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FTC Upholds Charges that Toys "R" Us Induced Toy Makers to Stop Selling Desirable Toys to Warehouse Clubs

Nations Largest Toy Retailer Ordered To Stop Illegal Practices Which Have Injured Competition and Consumers

FOR RELEASE

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Toys "R" Us, the nation's largest toy retailer, was ordered today by the Federal Trade Commission to stop engaging in illegal practices that keep toy prices higher and reduce choice for consumers. Toys "R" Us, the FTC said, was concerned that warehouse clubs -- with substantially lower prices -- presented a threat to its low-price image and its profits. The Commission determined that to eliminate this threat, Toys "R" Us used its dominant position as a toy distributor to extract agreements from and among toy manufacturers to stop selling to warehouse clubs the same toys that they sold to other toy distributors. The Commission's opinion, authored by FTC Chairman Robert Pitofsky, explains that Toys "R" Us wanted "to prevent consumers from comparing the price and quality of products in the clubs to the price and quality of the same toys displayed and sold at Toys "R" Us, and thereby to reduce the effectiveness of the clubs as competitors."

"Toys "R" Us rose to its current position as the largest toy retailer in the United States by offering a larger selection of toys than any other retailer at the lowest prices," said Chairman Pitofsky. "Indeed, a remarkable irony of this case is that if the law were as Toys "R" Us contends -- if a large [retailer] could cut off or encumber a new or innovative [company's] source of supply by exercising market power against suppliers -- then Toys "R" Us, itself an innovative marketer resented by larger and less dynamic [companies] a generation ago, could have been denied an opportunity to compete on the merits and win in the marketplace."

Toys "R" Us, based in Paramus, New Jersey, has about 650 stores located throughout the United States and roughly another 300 stores in foreign countries. Toys "R" Us offers an assortment of about 11, 000 individual toy items throughout the year. The company also buys about 30 percent or more of the large toy companies' total output and is usually their most important customer. Toy manufacturers who participated in the boycott account for 40 percent of all toy sales in the United States and therefore have market power, the Commission determined. According to the Commission, no other toy retailer carries as many toys or purchases such a large percentage of the toy manufacturers' output.

The Commission noted that retail margins enjoyed by different types of retailers vary widely. Toys "R" Us' average margins are close to 30 percent above cost. Warehouse clubs sell toys at prices as low as 9 percent above wholesale cost.

In the past, when Toys "R" Us faced new, lower-priced competition from Wal-Mart, Target and other regional and national discount chains, Toys "R" responded by lowering its own toy prices and improving the presentation of toys in Toys "R" Us stores. The Commission found, however, that Toys "R" Us behaved quite differently when confronted with the dramatically lower prices of the warehouse clubs. By the end of the 1980s these clubs had emerged as increasingly important toy retailers in much the same way that Wal-Mart and the other discounters had done before. The warehouse clubs -- by reducing costs, selling branded products at low prices and increasing product turnover -- soon became the fastest growing retail outlet of toys. Contemporary estimates predicted that they would grow to occupy a significant percentage of the toy market, bringing down retail prices in all channels of distribution as they grew.

Fearing that warehouse clubs presented a greater threat than Wal-Mart and Target had to Toys "R" Us' prices and profits, Toys "R" Us planned to restrict or cut off the clubs' supply of key toy products. The Commission found that Toys "R" Us did this by inducing its suppliers to sell to the clubs only toys that were unique and highly differentiated -- most often so-called "combo" packages of two or more toys -- from the toys sold to Toys "R" Us. According to the Commission, beginning in 1992, Toys "R" Us entered into *vertical* agreements with 10 manufacturers to restrict their sales to clubs. (The 10 toy manufacturers who entered into vertical agreements are: Mattel, Hasbro, Fisher Price, Tyco, Little Tikes, Today's Kids, Tiger Electronics, VTech, Binney & Smith and Sega.) Toys "R" Us also used the acquiescence of one manufacturer to obtain that of others, orchestrating a *horizontal* agreement among at least seven manufacturers to adhere to Toys "R" Us' restrictions. (These seven manufacturers are: Mattel, Hasbro, Fisher Price, Tyco, Little Tikes, Today's Kids, and Tiger Electronics.) "Through its announced policy and [these] related agreements, Toys "R" Us sought to eliminate the competitive threat the clubs posed by denying them merchandise, forcing the clubs' customers to buy products they did not want, and frustrating consumers' ability to make direct price comparisons of club prices and Toys "R" Us prices," the opinion states.

The Commission further found that Toys "R" Us enforced the agreements by fielding complaints from toy manufacturers about their competitors' sales to warehouse clubs. When manufacturers complained that a competitor was selling to warehouse clubs, Toys "R" Us again threatened to stop buying that competitor's products and got its renewed acquiescence to the sales restrictions.

The FTC announced its complaint against Toys "R" Us in May 1996. The charges were upheld by Administrative Law Judge James P. Timony in a September 1997 decision. Toys "R" Us appealed, and the Commission heard oral argument on February 19, 1998.

