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The effects of exclusive contracts on organizational competitiveness

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Dedication

I dedicate this thesis to my family for continuously supporting me throughout my life and my college experience. Their support and encouragement is what motivated me to continue through the honors program at James Madison University. I would also like to dedicate this thesis to Mollie Brooks for being my “Thesis Buddy” over the past year. Her support and friendship throughout this process considerably more enjoyable.

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Introduction

Organizational Competitiveness

In order to compete effectively, organizations must capitalize on their competitive advantages within their business strategy. Competitive advantage comes from “a firm’s resources and capabilities that enable it to overcome the competitive forces in its industry(ies)” (Dess, Eisner & Lumpkin, 2010). Organizations derive their competitive advantage from various aspects of the organization and these advantages must be difficult to imitate in order to provide a sustainable advantage. According to Michael Porter, there are three generic strategies to achieve competitive advantage. The first is cost leadership, which is requires minimizing costs in all aspects of the business. This does not necessarily mean that the company offers the lowest prices, just that they minimize their costs. The second strategy is differentiation, which involves creating a product or service that receives industry wide recognition as being unique and valued by customers. The final generic strategy is the focus strategy, used by companies that want to gain a competitive advantage by focusing on a very specific market (Porter, 1996). There are countless ways to achieve a competitive advantage within these generic strategies. Overall, the main competitive goal for an organization should be either to perform activities that are different from its competitors or to perform similar activities in a different way.

Strategic Assets

One way that organizations can attain a competitive advantage within their industry is by utilizing their assets, both tangible and intangible. Strategic assets must be “difficult or even impossible to copy” in order to provide a significant and unique advantage in the marketplace (Connor, 2007). Strategic assets can be broken down into smaller categories by specifically defining the durability and sustainability of these assets. Durability refers to the ease with which an asset can be lost to the competition and sustainability refers to an asset's lifespan. When considering the durability of strategic assets, assets can be divided into tangible and intangible assets. Tangible assets are defined as "organizational assets that are relatively easy to identify, including physical assets, financial resources, organizational resources and technological resources" (Connor, 2007). Conversely, intangible assets are defined as "organizational assets that are difficult to identify and account for and are typically embedded in unique routines and practices, including human resources, innovation resources, and reputation resources (Connor, 2007). Generally, tangible assets are easier to lose to the competition than intangible assets because they are easy to define and consequentially, they may be easier to imitate.

When examining sustainability, strategic assets can be divided into permanent and temporary assets. Permanent assets exist throughout the entirety of the organization's life and are still strategically critical throughout changing circumstances. Organizations establish their permanent assets early and they serve as the infrastructure for the organization's competitive decisions. Temporary assets are contingent upon market conditions and only provide a competitive advantage over a finite period. Organizations realize their temporary assets over time, after the initial formation of the organization and they are often specific applications of permanent assets for a short time. Tom Connor sums up the relationship between the two types of assets, saying, "Temporary strategic assets are manifested in superior products, services and processes, whilst permanent strategic assets provide the underlying capability to produce them through time" (Connor, 2007). A combination of both temporary and permanent assets can create a strong competitive advantage for an organization that knows how to utilize their assets effectively.

This paper will begin by defining exclusive contracts and examining the form and function of exclusive contracts in general. Following the introduction is an examination of exclusive contracts using an example-based approach. Each example will examine successful implementations of exclusive contracts. This paper will conclude with a discussion of exclusive contracts as a competitive strategy, based on both theory and the discussed examples.

Exclusive Contracts

An exclusive contract is defined as a contract between a buyer and a seller that prohibits one party from dealing with other agents (Segal & Whinston, 2000). The specifics of these contracts vary greatly and are contingent upon the specific competitive aims of each participating organization. The possible uses of exclusive contracts vary between different industries, as does the approval of their use. Some companies view exclusive contracts as a means of ensuring that their organization develops a relationship with one supplier while preventing other companies from imitating their unique product. Exclusive contracts may also be effective in protecting a company's time and investment from imitators. Despite potential positive returns on exclusive contracts, negative effects are also possible and have been extremely prevalent in recent years.

Although this paper uses the term "exclusive contracts" to describe arrangements between the supplier and buyer of a unique product, this term is generic and as such, there are many other terms that can be used to describe such arrangements. Licensing agreements and exclusive dealings are some other situations where the concept of exclusive contracts can be applied. However, it is important to note that exclusive contracts do not include agreements such as patents and trademarks. While these limit the use of a certain product or brand, the company who filed for the patent or trademark has exclusive rights for the product. Exclusive contracts must be between two or more parties and, while they can include rights to patents or trademarks, must include specifications on the rights granted to the other party. Exclusive contracts also generally include time and performance restrictions; otherwise, the agreement may be viewed as a merger or permanent partnership between two companies.

This paper will examine exclusive contracts as a differentiation strategy achieved through the utilization of a temporary intangible asset. Exclusive contracts are temporary because they are only valid over the specified period agreed upon in the contract. Exclusive contracts are also intangible because they are difficult to imitate and cannot be traded away without approval from both parties. Although an exclusive contract can provide a significant competitive advantage for an organization, changing market conditions or the expiration of the contract can quickly terminate that competitive advantage. Studying exclusive contracts and their effects on organizational competitiveness can allow organizations to utilize them in an effective way, making the most out of the temporary competitive advantage.

Historical Uses for Exclusive Contracts

Exclusive contracts are traditionally used to dictate the relationship between a firm and their suppliers. Historically, the product exchanged was typically a resource or finished product that the buyer required for their business. Typically, the buyer had other companies they could acquire the product from and, consequentially, the contract secured exclusive business between the two companies. The most common alternative to exclusive contracts is vertical integration. Vertical integration is defined as "an expansion or extension of the firm by integrating preceding or successive production processes" (Dess et al., 2010). Vertical integration offers the benefit of having a guaranteed supplier or distributer, like an exclusive contract, while also allowing the company to have complete control over the timing and quality of the material. When a company integrates backwards and begins to supply their own product, they no longer have to worry about the delays in supply that can occur within an exclusive contract. However, vertical integration can also be extremely risky. If a company integrates into an industry with which they are not familiar, or in which they do not have core competencies, they can actually hurt their product more than they help it. Additionally, vertical integration requires higher overhead and administrative costs that can be avoided with an exclusive contract.

Another way that exclusive contracts were historically used was through exclusivity deals with a company's distributor, known as exclusive dealings. Exclusive dealings are "a vertical restraint that restricts resellers from carrying products of competition manufacturers" (Heide, Dutta & Bergen, 1998). For example, Haagen-Dazs did not allow their distributors to carry any competing products. This practice ensures that the manufacturer is rewarded for investments in advertising and training while receiving the distributor's full effort. Although this situation may seem ideal for the manufacturer, there are additional negative aspects to such agreements. Firstly, it is costly and inefficient to monitor the inventory of all distributors, so manufacturers are often unable to determine if the terms of their exclusive contract are being violated. Additionally, exclusive contracts with distributors take away the customer's ability to compare products or raise their cost of comparing products, which may cause the distributor to lose customers. Losing customers hurts both the distributor and the manufacturer, so this may discourage exclusive distribution contracts (Heide et al., 1998). Limiting the availability of competitor's products was seen as an ineffective business practice unless certain factors were present. One of these factors is market differentiation, meaning that the products offered are unique and have a loyal customer base. When higher levels of differentiation exist, it is more likely that the companies will enter in to an exclusive distribution contract. Another motivator for these types of contracts is when there is a high threat of new competitors entering the market, although contracts used to deter entry can also be seen as anticompetitive. Finally, firm size also affects the use of exclusive dealings because larger companies have more power to negotiate for exclusive distribution (Heide et al., 1998). Although traditional studies of exclusive dealing have found it to be an inefficient practice, modern successful examples of these types of exclusive contracts will be discussed later in this paper.

Fisher Body – General Motors

The Fisher Body-General Motors exclusive contract is one of the oldest documented and widely studied examples of exclusive contracts available today (Klein, 2007). In 1919, General Motors entered into a contract with Fisher Body that required General Motors to purchase all of its automobile bodies from Fisher Body. There were two key exceptions to the ten-year supply contract: 1) General Motors could complete any existing contracts they had with other companies; 2) they could continue to produce their own automobile bodies. At the time, General Motors had few existing contracts, so Fisher Body quickly became their only supplier. Additionally, General Motors only produced open bodies, which the industry abandoned shortly after 1919, so they relied on Fisher Body for all their closed body models. Therefore, despite the previously mentioned exceptions, General Motors' contract with Fisher Body was essentially an exclusive contract. The main motivation behind the contract was to ensure that Fisher Body received compensation for their investments in technology that would allow them to produce General Motors' specific closed bodies. Although modern economists have disagreed about what specific accommodations Fisher Body needed reimbursement for, the most agreed upon theory is that they wanted compensation for their increases in capacity to accommodate General Motors' orders (Klein, 2007). At the beginning of this contract, General Motors invested $27.6 million and received 60% ownership of Fisher Body Corporation. Fisher Body placed General Motors' shares in a five-year Voting Trust, which meant that Fisher Body retained veto power. This ensured that General Motors did not immediately gain control of Fisher Body (Klein, 2007).

