Sherman Act Section 1 Fundamentals

A Lexis Practice Advisor® Practice Note by
Norman A. Armstrong, Jr., John D. Carroll, and Christopher C. Yook, King & Spalding LLP

Norman A. Armstrong, Jr.
King & Spalding LLP

John D. Carroll
King & Spalding LLP

Christopher C. Yook
King & Spalding LLP

This practice note provides an overview of Section 1 of the Sherman Act, which addresses agreements that harm competition. Section 1 prohibits "[e]very contract, combination . . . or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations." 15 U.S.C. § 1. Courts do not read Section 1 literally, however, because it would theoretically ban **all** contracts and stifle commercial activity. Instead, courts interpret Section 1 to only prohibit unreasonable restraints of trade. This practice note discusses the framework used to evaluate Section 1: whether there is a contract, combination, or conspiracy (i.e., concerted activity); whether a restraint is unreasonable; and whether a restraint affects interstate commerce or foreign trade. This note also examines two categories of restraints that can trigger liability under Section 1: horizontal (between competitors) and vertical agreements (between parties at different levels of the distribution chain).

For a more general overview of all U.S. antitrust laws and their application in civil litigation, see the practice notes Antitrust Law Fundamentals and/or Civil Antitrust Litigation Fundamentals. For a more focused discussion of horizontal or vertical restraints, see the practice notes Horizontal Restraints, Resale Price Restraints in Vertical Agreements, and/or Nonprice Restraints in Vertical Agreements.

Concerted Activity

Section 1 of the Sherman Act addresses only "concerted" activity, as opposed to the unilateral actions of a single firm, which are governed by other antitrust statutes. 15 U.S.C. § 1. An unlawful agreement under Section 1 must be a contract, combination, or a conspiracy involving separate actors. This section of the practice note first discusses what is a contract, combination, or conspiracy (i.e., an agreement) and what proof the courts require. Then, this section discusses the ***Copperweld*** doctrine, which dictates whether and to what extent commonly owned or closely affiliated entities can legally conspire with each other for purposes of Section 1.

Proving a Contract, Combination, or Conspiracy

A violation of Section 1 requires a showing that the alleged conspirators "had a conscious commitment to a common scheme designed to achieve an unlawful objective." Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752, 764 (1984). Plaintiffs can establish that defendants had this conscious commitment through direct or circumstantial evidence, both of which are described below. This section of the note also discusses the hub-and-spoke conspiracy.

Direct Evidence of a Contract, Combination, or Conspiracy

Direct evidence is that which is "explicit and requires no inferences to establish the proposition or conclusion being asserted." County of Tuolumne v. Sonora Cmty. Hosp., 236 F.3d 1148, 1155 (9th Cir. 2001). Direct evidence may include actual written agreements, covert recordings or videos (e.g., of a cartel meeting), documents directly showing the existence of a conspiracy, and eyewitness testimony. In many rule of reason cases, the parties dispute the reasonableness of a restraint rather than its existence, such as when there is an actual written agreement.

Example (written agreement). Antitrust cases involving most favored nation (MFN) clauses brought under Section 1 typically involve written, or at least express, agreements. For more information on how an MFN clause may violate the antitrust laws, see the practice note Most Favored Nation Clauses Risk Assessment.

The other types of direct evidence (i.e., other than written agreements), such as meeting recordings, eyewitness testimony, or party admissions, are more common in criminal cartel cases and in any civil follow-on actions to cartels. In criminal cartel cases, the Antitrust Division of the Department of Justice (the DOJ) has access to investigative tools that are not available in the civil context, such as the DOJ's Corporate Leniency Policy. Criminal cartel participants have an incentive to exit the conspiracy and cooperate with investigators against other cartel members.

Circumstantial Evidence of a Contract, Combination, or Conspiracy

Circumstantial evidence can also establish an unlawful agreement. There are limitations on the inferences that can be drawn from circumstantial evidence—ambiguous evidence that could be as consistent with lawful behavior as unlawful anticompetitive conduct cannot, standing alone, establish Section 1 liability. The rationale for such a rule is that courts and antitrust authorities do not want to deter procompetitive conduct. Therefore, to prove an agreement through circumstantial evidence, courts require that an antitrust plaintiff present evidence "that tends to exclude the possibility" that the alleged conspirators acted independently. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 588 (1986).

