Fordham Law Review

Volume 47 | Issue 4 Article 3

1979

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B.J. Douek

Recommended Citation

B.J. Douek, *A Proposed Rule of Reason Analysis for Restrictions on Distribution*, 47 Fordham L. Rev. 527 (1979).

Available at: https://ir.lawnet.fordham.edu/flr/vol47/iss4/3

COMMENT

A PROPOSED RULE OF REASON ANALYSIS FOR RESTRICTIONS ON DISTRIBUTION

INTRODUCTION

Continental T.V., Inc. v. GTE Sylvania Inc.[1] is fast becoming one of the most controversial decisions in antitrust history. In the first such decision this century to overrule a major Supreme Court precedent, the majority struck down the sales-agency distinction which had been established in *United States v. Arnold, Schwinn & Co.*[2] only ten years before to determine the legality of vertical territorial restrictions. The primary significance of *Sylvania* is that it directs the courts to turn away from the factitious, formalistic categories previously used to determine the legality of distribution restrictions.[3] Henceforth, courts must focus their inquiry on the underlying question of competitiveness[4] rather than on formal classifications.[5] *Sylvania* requires a showing of "demonstrable economic effect" to justify "departure from the rule-of-reason."[6] Reversal of the *Schwinn* decision, in which the Court reached its pinnacle in permitting the form of a transaction to dictate lawfulness, was an important first step toward an approach which allows businessmen to justify restrictions on distribution on the basis of competitive pressures.

In making this step, the *Sylvania* decision requires a new rule of reason test designed to permit businessmen to show what competitive pressures they face. The first purpose of this Comment, therefore, is to propose a functional rule of reason test to be applied in vertical territorial restrictions, the only type of distribution restriction which currently may be analyzed under this rule. To this end, Part I will briefly review the history of trade restraint litigation leading up to *Sylvania* to show how formalistic distinctions developed and how the result of modern cases depends upon the form of the restraint in question. This review will also show the need for a new test directed at competitive impact rather than form. Then, in an effort to establish a foundation for the proposed test, Part II will discuss economic theories relevant to the resolution of restraint of trade cases under section 1 of the

1. 433 U.S. 36 (1977).

2. 388 U.S. 365 (1967). Territorial restraints imposed on a dealer pursuant to a sale were deemed to be per se unlawful, though the same restraints imposed in an agency situation could be potentially lawful. *Id.* at 375. The *Sylvania* Court listed a large number of articles criticizing *Schwinn.* 433 U.S. at 48 n.13.

3. Restrictions on distribution include: resale price maintenance, exclusive territories, location clauses, and customer restraints, whether vertically or horizontally imposed.

4. National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 690-92 (1978). Although this case did not involve restrictions on distribution, it reaffirms the notion that competitiveness must be the central issue in questions of restraints of trade. Unfortunately, the decision does not explain how the competitiveness issue should be analyzed. *See* notes 143-44 *infra* and accompanying text.

5. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 58-59.

6. *Id.*

Sherman Act (the Act).[7] The test itself is proposed in Part III, and, in Part IV, the *Schwinn* and *Sylvania* fact patterns will be analyzed to demonstrate the mechanics of the test.

Hopefully, *Sylvania* will pave the way for future decisions abandoning formalistic distinctions in distribution restriction cases. Although the Court criticized such distinctions, it preserved in dicta two substantial vestiges of the formalistic approach[8]—the distinctions between horizontal and vertical restrictions and between price and nonprice restraints. The fundamental issue with respect to horizontal relationships[9] and resale price maintenance[10] has always been whether the restraints are so inherently pernicious that they must necessarily have a negative impact on competition.[11] The second purpose of this Comment is to demonstrate that many such restraints are procompetitive. Thus, Part V will show that the rule of reason analysis proposed below can apply to practices classified as horizontal or to agreements involving resale price maintenance to determine the legality of the restraint in question. Unlike a per se approach, a workable rule of reason test can distinguish procompetitive and anticompetitive restraints.