In 1922 and 1923, General Motors' sales began to increase rapidly and they developed a need for geographically convenient body parts plants. The original contract charged General Motors 17.6% over costs for bodies produced in order to cover Fisher's additional investment, but this cost failed to consider the need for additional Fisher Body plants closer to General Motor's assembly facilities. General Motors' change in demand gave Fisher Body an upper hand in the contract and allowed them to argue for terms that are more favorable. Fisher Body was reluctant to create smaller plants closer to General Motor's facilities and, consequently, caused holdups in General Motors' production processes. General Motors had little negotiation power because the contract prevented them from threatening to use a different supplier. Instead, Fisher Body held all the negotiating power and was able to require additional funds from General Motors in exchange for the new plants. The negotiations ended with General Motors building and leasing three of six new co-located plants for Fisher Body, with Fisher Body financing the remaining three plants. This new financing agreement cost General Motors around $20 million, paid to Fisher Body. By 1922, General Motors paid 50% of Fisher Body's increased capacity costs in addition to the original 17.6% up charge on the cost of the bodies.

After General Motors' Voting Trust ran out in 1924, General Motors began to consider the option of merging or acquiring Fisher Body to eliminate the extra costs they had been accruing since 1922. The loss of the Voting Trust gave General Motors considerably more bargaining power to renegotiate the unfavorable terms from their previous contract, but General Motors felt they had the legal obligation to respect Fisher Body's minority share so they did not immediately take over Fisher Body. Around this time, however, both Fisher Body and General Motors' stock prices declined rapidly and the idea of vertical integration began to make sense economically. Finally, in 1925, General Motors announced their intent to purchase Fisher Body.

When the final agreement was reached on May 13, 1926 both companies experienced increases in their stock prices (Klein, 2007). Although this case has mostly been used to illustrate the benefits of vertical integration, it also illustrates the risks of exclusive contracts when they are not utilized correctly. After discussing some benefits and negative consequences of exclusive contracts, this paper will give examples of how exclusive contracts have evolved since then and the ways that contracts can be written to avoid the problems illustrated in the Fisher Body-General Motors exclusive contract case.

U.S. v. Microsoft

Another more recent example of exclusive contracts is the contracts Microsoft entered in to in order to promote their web browser, Internet Explorer, over other web browsers, specifically Netscape. These contracts eventually led to an antitrust lawsuit in which Microsoft was found guilty. Microsoft began using exclusive contracts in 1996, after the release of Windows95, in order to ensure that Internet Explorer was the main web browser used with Windows. They entered in to exclusive contracts with a variety of sources that required either exclusive use of or preferential treatment for Internet Explorer. In their exclusive contracts with computer manufacturers, Microsoft initially required them to sell both Windows95 and Internet Explorer bundled together and added a clause that said they could not remove the Internet Explorer button from the desktop. Additionally, Microsoft added to the contract that the computer manufacturers could not place any items on the desktop that were larger than the Internet Explorer button (Whinston, 2001). Eventually, when Windows98 premiered in August 1998, Microsoft even removed the user's ability to uninstall Internet Explorer from their computer. In exchange for these exclusive contracts and for preferential treatment for Internet Explorer, Microsoft provided computer manufacturers with reduced Windows licensing fees and other monetary incentives. Essentially, Microsoft exploited the success of Windows in order to force users to choose their Internet Explorer as well.

By summer of 1996, Windows also had exclusive contracts with fourteen of the largest Internet service providers (Whinston, 2001). These internet service providers were unable to access Windows unless they promised to offer only Internet Explorer to their customers. A customer could request a different browser and have it shipped to them, but the contract required that between 75 and 85 percent of all browser shipments were Internet Explorer (Whinston, 2001). These contracts also offered additional monetary incentives to switch existing customers from using a different program to Explorer. Some contracts also required internet providers to make "differentiated" content that would be viewed better on Internet Explorer than other programs. Overall, Microsoft's exclusivity agreements were extensive and succeeded in blocking the competition.

Microsoft first came under investigation for anticompetitive conduct in 1990, when the Federal Trade Commission began a case against Microsoft's licensing practices. This case resulted in a tied vote, and the Federal Trade Commission tried again in 1994 by bringing a lawsuit against Microsoft over their exclusive contracts. At the same time, the Department of Justice issued regulations for Microsoft stating that "Microsoft shall not enter into any License Agreement in which the terms of that agreement are expressly or impliedly conditioned upon: (i) the licensing of any other Covered Product, Operating System Software product or other product" (Gilbert and Katz, 2001). While this should have discouraged the continued use of exclusive contracts, Microsoft continued its use of exclusive contracts through the Internet Explorer contracts mentioned above in 1995. Finally, on May 18, 1998, the government began a lawsuit against Microsoft saying that their exclusive contracts excluded rivals and allowed them to monopolize their market. After examining Microsoft's market power in the relevant industry and determining that their actions did indeed violate the Sherman Act, the court found Microsoft guilty on April 3, 2000 (Gilbert and Katz, 2001). Both Microsoft and the government proposed remedies, from ending the exclusivity of the contracts to splitting Microsoft in to two separate companies. While changing the company's structure by dividing it in to two separate companies is the easiest way for the government to ensure removal of the monopoly power, it may also negatively affect the efficiency of the company. Another proposed remedy for the case was financial charges against Microsoft for violating the Sherman Act. While this does not immediately change the anticompetitive actions that initiated the lawsuit, it does punish Microsoft for their actions and serves as a warning for companies considering similar actions in the future. The judge in charge of the case approved the government's remedies, including breaking up Microsoft in to two separate companies, but after appeals the breakup was reversed. The court then issued a consent decree that required Microsoft to reduce their anti-competitive behavior. The end to the antitrust suit finally came in 2011, after over 21 years, when the consent decree finally ended (Chan, 2011). Although the final ruling was not as severe as the first, this case serves as a major landmark antitrust case and illustrates how seriously the government takes such monopolies.

Internal and External Benefits of Exclusive Contracts

Exclusive contracts between organizations can benefit the company either internally or externally. If the benefit is internal, the impact on company overall profits is less tangible. Internal benefits affect the company's value chain, Michael Porter's system for analyzing a company's internal environment, which is comprised of primary and supporting activities. Primary activities include inbound logistics, operations, outbound logistics, marketing, sales and service. Secondary activities include general administration, human resource management, technology development, and procurement (Porter, 1985). Although exclusive contracts may help to make these processes more efficient, establishing a link to profitability is difficult because the effects are more indirect. However, if the benefit is external and affects the final product's value to other traders, exclusive contracts can provide a competitive advantage that leads to decreased competition and higher profits. Michael Porter developed a technique known as the Five-Forces Model of Industry Competition to analyze an industry's external environment. The five forces included in this model are the threat of new entrants, the bargaining power of buyers, the bargaining power of suppliers, the threat of substitute products and services, and the intensity of rivalry among competitors within the industry (Porter, 1980). When an exclusive contract is unique and difficult to imitate, it decreases the rivalry of competition among existing firms as well as the threat of substitute products or services because it ensures other companies cannot utilize the same product. This helps to reduce the bargaining power of the buyers, which allows the firm to choose a price point that is most beneficial for their organization. Exclusive contracts for unique products also decrease the bargaining power of buyers because they are unable to find another supplier of the same product. Finally, effective exclusive contracts decrease the bargaining power of suppliers by allowing the purchasing company to establish standards and rules within the contract.

Negative Impacts of Exclusive Contracts

The first possible negative impact of exclusive contracts is their potential adverse legal ramifications. Exclusive contracts can be perceived as anticompetitive in nature and often lead to lawsuits. The main source of legal concern stems from Section 2 of the Sherman Act for Anti Trust Laws. This states that "every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony." Exclusive contracts between industry leaders can provide an unfair advantage that discourages new entrants in the market and harms smaller industry members, creating a monopoly in that industry. However, exclusive contracts are not immediately deemed anticompetitive and U.S. antitrust law must use "a rule of reason standard in which possible economic efficiencies are balanced against possible anticompetitive harm" (Simpson, 2001). Although exclusive contracts may lead to monopolies, the costs of anticompetitive behavior to the participating organizations are extremely high. Therefore, it is more likely that firms use exclusive contracts to gain a competitive advantage and the antitrust implications are an unfortunate byproduct that they must deal with subsequently. Specific legal issues will be discussed later in this paper when examining current examples of exclusive contracts.

A second possible negative impact of exclusive contracts is free riding. Free riding exists when one of the participants reduces efforts because their contract is guaranteed (deMeza & Selvaggi, 2007). Although the exclusive contract provides benefits for both parties, one group's interests may receive better representation than the others may. Potential pitfalls in exclusive contracts concerning free riding include "the licensee may devote inadequate complementary resources, or learn from the licensor and then commercialize its own technology, or its priorities may change over time, or it may simply be less capable than initially thought" (Somaya, Kim, & Vonortas, p. 162, 2010). Situations like this are not beneficial and consequently, care must be taken in writing and choosing the details of the contract to ensure fair dealings. Creating strict performance guidelines within the contract can prevent free riding behavior as well.