Many allegations of concerted action by competitors are based on conscious parallelism, which means a pattern of conduct in which competitors act uniformly. A classic example of conscious parallelism is gas stations at the same intersection. Since gas stations post prices prominently, gas stations at the same intersection may often have the same or nearly the same prices, even if there is no agreement between the competing gas stations.

Courts hold that conscious parallelism alone will not support a finding of concerted action. Rather, plaintiffs must prove other facts and circumstances, known as plus factors, that, along with conscious parallelism, support an inference of concerted rather than unilateral activity. Courts have identified at least three types of plus factors:

- **Evidence that the defendant had a motive to enter a conspiracy.**

Example. Markets that are highly concentrated may be conducive to collusion. Conversely, in markets with a "fringe" of sellers, the conspiring firms may lose business to that fringe if they attempt to raise prices and/or may find it difficult to enforce discipline among the conspiring firms. So, there is greater motive to enter a conspiracy in a concentrated market, and less motive in nonconcentrated markets.

- **Evidence that the defendant acted contrary to its own interest.** This type of plus factor is typically considered the most important, because it is most probative of concerted action.

Example. Raising prices in a time of oversupply may be against a firm's independent economic interest.

- **Evidence that the defendants got together and exchanged assurances of common action or adopted a common plan (i.e., evidence implying a traditional conspiracy).** However, evidence that merely indicates an opportunity for collusion (e.g., attending the same trade show) is fairly weak on its own.

Courts view plus factors in their entirety rather than viewing each alone or in a vacuum.

Hub-and-Spoke Conspiracy

Note that a conspirator need not even communicate with all of its co-conspirators to engage in an unlawful horizontal agreement. In a hub-and-spoke conspiracy, one defendant serves as the "hub" connecting multiple "spokes," even though the spokes may not directly deal with each other. In the classic example, a dominant purchaser (the hub) enters into a series of agreements with its suppliers (the spokes). This set of vertical agreements becomes a horizontal agreement if there are facts showing an agreement among the spokes.

Example. In ***Toys "R" Us v. FTC***, FTC staff alleged, the full Commission agreed, and the Seventh Circuit upheld, that a leading toy retailer negotiated a series of agreements with toy manufacturers that the manufacturers would deal with discounting warehouse club stores only on certain terms (that were favorable to Toys "R" Us and unfavorable to the warehouses), but the manufacturers agreed to those terms only on the condition that all their competitors do the same. 221 F.3d 928 (7th Cir. 1999).

The Copperweld Doctrine

Under the ***Copperweld*** doctrine, agreements between separate legal entities are exempt from Section 1 if those entities have a "unity of purpose or a common design" by virtue of ownership or control. Copperweld v. Independence Tube Corp., 467 U.S. 752 (1984). At first glance, it may seem a straightforward proposition that a single person or entity cannot conspire with itself but there are myriad complex business arrangements that may or may not result in the formation of a single entity for antitrust purposes.

Example. In *American Needle, Inc. v. National Football League*, the Supreme Court held that the 32 football teams of the NFL were "independent centers of decisionmaking" capable of conspiring with each other and therefore subject to Section 1's prohibitions. 560 U.S. 183 (2010).

Many lower court decisions provide further guidance and suggest that businesses are more likely to be viewed as having a unity of interest or purpose (and hence avoid Section 1 liability) if one entity has majority ownership of the others, or if one entity has actual control or ownership of the others, formal arrangements notwithstanding.

Courts have held that the entities in the following cases were incapable of conspiring with each other for purposes of Section 1:

- A federal district court ruled that a parent company and its 51%-owned subsidiary are incapable of conspiring with each other for the purposes of Section 1. Direct Media Corp. v. Camden Tel. & Tel., 989 F. Supp. 1211, 1217 (S.D. Ga. 1997).
- The Fifth Circuit ruled that "sister corporations" (two companies wholly owned by another company) have effectively the same relationship as a parent company and its wholly owned subsidiary. Century Oil Tool Co. v. Prod. Specialties, 737 F.2d 1316 (5th Cir. 1984).
- The Eleventh Circuit ruled that Section 1 did not apply to U-Haul and some of its independent dealers because the dealers rented their equipment from U-Haul, which owned and bore most of the risk of loss on it. See Day v. Taylor, 400 F.3d 1272, 1277 (11th Cir. 2005).