The Commission agreed with Judge Timony that Toys "R" Us "halted a pattern of rapid growth of toy sales at the clubs" and noted that the "boycott hobbled individual clubs' toy business." Citing warehouse club Costco's experience, the Commission found that "while its overall growth on sales of all products during the period 1991 to 1993 was 25 percent, Costco's toy sales increased during the same period by 51 percent. But, after the boycott took hold in 1993, Costco's toy sales decreased by 1.6 percent despite total sales growth of 19.5 percent." The Commission also pointed out that reversal of the clubs' success as toy retailers can also be seen by examining individual toy manufacturer's sales to the clubs. For example, Mattel's sales to warehouse clubs declined from over $23 million in 1991 to $7.5 million in 1993.

The opinion underscores that the most significant effect of the agreements was to eliminate competition that would have driven Toys "R" Us to lower its prices had Toys "R" Us not taken action to stifle the competitive threat posed by the clubs.

The Commission found that Toys "R" Us' only asserted justification for its conduct -- that the agreements were necessary to prevent free riding on its advertising and "showroom" status -- was entirely without merit. The toy manufacturers and not Toys "R" Us (or any other retailer) promote toys to consumers, primarily by designing and purchasing television advertising, and Toys "R" Us is compensated for any services it does provide the toy industry, the Commission found.

The Commission used a four prong test that the Supreme Court has set out to provide guidance as to when boycotts are *per se* illegal under the antitrust laws. The Supreme Court found that these boycotts generally display four common factors. The opinion states that "[w]e conclude from the evidence in this case that each of the factors ... is present." First, the purpose of the group boycott agreement was anticompetitive, in that it was designed to disadvantage competitors of Toys "R" Us. Second, the firms involved (both Toys "R" Us and the manufacturers) were dominant in their markets. Third, the boycott cut off access to products and relationships needed for the boycotted firms to compete effectively. Lastly, the practice was not justified by plausible arguments that it enhanced overall efficiency. "Toys "R" Us and its reluctant collaborators set out to eliminate from the marketplace a form of price competition and a style of service that increasing numbers of consumers preferred," the Commission said.

The Commission also examined Toys "R" Us' conduct under the full *rule of reason* and found that its behavior would also be illegal under this more elaborate mode of analysis. The additional factors that the Commission examined were whether Toys "R" Us' behavior had a significant anticompetitive effect and whether any such effect is outweighed by legitimate business justifications. The Commission found that Toys "R" Us' orchestrated boycott "had harmful effects for the clubs, for competition, and for consumers" and that there was "no business justification for a boycott that had a pronounced anticompetitive effect."

The Commission's order prohibits Toys "R" Us from continuing, entering into, or attempting to enter into, vertical agreements with its suppliers to limit the supply of, or refuse to sell, toys to a toy discounter. The order also prohibits Toys "R" Us from facilitating, or attempting to facilitate, an agreement between or among its suppliers relating to the sale of toys to any retailer. Additionally, Toys "R" Us is enjoined from requesting information from suppliers about their sales to any toy discounter, and from urging or coercing suppliers to restrict sales to any toy discounter. According to the Commission, "[t]hese four elements of relief are narrowly tailored to stop, and prevent the repetition of Toys "R" Us' illegal conduct."

The Commission vote to issue the opinion and order was 4-0, with Commissioner Orson Swindle concurring in part and dissenting in part.

Commissioner Swindle concurred in the Commission majority's determination that Toys "R" Us ("TRU") entered into a series of anticompetitive vertical agreements with various toy manufacturers. However, he found that the evidence in the record was insufficient to support the majority's conclusion that TRU orchestrated a horizontal boycott among the manufacturers.

According to Commissioner Swindle, "it is precisely the plausibility of the vertical theory and the strength of the evidence underpinning that theory that undercut the majority's finding of a horizontal conspiracy among toy manufacturers." Swindle further stated that "[t]here is a paucity of evidence -- direct or circumstantial -- that the manufacturers developed among themselves a scheme to boycott the clubs." Indeed, "TRU's hammerlock on the manufacturers made [any such] horizontal agreement among the manufacturers simply unnecessary." He observed that "TRU's very indispensability gave each toy manufacturer every incentive -- every *unilateral* incentive -- to knuckle under to TRU's demands regarding the clubs." In Swindle's view, "No inference of horizontal agreement is necessary to make sense of the manufacturers' actions."

Swindle contended that rather than there being "hub and spoke" arrangement directed by TRU or some other type of horizontal conspiracy among manufacturers, the "glue that held TRU's scheme together was each manufacturer's individual decision not to cross its most important customer's interests." The Commissioner concluded: "I am simply unable to find a horizontal boycott on the basis of this evidence. The gaps and ambiguities in the record require that I dissent from the conclusion that TRU orchestrated an anticompetitive horizontal agreement."

The order will be effective 60 days after it is served on the respondent. Under the Commission's rules, ex parte communications regarding this matter are barred until the Commission has disposed of any petition for reconsideration, or until the time for filing such petitions (14 days after service) has elapsed.

Copies of the opinion and order and other documents associated with this case, are available from the FTC's web site at *http://www.ftc.gov* and also from the FTC's Consumer Response Center, Room 130, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580; 202-FTC-HELP (202-382-4357); TDD for the hearing impaired 1-866-653-4261. To find out the latest news as it is announced, call the FTC NewsPhone recording at 202-326- 2710.

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