Another negative aspect of exclusive contracts occurs when a company's free riding negatively affects the customer. This effect is seen more in contracts where the product involved in the contract is unique or valuable. If customer demand for the product is high and the product is exclusively sold through one company, that company no longer has an incentive to improve aspects of their performance. This includes customer service, research and development, and repair services. Lack of effort, free riding, and legal issues all negatively affect the customer's perceptions of the companies involved in the exclusive contract and can damage the reputation of the companies involved. More examples of negative customer perceptions will be discussed later in this paper.

Exclusive contracts provide a platform for companies to deter competition for a temporary period. However, this practice can lead to adverse legal ramifications and negative consumer perception. As such, companies need to carefully weigh their options before entering into an exclusive contract and must manage such contracts carefully so that the short term benefits are not negated by long term damage to a company's reputation.

Introduce Examples

The following sections will provide examples of the use of exclusive contracts through the examination of AT&T and Apple, Ticketmaster, Pfizer's exclusive contract for Lipitor, and Sony's exclusive contracts for Playstation games. Each example varies in the way the contracts are used and accepted. In the first example, AT&T and Apple use a short-term exclusive contract to deter competition for each company. The second example, Ticketmaster, uses many exclusive contracts to ensure that they have exclusive access to a majority of venues while rewarding the contracted organizations with a monetary incentive to sign the contract. The third example, Pfizer's exclusive contract for Lipitor, shows how widely accepted exclusive contracts are in the Pharmaceutical Industry and the possible effects this has on both parties of the contract. The final example, Sony, discusses the use of exclusive contracts in the video game industry by examining their contracts for exclusive Playstation games.

AT&T and Apple

The U.S. wireless industry has been rapidly growing since the demand for a wireless phone began to increase by 12% yearly from 2003 to 2008. Currently the industry is comprised of four main players: device manufacturers, wireless carriers, broadband infrastructure companies and application developers. The two players of main concern in this example are the device manufacturers and wireless carriers. Currently, some of the top device manufacturers are LG, Motorola, Blackberry, and Apple, although there are many other phone manufacturers. The cellular service market is considerably more concentrated, with the top four service providers comprising 80% of the U.S. market. These four service providers are AT&T, Verizon Wireless, Sprint Nextel and T-Mobile USA. There are other smaller wireless providers, such as rural providers, but they make up a very small percentage of the market. As of 2009, over 95% of the U.S. population lived in census blocks where there were three or more wireless service providers (Zhu, Liu & Chintagunta, 2011). Since there are few big players in the wireless provider market and customers have direct access to multiple options, the four big wireless providers must be highly competitive with each other to earn the most business. The main areas for competition are "coverage (including factors such as dropped calls), plan attributes (price, rollover minutes, free calling to other subscribers of the same provider), customer service quality, and quality of handsets" (Zhu, et al., pg 10, 2011). The last area for competition, quality of handsets, can affect the attraction rate of new customers to the provider; consequentially, an exclusive contract for a high quality phone can provide a large competitive advantage for a hardware company.

Since 2007, Apple and AT&T have been under scrutiny due to their exclusive contract for Apple's iPhone. Released in 2007, the iPhone offered customers the style and efficiency of Apple's iPod Touch combined with all the capabilities of a standard cell phone. The phone used a touch screen for navigation and allowed customers to use Wi-Fi or cellular signal to access the internet. Another novel feature of the iPhone was the use of applications, displayed on the phone's home screen, to guide the user's experience. Although the original applications were limited, the iPhone's features have allowed countless applications to be developed by third-party developers and sold through Apple's App Store. After Apple and AT&T began their contract, over two million iPhones were sold within the first six months. When the iPhone was launched in 2007, its biggest competitors were phones that were primarily used by commercial customers, such as the Blackberry. The iPhone revolutionized the consumer wireless segment and within two years it accounted for 10.8% of the worldwide cellular market share (Zhu, et al., 2011).

Details of the contract

Apple created an exclusive contract in 2007 to make their iPhone available exclusively to AT&T and their customers. Apple also implemented additional security measures to ensure the iPhone would not be compatible with any other wireless carrier while giving AT&T the right to exclusively carry the iPhone. All software downloaded to the iPhone must be purchased through Apple's App Store, which allows Apple to maintain complete control over the content of their applications. Additionally, any software developed for the iPhone must receive Apple's approval and the developer must pay a fee to have their software considered. Apple also enforced AT&T's exclusivity by adding a lock on the iPhone's SIM card, which would prevent mobility of the software from the iPhone to a different cellular device. These security measures not only ensured that the iPhone was incompatible with any other carrier, but allowed Apple and AT&T to maintain complete control over their unique product until the contract ended in 2011. The details of the contract have not yet been made public, but portions have been revealed as more controversy arises around the arrangement.

Public opinion of the contract

In general, there are mixed feelings among wireless carriers on the fairness of exclusive contracts. Larger wireless companies, such as AT&T and Verizon, support the practice, claiming it encourages innovation and competition. It also encourages the manufacturer and wireless provider to work together, especially on marketing and sales. Smaller wireless companies oppose the practice saying it negatively affects customers in rural areas by denying them access to the latest technology. They claim it also limits customer's options and can actually hurt competition. Exclusivity is certainly not the standard within the wireless industry, but many of the most notable handsets have begun as an exclusive contract. Typically, the contract lasts for several years or for the lifetime of the device, although rapidly changing technology places the average lifetime at around twelve months (Zhu, et al., 2011).

When specifically considering Apple and AT&T, the level of negative opinions about their exclusive contract is considerably higher. By creating an exclusive contract with AT&T, Apple was using exclusive contracts to create a demand for their phone that had not previously been reached before. The other popular phone at the time the iPhone was released was the Blackberry, which used exclusive contracts on a much smaller scale. Instead of exclusively working with one wireless provider, Blackberry made different versions of their phone exclusively available through different wireless providers. For example, T-Mobile was the first to sell the Blackberry Pearl, Verizon was the first to sell the Blackberry Storm and AT&T was the first to sell the Blackberry Curve (Zhu, et al., 2011). Additionally, the Blackberry did not use central software so it was easily adaptable among the wireless providers. Other phones had previously been available through only one wireless carrier but they were typically generic phones based on a similar model and customers had few complaints about their limited availability. Apple capitalized on the uniqueness of the iPhone and used their exclusivity in a completely new way by programming the iPhone to be deactivated if a different wireless provider or unapproved applications were used.

AT&T's mobile customers are required to sign a two-year contract when purchasing a new mobile device from the wireless carrier. However, when AT&T signed the exclusive contract it forced customers to stay with AT&T for longer than two years because their new iPhone was not compatible with any other wireless carrier. If a customer wished to terminate their contract with AT&T, their iPhone would no longer be functional and they would be forced to pay an early termination fee. In addition, AT&T was not contractually obligated to subsidize any part of the consumer's original purchase. This created a "captive" customer base for AT&T that lasted for at least five years after the iPhone's original release. While this customer base incentivized AT&T to enter into an exclusive contract with Apple, it also removed the need for competition with other wireless carriers. This guaranteed customer base "removes the market incentives for AT&T to improve customer service, upgrade its network, or respond to competitive prices" (McMurrer, p. 504, 2011). The new rules created by the exclusive contract caused consumers to question the legality and fairness of the AT&T contract for the iPhone, leading to possible adverse legal ramifications for AT&T and Apple.

Lawsuits against AT&T and Apple

A lawsuit in the Ninth Circuit court, Holman v. AT&T, began on June 29, 2007 as a result of Apple's then most recent update to the iPhone software, released on September 27, 2007. This update rendered any iPhone with unapproved software on it completely inoperable. Although Apple and AT&T's exclusive contract has remained private, some key parts of the contract have been made public. The following section of their contract, as published in *The Journal of Corporation Law*, summarizes the ways in which Apple planned to lock iPhone customers into AT&T service:

> "[C]ustomers will be forced to renew with [AT&T], despite initially being required to agree to only a two-year contract… Apple will enforce [AT&T's] exclusivity by installing SIM card program locks on all iPhones…[C]ontrary to standard industry practice, by which wireless providers subsidize the purchase of the cellular device in exchange for the consumer signing a contract with the provider conditioned on payment of a fee in the event of early termination, [AT&T] is not required to subsidize the consumer's purchase of the iPhone, but nonetheless charges a $175 early termination fee" (McMurrer, p. 500, 2011).

Additionally, the contract mandated that Apple and AT&T take legal action if anyone tries to get around the software lockout. It also ensures that Apple will wait to begin developing an iPhone that would be compatible on other wireless providers (McMurrer, 2011).

In 2008, Apple and AT&T submitted a motion to dismiss the case but were denied based on the *Grinnell* test. This test says that "power in a relevant market acquired and maintained not through business acumen but by leveraging technological control over the device" is in violation of antitrust law (McMurrer, p. 501, 2011). The court also based their ruling on the definition of relevant aftermarkets as defined in the 2008 Newcal Indus. v. Ikon Office Solutions case. This case focused on whether or not the aftermarket was "a natural monopoly resulting from the nature of the primary market, or if it was a contractually created monopoly" (McMurrer, p. 500, 2011). In 2010, the lawsuit was granted class action status by Judge James Ware of the US

District Court, who again used the Newcal case as the bases for his decision. The new class action lawsuit stated that the plaintiffs in the case included “all persons who purchased or acquired an iPhone in the United States and entered into a two-year agreement with Defendant AT&T Mobility, LLC for iPhone voice and data service any time from June 29, 2007, to the present.”