However, some courts maintain that the ***Copperweld*** doctrine to Section 1 applies narrowly: only to corporations owned 100% in common, or a de minimis amount less than 100%. See, e.g., Aspen Title & Escrow, Inc. v. Jeld-Wen, Inc., 677 F. Supp. 1477, 1486 (D. Or. 1987); Sonitrol of Fresno, Inc. v. Am. Tel. & Tel. Co., No. 83-2324, 1986 U.S. Dist. LEXIS 26034 (D.D.C. Apr. 30, 1986).

The treatment of joint ventures under the ***Copperweld*** doctrine has similarly evolved. The Sixth Circuit has held that a joint venture among a group of Ohio-based hospitals could be subject to liability under Section 1 for a conspiracy designed to keep new hospitals from entering the market. The court noted that the "substance, not form" of the arrangement is dispositive, and that the analysis looks beyond the mere corporate structure or formalities of a joint venture to assess whether the parties are truly functioning as a single entity. The Med. Ctr. at Elizabeth Place, LLC v. Atrium Health Sys., 817 F.3d 934 (6th Cir. 2016).

For more information on whether joint venture parties can take advantage of the ***Copperweld*** doctrine and the consequences of that answer, see the discussion of "Governance of the Joint Venture" in the practice note Joint Venture Antitrust Considerations.

Determining Unreasonableness – Framework for Review

Courts employ one of three tests to determine whether an economic activity amounts to an unreasonable restraint of trade in violation of Section 1:

- Under the **per se rule**, certain manifestly anticompetitive economic activities are deemed to be always unlawful, regardless of the actual consequences of those activities or the intent behind them, because they consistently produce anticompetitive effects and bear limited potential for procompetitive benefits. Courts apply the per se rule only to those agreements with which the courts have had sufficient experience (such as horizontal price-fixing) to recognize it as nearly always anticompetitive.
- Most other restraints are evaluated under the **rule of reason**, which requires the factfinder to weigh all aspects of an arrangement to determine, on the whole, if it constitutes an unreasonable restraint on competition. The rule of reason takes into consideration factors such as specific details about the business at issue, market conditions, and the arrangement's history, nature, and economic impact, as well as any procompetitive justifications. Also, the rule of reason considers whether there is a less restrictive alternative to the restraint.
- Some courts have employed the **"quick look test"** or "abbreviated rule of reason" where the anticompetitive effect is clear but the restraint does not fall into the per se rule. The quick look test is more administratively efficient than a full rule of reason analysis. The courts apply this standard to arrangements that seem to have an anticompetitive effect at first glance, but where there is also a plausible procompetitive justification or where the agreement arises in an un-

familiar context. The quick look test essentially shifts the burden onto the defendant to show empirical evidence of procompetitive effects.

The selection of the analytical test in any given case depends on the type of agreement and the surrounding economic circumstances. Note that the choice of framework is not always clear. Rather, courts determine it on an ad hoc basis based on the unique circumstances of each case. As one circuit court observed, "[t]he boundaries between these levels of analysis are fluid," and they "are best viewed as a continuum." Cont'l Airlines, Inc. v. United Airlines, Inc., 277 F.3d 499, 509 (4th Cir. 2002).

For more information on these three tests, including how they differ, and how they impact how a case proceeds, see the practice note Standards to Assess the Legality of Conduct in Antitrust Cases.

Interstate Commerce or Foreign Trade

The Sherman Act's reach is limited to interstate commerce or trade with foreign nations. While there are not many cases describing what is trade or commerce, the few that exist tend to deal with the activities of charitable or nonprofit organizations (e.g., universities). Activities of charities or nonprofits that are commercial in nature, rather than charitable or otherwise noncommercial, fit the definition of trade or commerce. As to whether the commerce is interstate, the Sherman Act's reach is roughly coextensive with Congress's power under the Commerce Clause.

Section 1 also prohibits unreasonable restraints upon foreign trade, but the Foreign Trade Antitrust Improvements Act (FTAIA) exempts some activities involving foreign trade from Section 1 liability. 15 U.S.C. § 6a. Specifically, the FTAIA carves out activities carried out abroad that do not have a "direct, substantial, and reasonably foreseeable effect" on domestic commerce. Section 1 does apply, however, when foreign trade or a related foreign activity significantly harms imports, domestic commerce, or American exporters. Accordingly, no litigant can recover damages based solely on foreign activity, because American antitrust laws do not regulate other nations' economies. Even when foreign conduct creates a substantial harm in the United States independent from the harm it creates overseas, antitrust claims based solely on the foreign harm will still fail in U.S. courts. However, a claim is colorable if it is based on domestic harms caused by foreign conduct. Courts increasingly interpret the FTAIA as a substantive element of an antitrust cause of action, and may dismiss a complaint upon a Rule 12(b)(6) motion if the complaint does not adequately allege a domestic injury.

