

By **Anthony A. Dean**

Creating a Sound Joint-Purchasing Facility

Companies adhering to a specific set of criteria can benefit greatly from a joint-purchasing facility while avoiding antitrust violations.

The creation of a joint-purchasing facility as a means of cost reduction is receiving increasing attention in many industries. By pooling purchases of materials or services, the members may be able to negotiate more favorable terms, take advantage of volume discounts, and realize economies of scale and other efficiencies. The candidates for such a facility, however, are likely to be competitors. Supply management professionals (as well as others) receive frequent admonitions from legal counsel not to have discussions with competitors, let alone enter into agreements with them, because of possible antitrust problems. Can a joint-purchasing facility be structured in a way that will avoid antitrust challenge?

Yes. A joint-purchasing facility is not a *per se* violation of the antitrust laws, but will be evaluated under the “rule of reason,” meaning that its purpose and effect on competition will be assessed in light of all the relevant facts and circumstances. If the limitations discussed below are observed, your antitrust counsel may well conclude that a joint-purchasing facility is feasible.

Antitrust Principles

The Sherman Antitrust Act makes any agreement in restraint of interstate or foreign trade unlawful and authorizes civil and criminal suits to enforce the prohibition. While complaints about price-fixing agreements among sellers are the most common, the Supreme Court has held that an agreement among competing buyers that purchased virtually all of a particular raw material in a geographic market area could also violate the antitrust laws. According to Guidelines the Federal Trade Commission (FTC) and the U.S. Department of Justice issued in 2000, however, such agreements are likely to violate the law only when the participants collectively possess sufficient market share and power to drive the price of the purchased product below what likely would prevail in the absence of agreement, and thereby depress output, or facilitate collusion by standardizing participants’ costs or by enhancing the ability to project or monitor other participants’ output level through knowledge of their input purchases.

A Business Review Letter (which does not approve an arrangement, but states only that, based on the facts provided the Department of Justice, it has no present intention of challenging it; it is rare, however, for the Department to challenge arrangements that have been the subject of favorable letters) from the Antitrust Division of the Department of Justice in October 2003 illustrates the application of the Guidelines. The Division stated that it did

not intend to challenge a consortium of independent and small cable television systems engaging in joint purchasing of television programs. The joint action could lower programming costs and therefore be pro-competitive, the Division said. It was unlikely to be anti-competitive because the consortium members served only a small percentage (10.2 percent) of all U.S. cable subscribers; collusion among members was unlikely because the consortium members competed to a very limited extent — only about 3.4 percent of the group’s subscribers were served by more than one member of the group; and the program was voluntary and members could choose to bid independently.

That Business Review Letter also noted that the antitrust enforcement policy for healthcare adopted by the FTC and the Antitrust Division in 1996 provides a “safe harbor” for joint-purchasing arrangements among healthcare providers. Such arrangements will not be challenged if: (1) the joint purchases account for less than 35 percent of total sales of the product in the relevant market, and (2) the cost of the jointly purchased products accounts for less than 20 percent of the total revenues of each competing participant in the joint plan. By citing the healthcare policy statement in its 2003 Review Letter, the Antitrust Division implied that the same percentages may be applied to joint-purchasing agreements in other industries. Such application of the “safe harbor” percentages is also suggested by a Business Review Letter in January 1999 in which the Antitrust Division approved a plan under which an association of funeral homes would engage in joint purchasing of caskets. It noted that membership in the association would be capped at a point such that its purchases would not exceed 35 percent of U.S. casket sales.

Creation and operation of a joint-purchasing facility will necessarily involve an ancillary exchange of information between the parties, including the most recent unit prices paid by each party under its supply contracts. The exchange of cost information among competitors can violate the antitrust laws depending on the character of the information and the use made of it. The Supreme Court has found, however, that an exchange of production cost information did not constitute a violation where there was no evidence of an actual agreement or concerted action to use the information to curtail production or raise prices. ►

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Application of the Standards and Recommendations

1. Limit size to avoid market power. The joint facility should not negotiate the purchase of a given material if the combined annual purchases of its members would be more than 35 percent of total annual U.S. sales of the material or more than 35 percent of total annual sales in any regional geographic market recognized as such in the trade. Such regional markets usually involve high bulk/low unit value, or perishable products that are not shipped long distances.