When considering the recent Apple and AT&T case, legal professionals have also been referring back to a tariff in 1968, during AT&T’s initial monopoly on the telephone industry. At the time, AT&T was the only provider of telephone hardware in the developing telecommunications industry. AT&T designed and developed its own equipment in order to standardize the production of telephones and quickly became the single dominant force in the telecommunications industry. However, problems with AT&T’s dominance quickly became apparent, especially due to AT&T’s exclusivity. Since AT&T developed its own products, they prevented the development of any third party hardware to be attached to their phones. This practice blocked innovation in the early to mid 1900s, a time where innovation was necessary to develop emerging technology (McMurrer, 2011). While individuals wishing to produce attachments for AT&T’s phones made multiple appeals, the one of most concern for today’s lawsuit is the Carterphone appeal in 1968. The Carterphone was a device that supplemented a landline phone and allowed phone calls to bridge both wired and wireless communication systems using a Carterphone operator. However, FCC tariff No. 132 stated that “[n]o equipment, apparatus, circuit or device not furnished by the telephone company shall be attached to or connected with the facilities furnished by the telephone company, whether physically, by induction, or otherwise” (McMurrer, p. 502-503, 2011). The intent of the tariff was to allow telephone companies to create their hardware without harmful interference from inexperienced third parties. The court found that the tariff was over inclusive in the Carterphone case, as there was no apparent harm to the telecommunications industry in the new device. Instead, the tariff was simply helping AT&T maintain its monopoly power by discouraging new entrants. The resulting regulations "forced the separation of the sales of wireline telephone service from equipment and provided consumers the freedom to attach non-harmful third-party devices to the telephone network" (Zhu et al., p. 3, 2011). The Carterphone regulations could potentially apply to attaching non-harmful third party applications to the iPhone, and questions have been raised about whether or not the same regulations should be applied to the wireless market.

Effects of the Contract on AT&T's Profits

Although little research has been done on the effects of exclusivity on wireless providers, the benefits for AT&T in this case are clear. By providing a unique phone that no other provider could copy, AT&T not only gained new customers but also retained old ones past their initial two-year contract. For example, 23% of new AT&T customers in the first quarter of 2009 cited their decision to subscribe as wanting "a phone not offered by my carrier" (which is assumed to be the iPhone). Additionally, customers who had switched from another wireless provider made 40% of new iPhone purchases during that time. While both Verizon and AT&T attracted more subscribers in 2008, AT&T was able to attract more new subscribers than Verizon and most of their new subscribers chose to purchase the iPhone (Zhu et al., 2011). In exchange for this boost in sales, AT&T spent $572 million on sales and marketing for the iPhone in 2007.

Although the benefits for AT&T are clear, the benefits for Apple are not as easily determined. By making the iPhone exclusive, Apple succeeded in creating an overwhelming demand for their product. However, Apple had already experienced success with their iPod products and demand potentially would have been equally high if the phone had been available on all carriers. Instead, Apple limited their customer base to about 30% of the United States. According to a study in progress on the effects of the iPhone's exclusivity, it is estimated that Apple's market share would have been .09% higher if both AT&T and Verizon had carried the iPhone. If the phone had been available on all carriers, Apple's market share would have gone up an additional 1.23% (Zhu et al., 2011). This implies that exclusivity is considerably more lucrative for the wireless provider than for the device manufacturers.

Another unintended effect of the exclusive contract between Apple and AT&T was the creation of new competitors. While any Smartphone released after the iPhone was compared, usually negatively, to the iPhone, Verizon's Droid is the only model that came close to competing. Although the Droid was later to market, it offered many features that the iPhone did not. The Droid came with a better quality camera, additional memory space and a longer battery life. Additionally, the Droid was considered more technically sophisticated than Apple's iPhone. The iPhone was seen as overly simplifying its technology, while the Droid was more appealing to individuals who are technically perceptive. However, the everyday user had come to appreciate and expect the iPhone's user-friendly functions, so the benefits of a technical Droid were not appreciated. Droid also had the advantage of using Google navigation software, which was superior to the GPS navigation software on the iPhone. Additionally, the Droid had an open software system that allowed anymore to create applications. This contradicted Apple's strict rules about third party software on the iPhone. Andrew Berg, a columnist, described the benefits of the Droid's open software, saying "[w]hile the [Federal Communications Commission] may be a pain in many a side as it preaches any app, any device, on any network, that's exactly the future for which most consumers are hoping. While that ideal may never be achieved, the Droid comes closer than the iPhone does" (Berg, p. 14, 2010). Despite the benefits that the Droid was able to offer over the iPhone, few customers prefer the Droid. Berg also noted that "while the Droid may succeed in stealing some market share from Apple, it's simply not going to convert a significant number of loyal iPhone users who have become accustomed to a very unique kind of simplicity" (Berg, p. 14, 2010). While this may be true, the Droid still created competition that Apple could have avoided by making the iPhone immediately available on all carriers.

Ticketmaster

Introduction on Ticketmaster

Ticketmaster.com, part of the Live Nation Entertainment group, serves as the number one ticket provider in the country. Ticketmaster leads the market in online event tickets and has held that position for over twenty-five years with virtually no competition. Since Ticketmaster's merger with Live Nation, Live Nation Entertainment has become one of the most powerful forces in the music industry. In 2010, Ticketmaster sold 120 million tickets worth $8 billion (Salter, 2011). Although Ticketmaster has been hugely successful, they have undergone countless public attacks, including multiple lawsuits. Their pricing system and position as a near monopoly have earned them the label of the most hated brand in the world, although they have remained the industry leader despite such bad press (Salter, 2011).

How they Utilize Exclusive Contracts

Ticketmaster's main competitive advantage stems from the exclusive contracts they have signed with thousands of venues throughout the United States. While the specifics of these exclusive contracts may vary, the main implication of the contract is that any band who wishes to play in that venue must sell their tickets through Ticketmaster.com. Ticketmaster then makes their profit by charging processing fees for every ticket purchased, potentially taking some profit from the artists themselves. Ticketmaster also gives a cut of their profits to the venues who sign with them, providing incentives for more venues to enter into similar exclusive contracts. These exclusive contracts changed the music industry greatly when they first began. The traditional ticket seller agreement had venues paying a ticket vendor thousands of dollars to sell tickets for them. Ticketmaster's new agreements not only removed that cost, but also actually provided additional income for the venues that signed with them. This has allowed Ticketmaster to create what has been called a monopoly by critics, as bands and venues that choose not to sign with Ticketmaster are placed at a considerable disadvantage (Knopper, 2009). Ticketmaster argues that this is not a monopoly but instead, it allows Ticketmaster to provide better services for their customers and the venues.

Lawsuits

One of the first major complaints lodged against Ticketmaster dates back to 1994, when Pearl Jam filed an antitrust lawsuit against Ticketmaster over unfair service charges for their upcoming tour (Boehlert, 1995). Pearl Jam wanted to charge fans less than two dollars for service fees, which would bring their total ticket price to eighteen dollars. Ticketmaster wanted to charge fees two to three times that amount, which prompted Pearl Jam to file the lawsuit. The lawsuit was originally prompted by the Justice Department, who wanted to investigate Ticketmaster's monopoly in the ticketing industry. At the time, Ticketmaster already controlled seventy percent of the market and Pearl Jam claimed that this gave artists no choice in where they could sell their tickets. This lawsuit was the first time that Ticketmaster's exclusive contracts became public. Although many other bands agreed with Pearl Jam's position in the lawsuit, most were reluctant to join them. When trying to tour without using Ticketmaster, Pearl Jam was forced to perform at fairgrounds and soccer fields instead of the major venues that Ticketmaster controlled. Pearl Jam was unable to defeat Ticketmaster in an initial trial in DC, due mostly to the company's lobbying efforts, but continued to try through the Justice Department's investigation. A short time later, the Justice Department declared that their investigation was closed, with no findings against Ticketmaster. Although Pearl Jam lost their case and was forced to cancel the rest of their tour dates that year, their attempt was not completely futile. Pearl Jam's lawsuit pushed Ticketmaster's exclusive contracting strategy into the public eye and showed that it was possible to take on the ticketing giant (Boehlert, 1995).

Almost ten years later, in 2003, Ticketmaster faced with another lawsuit from a smaller band called String Cheese Incident. At this time, Ticketmaster had increased their control over the market and had exclusive contracts with 90% of the country's arenas and amphitheaters. They also began to have contracts with top concert promoters, who could then focus on gathering customers rather than the logistics of gathering the tickets. String Cheese Incident decided to file a lawsuit against Ticketmaster because they had their own ticketing company. The band claimed that Ticketmaster's exclusive contracts and service charges block all competition, which violated the Sherman Anti Trust Act. The main problem occurred when Ticketmaster tried to restrict the number of tickets traditionally held for bands to give to friends and family members (Greenberg, 2003). Ticketmaster felt that these tickets threatened their investment in the shows because bands were reselling them instead of giving them away in order to receive the total profit. Ticketmaster sent a letter to their clients saying that bands would not be allowed more than 8% in ticket holds. String Cheese Incident was used to getting much more than this to sell through their own ticketing service, SCI Ticketing. The band tried to fight Ticketmaster on this by going to different venues, but ended up straining their relationship with their usual venues and causing larger issues for the band. Then, in 2002, it became public that Ticketmaster was allowing excessive ticket holdbacks for bands signed to the online ticketing service Musictoday in order to guarantee that Musictoday did not file an antitrust suit against them (Greenberg, 2003). This infuriated String Cheese Incident further and lead to their eventual lawsuit against Ticketmaster in 2003. Although the band's claims were originally dismissed as unimportant by Ticketmaster, the lawsuit was eventually settled out of court.