For more discussion of FTAIA and how the U.S. antitrust laws apply to foreign trade, see the practice note Foreign Trade Antitrust Improvements Act (FTAIA) and the Extraterritorial Reach of U.S. Antitrust Laws.

Examples of Horizontal and Vertical Agreements

Horizontal Agreements

Horizontal agreements are those imposed by agreement between competitors in a relevant market. The following horizontal agreements are examples of those that may be unlawful under the antitrust laws:

- **Price-fixing agreements.** Agreements between competitors to fix prices for services or products are always or almost always per se illegal. The Supreme Court has called horizontal price-fixing an "archetypal example" of an unlawful restraint. Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643, 647 (1980). For more information on price-fixing, see the practice note Horizontal Restraints.

- **Market or customer allocation.** Like price-fixing, an agreement to allocate a geographic, product, or service market is a classic example of an unlawful horizontal agreement. Geographic market allocations are agreements between competitors to carve a relevant market into territorial parcels and assign them to competitors to minimize competition. The Supreme Court has frequently applied the per se rule to market division cases, stating that "[h]orizontal territorial limitations . . . are naked restraints of trade with no purpose except stifling of competition." Palmer v. BRG of Georgia, Inc., 498 U.S. 46, 49 (1990), citing White Motor Co. v. United States, 372 U.S. 253, 263 (1963). For more information on market allocation, see the practice note Horizontal Restraints.

- **Group boycotts.** The most direct form of a group boycott occurs when a group of businesses deals with third parties on the condition that the third parties do business on the groups' terms or refuse to deal with those businesses' competitors. As the term implies, group boycotts are **concerted** refusals by one group of businesses to deal with another group of businesses. Accordingly, one competitor's refusal to deal with a particular business (i.e., a unilateral refusal to deal) is not a group boycott. For more information on group boycotts, including when the per se rule might apply, see the practice note Group Boycotts or Concerted Refusals to Deal.

- **Information exchanges.** Market competitors frequently exchange industry information, whether directly or through trade associations. Although exchanging information is not per se illegal, it can independently violate Section 1 or be treated as circumstantial evidence of unlawful horizontal agreements, such as price-fixing conspiracies. Therefore, you should consider the exchange of pricing information between competitors a high-risk practice under certain circumstances. For more information on when information exchanges may violate Section 1, see the practice note Exchanges of Competitively Sensitive Information.

Vertical Agreements

Vertical agreements—that is, arrangements between firms at different levels of a single distribution chain—can also violate Section 1 of the Sherman Act. These types of arrangements are labeled vertical because they involve firms at different levels within a chain of distribution, rather than between horizontal competitors within a market. Vertical arrangements subject to antitrust scrutiny commonly arise under two circumstances: arrangements directly involving prices and those impacting product distribution. A few common examples of vertical restraints are discussed further below.

Vertical Price Restraints

Vertical price restraints, also referred to as resale price maintenance, refer to a manufacturers' imposition of restrictions on the price at which distributors or retailers can sell its products. These types of arrangements can be anticompetitive because they may result in products being sold to consumers at supracompetitive prices—that is, above the prices naturally dictated by market forces. Resale price maintenance can involve the imposition of either minimum or maximum prices. Courts scrutinize minimum price restraints more closely because they set a floor for prices. From a manufacturer's perspective, resale price maintenance can encourage competition between brands (interbrand competition) by incentivizing retailers to invest in high-quality service and eliminating free-riding discount retailers. This justification may be particularly applicable to luxury brands, where the customer experience may be even more impactful. Empirical economic studies have confirmed the correlation between resale price maintenance and fostering interbrand competition.

