Pacific Stationery & Printing Co.*, 472 U.S. 284, 295 (1985); *see also, e.g., State Oil Co. v. Khan*, 118 S. Ct. 275, 285 (1997) (overruling *Albrecht v. Herald Co.*, 390 U.S. 145 (1968), to hold that maximum retail price ceilings are not per se illegal), *NCAA v. Board of Regents*, 468 U.S. 85, 100-01 (1984) (declining to apply the per se rule to a "horizontal price fixing and output limitation" agreement because the case involved an industry "in which horizontal restraints on competition are essential if the product is to be available at all"), *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 15 (1984) (requiring that the plaintiff show market power before the Court would apply the per se rule to a tying agreement).

28. *Discon*, 93 F.3d at 1059 ("[W]e believe that the District Court may have been misled into categorizing the arrangement as one that is presumptively legal.")

29. For an extensive discussion of the ambiguities inherent in, and practical significance of, distinguishing in dual distribution contexts between horizontal restraints that are per se illegal and vertical restraints that are evaluated under the rule of reason, see Val D. Ricks & R. Chet Lottis, *Seeing the Diagonal Clearly*, 28 U. Tol. L. Rev. 151 (1996). The authors note that the distinction can "make or break" a case. *Id.* at 151; *see also, e.g., Albert A. Foer, The Political-Economic Nature of Antitrust*, 27 ST. LOUIS U. L.J. 331, 337-38 (1983) ("With only slight exaggeration, there is really only one thing one needs to know about the rule of reason: when the rule is applied, the defendant virtually always wins"), Richard A. Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1, 14 (1977) ("[T]he content of the Rule of Reason is largely unknown, in practice, it is little more than a euphemism for nonliability."). *But see, e.g., NCAA*, 468 U.S. at 119-20 (finding the challenged agreement illegal under rule-of-reason analysis).

labels do not always supply ready answers.”<sup>30</sup> The court did not immediately condemn the agreement as a per se illegal group boycott. Instead, following the logic of *BMI*, it suggested NYNEX should have an opportunity to explain its actions.<sup>31</sup> While the decision is somewhat ambiguous, it seems that the district court should apply the per se label only if NYNEX fails to prove any procompetitive justification for its agreement with AT&T Technologies.<sup>32</sup> The per se rule does not do any work. The agreement is no more—and no less—illegal if called per se illegal after a balancing test that essentially recreates the rule of reason than if found unreasonable under the rule of reason itself.<sup>33</sup>

*Discon* is dangerous because it allows a more extreme reading: Absence of a procompetitive justification in the complaint may serve as grounds for condemning potentially reasonable exclusive dealerships as per se illegal group boycotts without adequate (or any) consideration of possible procompetitive justifications. By permitting the use of a per se rule, *Discon* threatens to exact overcompliance through intimidation.

### III

A future decision could mitigate the potentially chilling effects of *Discon* by clarifying the distinction between horizontal and vertical agreements as applied to supplier-purchaser agreements. But the ad hoc line the court drew between “two-party group boycotts” and “exclusive dealerships” was a symptom of the court’s concern that the rule of reason can function as a standard of presumptive legality. Though expansion of a per se rule is not an appropriate response, the court’s fears may be well-founded. A better solution would be a renewed commitment to—and confidence in—the careful evaluation demanded by the rule of reason.

—Deborah A. Widiss

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30. *Discon*, 93 F.3d at 1059 (quoting *BMI*, 441 U.S. at 8).

31. *See id.* at 1061.

32. A footnote appended to the court’s last sentence in this section, however, suggested the possibility of a presumptive use of the per se rule since “the traditional rationale for applying the rule of reason to two-firm group boycotts—the promotion of interbrand competition over intrabrand competition—does not exist in this case.” *Id.* at 1061 n.6. Explicitly stating that the per se rule should be applied because of NYNEX’s monopoly power would at least circumscribe the reach of the decision. But this statement failed to recognize that there was no interbrand competition because NYNEX was a state-sanctioned monopoly. Since the court recognized that supplier-purchaser agreements can provide valuable efficiencies and since, in general, state regulators should be able to ensure that such efficiencies are passed along to the consumer, the absence of interbrand competition should not be dispositive. *Cf. State Oil Co.*, 118 S. Ct. at 280 (stating that the proper inquiry in establishing a per se rule is “not whether [the practice] is ever illegal, but whether it is always illegal” (quoting *Albrecht*, 390 U.S. at 165 (Harlan, J., dissenting))).

33. The court might have been concerned that the rule of reason would require extensive factfinding and complicated dissection of markets. While this is often true, the Supreme Court has stated that sometimes the rule of reason may be employed in the “‘twinkling of an eye.’” *NCAA*, 468 U.S. at 109 n.39 (quoting PHILLIP AREEDA, *THE “RULE OF REASON” IN ANTITRUST ANALYSIS* 37-38 (1981)).