Although no lawsuit was filed, major controversy arose again in 2009 when Ticketmaster had malfunctions with their system while selling Bruce Springsteen tickets for two shows in New Jersey. Fans who wanted to purchase a ticket were immediately redirected to Ticketmaster's secondary ticketing site, TicketNow, which sells Ticketmaster's extra tickets at a much higher cost. Since Ticketmaster is the exclusive dealer for most major performance venues, fans were forced to either purchase the high priced tickets or miss their chance to see Bruce Springsteen. US Representative Bill Pascrell from New Jersey addressed the issue after receiving complaints from his constituents, saying "there is a significant potential for abuse when one company is able to monopolize the primary market for a product and also directly manipulate, and profit from, the secondary market" (Pascrell, 2009). This illustrates the power that Ticketmaster's exclusive contracts give them over customer bargaining power. Since Ticketmaster has sole access to the tickets for particular concerts, true fans have no choice but to purchase the tickets at any price Ticketmaster chooses.

Main Competition and Comparison of Profits

Although some companies have attempted to detract from Ticketmaster's success in the past, none have even come close to hurting Ticketmaster's market share. The only real threat Ticketmaster has encountered so far occurred when Live Nation opened Live Nation Ticketing, as they are the only company with comparable industry power in the music industry. Fortunately for Ticketmaster, the 2009 merger of Live Nation with Ticketmaster put an end to the impending competition for online ticket sales (Salter, 2011). Although other companies have been unable to truly compete with Ticketmaster in terms of market share, many companies have tried to compete by offering a similar product with slight variations. The most direct competitor with Ticketmaster is TicketFly, although their market share is nowhere near Ticketmaster's.

TicketFly was founded by former Ticketmaster employees and has attempted to steal Ticketmaster's clients by offering free services and many social media services. StubHub, owned by eBay, is the largest player in the secondary ticket market, and allows fans to sell extra tickets on their server. Although StubHub does not compete in the same field as Ticketmaster, they have pioneered many features, such as interactive seating charts, that Ticketmaster now uses. Another unique competitor for Ticketmaster is ScoreBig, a members only ticket site that utilizes a "name your own price" feature similar to the one used by Priceline.com. Unlike Ticketmaster, ScoreBig focuses on selling the 40% of tickets that typically go unsold for a concert. Finally, many artists have been choosing to promote their own tickets instead of going through Ticketmaster controlled venues. These artists will offer presale tickets, bundled merchandise and other rewards to encourage fans to purchase tickets directly from them. While all of these alternatives to Ticketmaster exist today, CEO Nathan Hubbard believes that their main competition will potentially come from "the Apple's and Google's of the world" and has attempted to make Ticketmaster more flexible and innovative to prepare for future competitors (Salter, 2011).

Public Opinion

Despite their seemingly unstoppable success, Ticketmaster has been called one of the most hated brands in the world and has even earned the nickname Ticketmonster (Salter, 2011). Several artists, such as Dave Matthews Band and John Legend, have chosen to sell their own tickets and merchandise directly to their fans instead of using Ticketmaster as the intermediary. Ticketmaster's CEO, Nathan Hubbard, spent most of his career prior to Ticketmaster trying to undermine the company by finding alternatives for him and other artists. He began his career working for Dave Matthew's manager Coran Capshaw, one of the industry's most well known innovators and Ticketmaster opponent. Hubbard served as CEO for Capshaw's Musictoday, which allowed artists to sell tickets and merchandise directly to fans. Hubbard also helped launch Live Nation's ticketing site before their merger with Ticketmaster, creating Ticketmaster's most serious threat since they reached their position as industry leader (Salter, 2011). Currently, as CEO of Ticketmaster, Hubbard undergoes the challenge of trying to turn one of the most hated brands in the world into a well-liked, or respected, brand. One of Hubbard's main goals is to move Ticketmaster's service fees to the beginning of the purchasing process so customers are aware of the full ticket price before purchasing. While this keeps end users happy, Ticketmaster's clients, the concert venues, have been skeptical about the change. Since Ticketmaster's exclusive contracts are frequently renewed and renegotiated, Ticketmaster must maintain a careful balance to satisfy both their customers and their venues. Previously, Ticketmaster had seemingly abused their exclusive contract relationships by not providing the service they required and, consequently, venue relations had suffered greatly. The only way for Ticketmaster to retain its control of the market is to continue its exclusivity with the nation's largest venues, and Hubbard has been trying to repair damaged relationships to ensure this happens (Salter, 2011).

Pfizer's Exclusive Contract with Lipitor

Overview of Pfizer

Since its inception in 1849, Pfizer has grown to become one of the largest pharmaceutical companies in the United States. They have represented some of the country's most groundbreaking new drugs and have had success with everything from Vitamin C to Viagra. Recently, Pfizer has found success with the drug Lipitor, commonly known as atorvastatin. Lipitor, when used in conjunction with diet and exercise, lowers "bad" cholesterol in order to prevent heart attacks and strokes. Lipitor has been called the world's best selling drug ever, bringing $10.7 billion in profit to Pfizer in 2010 ("Loss of lipitor," 2012). Lipitor was initially introduced by Parke-Davis Research Company in 1997 and sold by Warner-Lambert, a much smaller pharmaceutical company. Lipitor's success fueled a bidding war to acquire the exclusive contract from Warner-Lambert. Pfizer bought stock in Warner-Lambert until they were able to achieve a hostile takeover in June 2000, acquiring the rights to Lipitor in the merger.

Exclusive Contracts in the Pharmaceutical Industry

Exclusive contracts are essential in the pharmaceutical industry in order to ensure that the creator of a new drug is properly compensated for his or her time. The inventor of a new drug must first file for a patent so that they are guaranteed data exclusivity. Data exclusivity refers to "a practice whereby, for a fixed period of time, drug regulatory authorities do not allow the registration files of a pioneer drug company to be used to register a therapeutically equivalent generic version of that medicine" (Gangil, Thunga & Nagaich, 2010). This practice encourages innovation within the pharmaceutical industry because it allows the creator of the drug to receive substantial returns on their investment. It also provides reimbursement for the time it takes to test new drugs for efficiency and safety. Estimates of the average total development costs for a new drug suggest that the total cost is around $800 million, with 60% of the cost incurred through testing (Gangil et al., 2010). Without data exclusivity, generic copycat products could easily replicate the formula for the original drug without incurring the costs of testing, allowing them to sell the generic drug at a much lower cost. Once the inventor has received the proper patents for data exclusivity, they enter into an exclusive contract with one pharmaceutical company who takes care of marketing the product. These contracts help to further protect the inventor's investment and prove profitable for both parties involved.

Legal Aspects

The Bayh-Doyle Act of 1980 laid the foundation for government funded research by mandating that the inventor retain private control of their creation despite receiving federal grants. This initial incentive for research doubled the patent count from research universities from 1979 through 1984, which then doubled again from 1984 through 1989 (Kesselheim, 2010). This illustrates the importance of reimbursement and patent exclusivity on research incentives for new drugs. Next, the Orphan Drug Act of 1983 gave federal grants, tax breaks, and seven years exclusivity to orphan drugs after their FDA approval. This act only applied to drugs that would treat rare diseases because the smaller patient market made it harder for pharmaceutical developers to recover their costs during the initial exclusivity period. The Orphan Drug Act lead to the approval of 325 "orphan" products from 1983 through 2008, as opposed to 10 approved products in the previous decade (Kesselheim, 2010). The Waxman-Hatch Act of 1984 changed the regulations for generic drugs, giving the first generic drug 180 days of exclusivity before other generic drugs could be made. The intentions of the Waxman-Hatch Act were to encourage generic drug manufacturers to question approved patents and to create generics sooner by rewarding them for the legal fees required to question a brand name patent. This law has increased the number of generic drug prescriptions from 19% in 1984 to over 70% today (Kesselheim, 2010). Although the Waxman-Hatch Act has been effective in increasing the use of generic drugs, secondary effects of the generic exclusivity period have been increasingly controversial. Many companies with exclusive rights to brand name drugs have begun paying generic manufacturers to delay or give up their 180 days of exclusivity so the brand-name producing company can continue to profit. While this may be effective in extending the profitable period for brand name drug manufacturers, it also delays the arrival of lower cost drugs to the market. The final major act regarding drug exclusivity is the Prescription Drug User Fee Act of 1992, which allowed the FDA to charge a user fee in exchange for a faster drug review process. This shortened the average review time of a new patent application from 31 to 14.5 months; however, the number of drugs withdrawn after their approval due to safety concerns increased greatly (Kesselheim, 2010).