In an influential decision from 2007, the U.S. Supreme Court held that resale price maintenance does not always harm competition and must thus be evaluated under the rule of reason. Leegin Creative Leather Prods. v. PSKS, Inc., 551 U.S. 877 (2007). The court cited the growing scholarship recognizing the procompetitive aspects of the practice and noted that that evidence suggested the efficient use of resale price maintenance was not just hypothetical. Therefore, antitrust challenges to resale price maintenance agreements under federal antitrust laws are evaluated under the rule of reason, taking into consideration the specific details of the business as well as competitive harms and procompetitive justifications. However, note that some states continue to treat minimum resale price maintenance as per se illegal under their own antitrust laws.

For more information on vertical price restraints, including state-level treatment of minimum resale price maintenance, see the practice note Resale Price Restraints in Vertical Agreements.

Exclusive Dealing Agreements

One common example of a nonprice vertical restraint that affects product distribution is an exclusive dealing agreement, where a buyer (or seller) agrees to only purchase from (or sell to) one particular seller (or one particular buyer) for a set period of time. Such arrangements can harm competition either by foreclosing sales outlets to a seller's competitors or by cutting off other manufacturers' access to important input materials (exclusive supply agreements). However, exclusive dealing arrangements can also have procompetitive effects. For example, exclusive dealing agreements may benefit competition by encouraging retailers to provide high levels of service by focusing on a single manufacturer, and can also ensure consistent supply and predictable pricing to consumers.

Because exclusive dealing agreements have some procompetitive aspects, courts evaluate them under the rule of reason, not the per se rule. Exclusive dealing agreements do not violate Section 1 unless they foreclose competition in a substantial share of the market. In Tampa Electric Co. v. Nashville Coal Co., the Supreme Court held that the analysis must go beyond the quantitative assessment of the percentage of the relevant market foreclosed, to an evaluation of the probable future effects and the particularized considerations of the parties' operations, including potential procompetitive public interest considerations. 365 U.S. 320, 328, 334–35 (1961). Among the factors courts consider in applying the rule of reason test are the nature and extent of foreclosure and the duration of exclusivity.

Note that plaintiffs can challenge exclusive dealing agreements not only under Section 1 of the Sherman Act, but also Section 2, and also Section 3 of the Clayton Act and Section 5 of the FTC Act.

For more detail on the antitrust risk of exclusive dealing arrangements, see the practice note Exclusive Dealing Arrangements and Anticompetitive Concerns. For more detail on nonprice vertical restraints in general, see the practice note Nonprice Restraints in Vertical Agreements.

Norman A. Armstrong Jr., Partner at King & Spalding LLP

Norman A. Armstrong, Jr. is a partner in the Washington, D.C. office of King & Spalding and co-heads the firm's global Antitrust Practice Group. His practice focuses on antitrust litigation, complex transactions, antitrust counseling, and government investigations in both civil and criminal matters. Norm represents clients before state and federal regulators including the Department of Justice and the Federal Trade Commission as well as foreign competition agencies across a wide range of industries. Norm is the former Deputy Director and Deputy Assistant Director of the Federal Trade Commission and holds leadership positions in the American Bar Association Section of Antitrust Law.

John D. Carroll, Partner at King & Spalding LLP

John D. Carroll is a partner in the Antitrust Practice Group in the Washington, D.C., office of King & Spalding. His practice focuses on civil and criminal antitrust matters, including mergers & acquisitions, strategic counseling and compliance, and global cartel investigations, where he represents clients before the Department of Justice Antitrust Division, Federal Trade Commission, and international and state antitrust enforcement authorities. John holds leadership positions in both the American Bar Association Section of Antitrust Law (Vice-Chair, Healthcare & Pharmaceuticals Committee) and the American Health Lawyers Association Antitrust Practice Group (Social Media Chair). John started his career as a staff attorney in the Mergers I Division of the Federal Trade Commission's Bureau of Competition. While with the FTC, he investigated, challenged, and negotiated settlements in a number of potentially anti-competitive business combinations in the technology, consumer products, defense, healthcare, and pharmaceutical industries and received an Award for Meritorious Service for work on merger litigation.

Christopher C. Yook, Senior Associate at King & Spalding LLP

Christopher C. Yook is a senior associate in the Antitrust Practice Group of King & Spalding. He advises clients on the antitrust implications of strategic business decisions, including securing approvals for cross border mergers and acquisitions. Chris also represents clients in government enforcement actions and complex civil litigation, including some of the largest class actions. Chris has received recognition for his achievements in antitrust litigation and also holds leadership roles in bar associations, including serving as a Young Lawyer Representative for the American Bar Association Section of Antitrust Law.