2. Structure to avoid opportunity for collusion. The joint facility should not negotiate the purchase of materials that are significant inputs (as a fraction of total cost) in the manufacture of finished products that members of the joint facility sell in competition with each other. The total annual cost of the jointly purchased products should not exceed 20 percent of the total revenues of each competing participant in the joint enterprise. This limitation suggests that joint facilities will tend to have members of roughly equal size. Companies that are small in relation to other members may not be welcome because 20 percent of the revenues of the smallest member will be the maximum that can be purchased jointly.

In choosing joint-purchasing partners, it is also desirable to look for companies that purchase the same raw materials, but which do not compete or compete to only a limited extent at the output level. Chemical producers, for example, may purchase the same basic chemical feedstocks, but use them to produce different end products. If the members do not compete at the output level, the above limitations on amount of purchases will not apply.

3. Limit the exchange and use of competitively sensitive information. To determine the feasibility of joint purchasing, the parties may only need to exchange general information such as the raw materials that are purchased by the participants, approximate quantities and potential suppliers. In most cases, this exchange will not entail antitrust risk. Creating the facility will require exchanging more detailed information for each product that will be purchased jointly, including each company's annual dollar volume (its "spend"), the business units making the purchases, the locations using the product, the name of the principal supplier, whether long-term contracts exist and, if so, their terms and expiration or termination dates. Unit prices for specific products also can be exchanged, but it is preferable to defer doing so until shortly before the termination of any existing contracts and the commencement of joint-purchasing negotiations.

To further exclude a possible charge of collusion, the parties should consider limiting distribution of information that could be used to predict other participants' output or prices by entering into a confidentiality agreement. Although such an agreement is

not essential if the parties are well below the "safe harbor" percentages discussed above, it will provide valuable insurance against antitrust challenge in any case.

An appropriate agreement will provide, among other things:

- a. That confidential information be exchanged in writing.
- b. That each such writing be marked "Confidential" in a prominent manner.
- c. That Confidential documents will only be disclosed to purchasing department employees of the members that are responsible for the creation or operation of the joint facility, officers and in-house and outside attorneys with responsibility for the project, and others who have a "need to know" related to the joint facility. Persons to whom disclosure is made should confirm that they have read and understood the terms of the agreement.

4. Permit independent purchasing. If it is feasible from a business standpoint, each member should be permitted to "opt out" of the joint facility with respect to any particular product and purchase it independently. Permitting such flexibility is not absolutely necessary (according to a 2000 Business Review Letter), but it is regarded as a positive factor by the enforcement agencies. In addition, each party should be permitted to withdraw from the facility after a reasonable time and on reasonable notice to the others. Following a withdrawal, the remaining members may have the option to terminate the facility.

Implementation

A joint-purchasing facility can be created by contract among the participants. One simple operating method is for the member that currently purchases the largest annual amount of a particular input to take the lead in negotiating new purchase arrangements for that product at the best prices and terms that can be obtained based on all of the members' requirements. Such negotiations will commence in advance of the expiration of existing long-term supply agreements, or sooner if supply contracts are terminable. Any savings that are realized over current prices will be shared among the members in accordance with an agreed-upon formula or formulas.

When the number of members is large, or when it is expected that the volume of purchases will be large, that logistics will be complex and that the facility will enjoy an extended lifetime, the additional expense of creating a joint venture corporation, LLC or partnership may be justified. Such an entity may have independent management and may purchase and resell for its own account as well as acting as the agent for its members, issues that are beyond the scope of this analysis. Depending on the circumstances, especially the extent to which the members compete, seeking a Business Review Letter may be a prudent step. Large joint ventures (total investment of \$50 million or more) will require a formal report to the enforcement agencies. *ism*

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