Public Opinion

Although data exclusivity encourages innovation within the pharmaceutical industry, public opinion on the subject has been both positive and negative. While legal mandates on the subject have good intentions, many of the above mentioned laws inadvertently reward unwanted behaviors and have been misused by manufactures in order to increase their profits. As mentioned above, the 180-day exclusivity for generic drugs created by the Waxman-Hatch Act has lead to many settlements between brand name drug producers and generic drug producers in order to prolong the original drug's exclusivity. The Orphan Drug Act encourages the creation of drugs for rare diseases, but those drugs are still sold at a high price and will most likely recover their research and development costs without government aid. Additionally, the patient end costs of a brand name drug during the exclusivity period are often high, which has contributed to the rising costs of health insurance, especially in public insurers such as Medicaid (Kesselheim, 2010). Most private insurance companies have drug programs that incentivize the use of generic drugs in order to cut down on their costs. When the higher cost drugs are prescribed, patients will often times not adhere to the recommended dosage of a drug in order to save money, which can eventually lead to even greater health problems. A survey conducted by Consumer Reports National Research Center in June 2011 found that "consumers continue to economize on healthcare by cutting corners in ways that may be dangerous. In the past year, nearly half (48%) took some action to reduce costs- up by 9 percentage points from 2010…and 28% failed to comply with prescriptions ("Best buy drugs," 2011)". Therefore, while drug exclusivity may be in the best interest of the consumer by incentivizing the creation of new drugs, it is not always seen as beneficial by the public.

Pfizer and Lipitor

Although the exclusive contract practices used by Pfizer are in line with the industry practices described above, Pfizer has recently encountered setbacks due to their exclusive contract for Lipitor. Their first setback was a lawsuit filed by AFL-AGC Building Trades Welfare plan, a health and welfare benefit plan in Alabama, over an alleged anticompetitive agreement between Pfizer and generic drug marketing company Ranbaxy. The lawsuit, filed in New York in 2011, claimed that although Lipitor's original patent ran out on March 24, 2011, Pfizer and Ranbaxy conspired to delay the sale of generic drugs for twenty months (Hurtado, 2012). The basis for the suit was a lawsuit settlement between Ranbaxy and Pfizer in 2008. In 2008, Ranbaxy was the first to challenge Pfizer's patent for Lipitor. Pfizer promised Ranbaxy the rights to a generic form of Lipitor in exchange for a twenty-month extension on their original exclusive production deal. The plaintiffs in the New York case stated the following; "Defendants' scheme was successful -- generic Lipitor did not become available for sale until November 2011. As a result of defendants' illegal acts, plaintiffs and the indirect purchaser class were forced to pay billions of dollars more for Lipitor than they would have absent defendants' anticompetitive scheme" (Hurtado, 2012). Another lawsuit began in November, when eleven pharmacies sued Pfizer for similar reasons in San Francisco. These pharmacies claim that Pfizer and Ranbaxy not only delayed the availability of generic Lipitor but also engaged in price fixing. This is based on the current cost of Lipitor, $4 a day, as compared to the cost for a generic version, 10 cents a day (Hurtado, 2012). These cases are both still pending.

After Lipitor's U.S. patent protection expired on November 30, 2011, United Sates sales for Lipitor dropped 42% and international sales dropped 24%. Overall, this loss cost Pfizer around $5 billion in their fourth quarter profits ("Loss of lipitor," 2012). Companies such as Watson Pharmaceuticals and Ranbaxy Laboratories Ltd have recently begun making generic versions of Lipitor. Since then, Pfizer has fought to retain the competitive advantage derived from the exclusive contracts through other less widely accepted means. One of their main strategies involves offering large discounts to customers who agree to stay with Lipitor over any new generic versions. By offering customers prices as low as $4 for a one month supply of Lipitor, Pfizer could potentially retain customers long enough that they could start charging normal prices again. Additionally, contracts with healthcare companies such as United Health Group and Coventry Health Care provide monetary incentives for the companies to block sales of generic Lipitor pills. These efforts have pushed the price of Lipitor even lower than some generic versions in order to attempt to maintain their market share. Pfizer has also licensed the rights to make the generic version to a specific company, Watson Pharmaceuticals, in order to retain some control over the production and continue to collect on the benefits (Armstrong, 2012).

Sony's Exclusive Contracts for Playstation2

When the video game industry began it focused on games for children; however, the video game industry has expanded beyond the children's market and is now most popular with young adults (the average age for a game player is currently 33 years old). Sales in the video game industry, including hardware and software sales, reached around $10 billion in 2005, a figure greater than Hollywood's box office sales. A video game system, by definition, is "a hardware platform that allows demanders (the video game consumers) to trade with suppliers (the video game publishers)" (Prieger & Hu, 2010). While the video game industry is considered a two-sided market, meaning a combination of hardware and software sales make up the overall profits, the main source of profit comes from software sales. Hardware developers Sony and Microsoft have even been known to sell video game platforms at a loss with the hopes of recovering their costs through either the sale of in-house produced games or license fees and royalties from independent game publishers (Prieger & Hu, 2010).

If a video game platform has only a few games created for it, it will die quickly die in the market place. This was the case when Sega produced the Dreamcast. Sega relied too heavily on only a few games and was eventually forced to end production of the Dreamcast platform in 2001. The main players in the video game industry today are Sony's Play-Station 3, Microsoft's Xbox 360 and Nintendo's Wii. However, this paper will focus more on the beginning of these hardware systems' dominance, between 2000 and 2004. During this time, Sony produced the Playstation2, Microsoft produced the Xbox, and Nintendo produced the GameCube. These gaming systems first introduced some of the most well known exclusive video games during this time period, and are still exploiting the success of these exclusives today.

Exclusive Contracts in the Video Game Industry

Exclusive contracts within the video game industry have been extremely prevalent since the industry's formation, led mainly by Nintendo in the 1980's. Video game hardware is of no use without the corresponding software. Kazuo Hirai, president of Sony Computer Entertainment, illustrated this situation by saying "You can have the best technology, the most advanced box in the world. But without the applications, that box will only collect dust on the retail shelves" (Binken & Stremersch, 2009). This realization is a large part of what has been driving the increase in exclusive contracts for video game software. As of 2010, one-third of Playstation 3 games and one-sixth of Xbox 360 games were exclusive. Exclusive games are defined as "games that can be played on one system, because the [platform] producer either created the game itself or negotiated an exclusive contract with a video game maker" (Prieger & Hu, 2010).

Hardware developers, such as Sony and Microsoft, have two sources of revenue from their product. The first is hardware sales and the second is licensing fees for complementary software. Most customers will only purchase one hardware system, so the availability of complimentary software is extremely important to hardware developers. Additionally, studies assume that "platform membership by itself does not provide any utility to the customers. Rather, the utility from membership accrues from being able to buy and consume the complements available for the platform" (Mantena, Sankaranarayanan & Viswanathan, p. 81, 2010). Consequentially, hardware developers want to ensure that their collection of complimentary software is unique and successful enough to warrant purchasing their system. Software developers have a larger incentive to develop software for larger hardware platforms, because more users own those platforms. Smaller hardware developers who wish to expand their compatible software portfolio can benefit from exclusive contracts because they take away business opportunities from the larger hardware platforms.

When beginning to develop new software, the developer can approach hardware platforms for either an exclusive or non-exclusive license for their product (or a game publisher can do this for the developer). At this time, platforms can choose to either reject the software or accept it for their platform. If multiple platforms are interested in exclusive contracts for this new software, they can begin a bidding war. During this time, the hardware platforms also negotiate the licensing fee they will charge based on a percentage of the software's total cost. After this process, the software developer or game publisher can decide which licenses to accept and can begin developing versions for the accepted hardware platforms. The main considerations when deciding which company to provide exclusivity to are the console's current and expected installed customer base (Prieger & Hu, 2010).

In addition to providing additional licensing revenue for hardware platforms, exclusive contracts have the potential to increase hardware sales. Sales of the primary hardware depend on the availability of complimentary software; additionally, the introduction of exceptional, or "superstar," software can increase hardware sales substantially. On average, popular software can increase hardware sales by 14% (167,000 units) beyond the effects of other hardware and software attributes (Binken & Stremersch, 2009). Superstar games are difficult to copy due to superior qualities and have substantially higher sales; the average software sale for superstars is 1.3 million units while nonsuperstars are 187,000 units. However, it is difficult to determine superstar status before a game is released because quality is often determined by consumer reaction. Some games do not recover their costs at all while others, such as *Grand Theft Auto – San* Andreas, can have returns more than 30 times the average development cost (Prieger & Hu, 2010). Hardware developers must take a risk when deciding which new software they should obtain an exclusive contract for because there is no verifiable test for superstar potential. When software is chosen correctly, the rewards can be extremely high. Hardware systems with the most exclusive superstars are the most successful (ie: Playstation and Xbox). Consequently, hardware platforms will pay extremely high fees to obtain exclusive rights to superstar software. Sony paid tens of millions of dollars to make software developer and publisher Take Two's *Grand Theft Auto* exclusive to Playstation2 and Microsoft paid $50 million for two downloadable episodes of the same game (Binken & Stremersch, 2009).

Although the exclusive contracts described above are similar to the contracts that have spurred antitrust concerns in other industries (such as Apple and AT&T in the wireless industry), few legal complications have occurred in the video game industry. The main legal case that relates to video game exclusivity is *U.S. v. Microsoft*, as mentioned earlier, in which Microsoft was charged with abusing its monopoly power by entering into contracts with Internet content providers and software developers to exclude competitors to Microsoft's Internet Explorer browser (Prieger & Hu, 2010). The main difference between the Microsoft case and video game exclusivity is the exploitation of monopoly power. Since there is no one dominant hardware system, there is no monopoly to exploit. Anticompetitive harm would only exist if a contract prevented entry or encouraged the exit of rival platforms that held potential value for customers. If a dominant hardware developer enters in to an exclusive contract, they force their competitors and potential market entrants with producing or contracting their own exclusive. This can raise costs and diminish competition. However, most video games have a short lifecycle (around 12 months) and exclusivity provides diminishing returns. According to a study on the effects of exclusivity, "[e]xclusivity helps a firm establish market share at first, but beyond a certain point additional locking up of software supply no longer hurts rivals" (Prieger & Hu, p. 2, 2010). These factors have prevented antitrust litigation on the subject so far, although changes in industry practices may lead to such litigation in the future. However, as long as exclusive contracts continue to allow firms to enter and establish market share without developing a monopoly, there may not be a need for antitrust intervention.

Sony's Exclusives

As mentioned above, Sony's Playstation 3 and Microsoft's Xbox 360 are the leaders for today's video game industry. When the two companies first experienced their success in the market, between 2000 and 2004, Sony's Playstation2 was the overall leader. Playstation2 was introduced in October 2000, and by 2004 they had maintained the highest percentage of software variety as well as the highest profits (Prieger & Hu, 2010). The Xbox was introduced a year later and had a lower price and a higher hardware quality then the Playstation2. Despite Xbox's advantage in other areas, Playstation2 was able to remain the best-selling platform because it had a larger portfolio of available software. The biggest success for Sony was the exclusive release of Grand Theft Auto on Playstation 2. Grand Theft Auto is a popular video game that was developed by software developer and publisher Rockstar Games. Three games from the Grand Theft Auto series have ranked as the top three software titles based on revenue; Grand Theft Auto: Vice City at $334.9 million, Grand Theft Auto: 3 at $319.9 million, and Grand Theft Auto: San Andreas at $276.5 (Prieger & Hu, 2010). Sony has utilized exclusive contracts in multiple ways. For their top seller, Grand Theft Auto: Vice City, Take 2 and Sony agreed to a one year exclusivity agreement, after which the game also became available on the Xbox. The two agreed to a similar two-year exclusivity agreement for Grand Theft Auto 3 and a one-year exclusivity agreement for Grand Theft Auto: San Andreas.

Despite the success from Grand Theft Auto, it is important to note that non-exclusive games brought in more revenue than exclusives for both Playstation2 and Xbox. Even though Playstation2 had more blockbuster exclusive games than non-exclusive, their non-exclusive games still brought in more total revenue. This may be because non-exclusive games earn revenue more quickly because their widespread availability can increase their popularity immediately after their release. Additionally, 8 out of the top 13 software titles based on revenue were made immediately available on all platforms (Prieger & Hu, 2010). Another example of a company that has been especially successful in producing non-exclusive software is EA games. They signed an exclusive contract with NFL in 2004 which gave them exclusive rights to NFL teams and players for five years. EA has been able to leverage its competitive advantage from this contract as well as its market power to refuse exclusive contracts with platform developers. As of 2005, eighty-seven percent of their software was available on at least two platforms and they had seven games out of the top thirteen with the highest revenue (Prieger & Hu, 2010).

The Decline of Exclusive Licensing

Despite the past popularity of exclusive licensing to one platform, the practice is becoming much less common. Josh Rubin is the co-founder of Naughty Dog, a software developer that favored Playstation. According to Rubin, "There's no reason to do an exclusive. There is a huge financial disadvantage" (Van Zelfden, p. 58, 2007). Many software producers only enter in to exclusive contracts because it will allow them to get a lower royalty rate and marketing assistance. Rubin explained the problems with exclusives by saying "It's kind of like selling your soul to get money to market the title and then when the title comes out, they don't make as much money because it's only on one platform, but it was the only way they could afford to promote the game in the first place" (Van Zelfden, p. 59, 2007). Currently, no hardware has enough units sold to justify exclusivity agreements. Additionally, software developers have the potential for a much higher profit by making their software available on all platforms. Games are becoming increasingly more expensive to make due to changes in technology. Since it only costs a software developer 10-15% more to adapt the software to an additional hardware platform, software developers may need to pass by exclusivity to recover their costs. Another consideration is the possibility of merchandising. Many video games lead to movies, comics, action figures, etc. and exclusivity limits the potential customer base for these products.

Discussion

Lessons Learned from Previous Examples

Although the examples discussed in this paper are from varying industries, they each have general business applications that should be considered by any company considering an exclusive contract as a competitive strategy. The first example, Apple and AT&T, highlights the importance of considering customer's needs when entering into an exclusive contract. The second example, Ticketmaster, is similar to the Apple example but also illustrates the negative effects on public opinion when exclusive contracts are abused. The third example, Pfizer, highlights the effects the end of a successful contract may have on a company's profits and the importance of considering the law when trying to maintain your competitive advantage. The final example, Sony and Playstation2, illustrates the uneven nature of exclusive contracts and raises questions about who really benefits from such agreements. Many of these considerations are apparent in all four examples and, consequentially, general conclusions can be made about the proper use of exclusive contracts.

There are some similarities between the examples discussed in this paper that may indicate what types of companies are more successful when using exclusive contracts. The first major similarity is product differentiation. Each company that entered in to an exclusive contract offered a unique product or service that created new value for their customers. In the cases of Apple and Sony, their products utilized a new technology that could not be found through other distributors. Apple's iPhone was especially unique and customers who wanted a smart phone of that caliber were forced to switch to AT&T to obtain it. Sony's exclusive games may have been similar to other available games, but the story of Grand Theft Auto was unique and consequentially, many loyal customers were willing to accept the exclusivity of the game and purchase it for Playstation2. In the case of Pfizer, brand name drugs are inherently differentiated because legally they cannot have serious competition until after their exclusivity period is over. Ticketmaster does not quite fit in to the differentiation standard because they achieve their differentiation through their exclusive contracts. The ticketing service they provide uses technology that is similar to their competitors; however, they differentiate themselves by having access to the majority of the performance venues across the United States.

The second similarity between the examples in this paper is the size of the companies entering in to the exclusive contracts. Larger, well-established companies are more likely to initiate exclusive contracts because they have more power to negotiate for exclusive contracts. With Apple, their size and the inherent demand for their products allowed them the freedom to enter in to an exclusive distribution contract with any wireless provider they wanted. AT&T was also previously established and could offer Apple access to a large customer base, which gave both Apple and AT&T bargaining power when entering in to their exclusive contract. Ticketmaster's size gives them considerable power when negotiating their contracts and has allowed them to continue growing by signing contracts with new venues. Due to their size, Ticketmaster has established such a large presence in the music industry that bands and venues that choose not to sign with them are placed at a considerable disadvantage (Knopper, 2009). When considering Pfizer, their size and resources helped them not only acquire the company that had the original exclusivity contract but also helped them take steps to retain their exclusivity beyond the original legal period. In Sony's case, size of the company is generally important in video game exclusivity contracts because it directly correlates to how many customers the software developer will be able to reach through their exclusivity. Overall, company size is a consideration and can lead to more successful exclusive contracts. However, as illustrated in many of these examples, size can also open a company up to anti-trust lawsuits. Therefore, a careful balance must be struck between using a company's size as an incentive for exclusivity with that company and using their size to monopolize the market through exclusivity.

Who do exclusive contracts really benefit?

Although exclusive contracts can be used as a competitive advantage, it is not always clear which company is benefitting from the agreement. When the contract involves a unique product, such as the iPhone or a superstar video game, the product's creator actually may be sacrificing profit by entering into the contract. In Apple and AT&T's case, Apple had the potential to make a much higher profit by making the iPhone available on all carriers. The deal may have helped in increasing demand for the product, but that is hard to determine since Apple already had a loyal customer base after their success with the iPod. By tying themselves to one wireless company, Apple narrowed their customer base to only 30% of the US market, excluding and potentially losing interested customers on other wireless networks (Zhu et al., 2011). Since the typical wireless contract lasts for two years, the exclusivity of the iPhone for almost five years may have potentially lost them loyal customers who would have resigned their contract one or two times during that time period. Additionally, restricting the iPhone to one carrier forced other wireless carriers to find new ways to compete. This lead to the creation of new smart phones, such as Verizon's Droid, that attempted to imitate the iPhone's qualities. Although these new smart phones have not surpassed the iPhone's popularity, they still take potential customers away from the iPhone. Alternatively, the Blackberry was released on all carriers and there was no need to create similar commercial devices because all customers had access to the Blackberry. Although Apple has a large market share now, they may have had larger control of the market if the iPhone had been immediately available on all carriers. AT&T, on the other hand, benefited greatly from the iPhone's exclusivity. Not only were they able to sell the iPhone at a premium and collect on data charges, they were also able to steal customers from rival wireless providers. Consequentially, AT&T appears to have benefited much more than Apple in their exclusive contract.

A similar situation appears in the case of Sony and their exclusive video games. As mentioned before, software producers have the potential to make a lot more money when they offer their games on all hardware systems because it gives them access to the entire gaming community. The main benefit from entering into an exclusive contract goes to the hardware producer because they are able to take potential profits away from their competitors. The main reason for entering into a contract like this for the software company is to subsidize the cost of producing the software. They can also receive marketing and sales assistance from the hardware company. Hardware companies are aware that they receive most of the benefit from an exclusive contract, which is why they offer software companies high initial payments and low royalty rates in exchange for exclusivity.

In the case of Ticketmaster, the exclusive contracts clearly benefits Ticketmaster more than the venues that enter into the contracts with them. However, another concern here is how their exclusive contracts negatively impact their customers. Their exclusive contracts have removed their customer's ability to choose what company they want to work with. When considering the artists as the customers, one just has to refer back to the Pearl Jam lawsuit to see the negative effects. Pearl Jam was unable to tour for a summer when they tried to avoid using Ticketmaster and suffered greatly from their attempt (Boehlert, 1995). Ticketmaster's other customers, concertgoers, also suffer due to Ticketmaster's control over most venues. Customers have very little bargaining power because they lack options and, consequentially, Ticketmaster has considerable freedom when setting their ticket prices.

Pfizer has similar problems as Ticketmaster in regards to how their contracts affect their customers. Both situations provide a competitive advantage for the companies involved, but do so at the customer's expense. Pfizer's customers may suffer because they cannot afford to purchase brand name drugs. This higher price is acceptable during the initial exclusivity period according to the pharmaceutical industry's standards; however, the main harm occurred when Pfizer tried to prolong their exclusivity agreement beyond the legally mandated period. While the original exclusivity period is in place to ensure that the drug's creator is properly rewarded for their time and effort, extending the exclusivity period only serves to increase the monumental profits Pfizer had already accrued. Their decision is not only potentially illegal, but also ignores the needs of patients using Lipitor.

When is it beneficial to have an exclusive contract?

Although the examples discussed in this paper illustrate some of the negative aspects of exclusive contracts, they also hint at what conditions lead to beneficial exclusive contracts. The main condition that must be considered when entering into an exclusive contract is whether or not it will create a monopoly for either company involved. While the prospect of higher profits and decreased competition may be appealing, anti-competitive lawsuits and negative public image have the potential to cost much more in the long term. Ticketmaster's experience with this especially illustrates the effects monopoly accusations can have on a company's public image. While no company has been able to overtake Ticketmaster so far, there is still a chance that another company could. Ticketmaster has made many enemies since they began taking over their section of the industry; consequentially, there are many companies who are attempting to compete with and eventually surpass Ticketmaster. When a company becomes the top in their industry, they become the company that everyone aims to overtake. Therefore , they open themselves up to increased levels of scrutiny and competition. Additionally, by creating enemies within their industry Ticketmaster has opened themselves up to the potential for even more lawsuits in the future. Although their current CEO is attempting to repair these relationships, many people have spent their musical careers fighting Ticketmaster and it is unlikely that they will stop (Salter, 2011).

Another condition that may warrant an exclusive contract is when one company does not have the resources to properly market or create demand for a new product. Apple and AT&T's exclusive contract came close to meeting these conditions, but the high demand and lack of substitutes for the iPhone made the exclusive contract almost unnecessary. Apple had the resources they needed to market the iPhone on their own but chose to partner with AT&T through an exclusive contract anyway. Additionally, the demand for the iPhone was already high when the product first launched due to the success of the iPod. Delaying availability may have frustrated customers and caused a decrease in demand over time. Only customers that had an overwhelmingly high demand would make the effort to switch to AT&T for the iPhone; other customers may have chosen to do without in favor of convenience or a preferred wireless carrier.

Software for video games is a good example of when an exclusive contract assists a company who lacks the resources to launch their product on their own. As mentioned above, software companies have the potential to make more money when they make their product available on all consoles; however, rising costs of video game development has forced developers to seek assistance. By making their product exclusive, software developers usually receive an initial payment, better royalty rates and marketing assistance. Software companies have also begun using short-term exclusive contracts, which could be potentially beneficial in other situations. These short-term contracts give the software companies the assistance they need to launch their product while guaranteeing one hardware company a specified exclusivity period. Then, once that exclusivity period is over, the software company is free to make their game available to all consoles. These contracts usually last around a year and create a short period of exclusivity that can also assist in building demand for the product. Additionally, having a year of exclusivity can give software developers a trial period to test the game's popularity on one console before investing in development for other consoles. This also protects the software developer if the game is not successful because they had help with the initial development costs and they did not spend the extra money to make the software compatible with other consoles. Short-term exclusivity may have been a better option for Apple and AT&T because it might have prevented the level of customer dissatisfaction that resulting from their initial exclusive contract. Had their exclusivity only been for a year or two, AT&T would have had the advantage of being the first carrier to provide the iPhone but their customers would not have been forced in to a five-year contract. This change could have potentially allowed Apple and AT&T to avoid the lawsuit that they are currently facing.

When choosing to enter into an exclusive contract, it is also important to consider the alternatives available. In cases where the motivation for the contract is resource sharing, a strategic partnership may be equally efficient. This allows companies to share resources and knowledge during the development phase of a product without putting a specific time restraint on the relationship. If Apple had entered into a strategic partnership with AT&T instead of an exclusive contract, they could have continued to offer benefits to AT&T but would have been more adaptive when consumers began to demand the iPhone on other carriers. Additionally, any issues about AT&T's service or data charges would not have reflected directly upon Apple. This flexibility is essential when releasing a new product because, even with careful planning and market research, companies can never know without a doubt how a product will fare in the market. Furthermore, strategic partnerships allow for collaboration without making one company dependent on the other. As mentioned before, a potential downfall of exclusive contracts is free riding. A strategic partnership allow companies to work together but gives each company a more flexible exit strategy in case the other does not uphold their end of the bargain.

As mentioned at the beginning of this paper, another alternative to exclusive contracts is vertical integration. Vertical integration also guarantees supply but gives the parent company considerably more control over the processes. Sony's main competitor, Microsoft, has been successful with this alternative. Rather than use an exclusive contract to obtain exclusivity to Halo, Microsoft's blockbuster game for Xbox 360, Microsoft acquired the software company that created the game. This may be the reason that Halo and Halo 2, the 8th and 4th top software titles by revenue, are the only titles out of the top 13 that have been released on only one console (Prieger & Hu, 2010). Microsoft created a high demand for the game and maintained complete control over the supply by acquiring the software company. It should be noted that Bungie became independent from Microsoft in 2007, after the release of the first two Halo games. However, Microsft retained an equity interest in Bungie and exclusivity for all future Halo releases (Microsoft News Center, 2007). Sony, on the other hand, eventually lost their exclusivity for Grand Theft Auto due to the short term of their exclusive contracts and was forced to fight for exclusivity when the sequel games were released.

Conclusion

Although exclusive contracts have been used in business since the early 1900's, their recent uses have changed the way companies create exclusive contracts. By using them to control a unique product or service, companies use exclusive contracts to gain control over their industry rather than the traditional contracts to create a relationship with a supplier or distributor. It is difficult to determine if this practice will continue since there have been anti-trust lawsuits in the case of Apple, Pfizer and Ticketmaster. Apple and Pfizer's cases are still pending but the outcomes of those cases may either incentivize or discourage future exclusive contracts. Ticketmaster has succeeded in winning all lawsuits they have been presented with so far, but the damage to their public image will take a long time to repair. Although recent lawsuits have not ended negatively yet, one just has to refer back to the *U.S. v. Microsoft* case to see the possible negative outcomes from a lawsuit regarding exclusive contracts. While there may be considerable benefits to exclusive contracts, the negative aspects potentially outweigh those benefits, making such contracts dangerous to enter in to.

Companies who are interested in entering in to an exclusive contract must examine multiple aspects of the arrangement to ensure that their contract will be successful. They must look at the risk involved for each participant in the contract as well as who receives the most benefit from the contract. If the benefits are equal between both companies than the exclusive contract may be worthwhile. The contract may also be worthwhile if one company is sacrificing some of their potential external benefit in exchange for resources or assistance from the other company. Companies must also consider the effects an exclusive contract will have on their customer base. If there are any negative effects on the customers because of the exclusive contract, then the companies must be prepared to either handle the bad press or edit the contract so that it is more customer friendly. The final major consideration before entering in to an exclusive contract is the acceptance level of such contracts within that particular industry and the anti-trust implications exclusive contracts. Lawsuits can be damaging and expensive, outweighing the benefits of added profits from the exclusive contracts. If a company considers the potential negative outcomes and finds that their exclusive contract has a low risk of encountering them, then exclusive contracts can lead to higher profits and a guaranteed relationship with another company.

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