I. HISTORICAL DEVELOPMENT OF PRECEDENT

The sweeping language of section 1 of the Sherman Act declares illegal "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations."[12] The early view was that Congress intended that the statute be construed literally so as to condemn all contracts restraining trade.[13] Realizing, however, that every contract restrains trade to some degree,[14] later courts concluded "that Congress did not intend to prohibit all contracts, nor

7. 15 U.S.C. § 1 (1976).

8. According to the Court, the *Sylvania* decision did not affect horizontal restraints, 433 U.S. at 58 n.28, or price maintenance, *id.* at 51 n.18.

9. Agreements among firms that ordinarily would compete among themselves or that operate at the same market level involve horizontal relationships. For example, in United States v. Sealy, Inc., 388 U.S. 350 (1967), a group of mattress manufacturers formed a trademark licensing corporation in order to allocate exclusive territories and fix prices among themselves. Because they were potential competitors, the arrangement was found to be horizontal. *Id.* at 352; *see* 28 Wash. & Lee L. Rev. 457, 461-62 (1971).

10. In a resale price maintenance arrangement, manufacturers set the price at which their product must be resold by wholesalers or retailers or the price below which their products may not be resold. *See, e.g.,* Dr. Miles Medical Co. v. John D. Parke & Sons Co., 220 U.S. 373 (1911); F. Scherer, Industrial Market Structure and Economic Performance 512 (1970).

11. Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958), *discussed at* note 19 *infra* and accompanying text.

12. 15 U.S.C. § 1 (1976).

13. In United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290, 291-304 (1897), eighteen railroads operating west of the Mississippi established a freight rate schedule to prevent competitive forces from reducing rates to a below-cost level. The cartel, however, imposed no restrictions affecting market share or potential customers. The Court applied the "plain and ordinary meaning of [the] language" of the Act, *id.* at 328, to find the railroad-rate cartel illegal. *Id.* at 291-304.

14. Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

even all contracts that might in some insignificant degree or attenuated sense restrain trade or competition."[15] Justice White wrote in *Standard Oil Co. v. United States*[16] that congressional intent was to hold unlawful only those agreements and combinations which unduly restrain interstate or foreign commerce and that the standard for determining whether the statute has been violated is the standard of reason.[17] This standard, which came to be known as the rule of reason, is described in the oft-cited language of Justice Brandeis: "Every agreement concerning trade, every regulation of trade, restrains. . . . The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition."[18]

Notwithstanding the pronouncements that a reasonableness standard be used in determining the legality of restraints on trade, the Court made clear in *Northern Pacific Railway v. United States* that not all cases are subject to such a standard:

> [C]ertain agreements or practices . . . because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. This [is the] principle of per se unreasonableness . . . .[19]

Therefore, under a per se rule the complainant need show only that defendants engaged in a prohibited practice. This practice is automatically deemed to be illegal even absent proof of an antisocial or anticompetitive effect.[20]

15. United States v. Topco Assocs., 405 U.S. 596, 606 (1972). The progression to the less literal interpretation expressed in *Topco* began one year after United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897), *see* note 13 *supra*, in a case of similar facts, United States v. Joint Traffic Ass'n, 171 U.S. 505, 558 (1898). The *Joint Traffic* Court rejected defendants' argument that cartels were necessary to prevent monopoly, *id.* at 576-77, saying that an agreement "which directly and effectually stifles competition, must be regarded under the statute as one in restraint of trade." *Id.* at 577. For the first time the Court recognized that restrictions with only indirect and incidental effects on competition could potentially be lawful. *Id.* at 568. The Court's rationale was based partly on the circuit court opinion of United States v. Addyston Pipe & Steel Co., 85 F. 271 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899), in which Judge Taft wrote that all restraints are unlawful except those "merely ancillary to the main purpose of a lawful contract, and necessary to protect the covenantee in the enjoyment of the legitimate fruits of the contract, or to protect him from the dangers of an unjust use of those fruits by the other party." *Id.* at 282. Conversely, if the main purpose is to restrain competition, nothing will justify the restraint. *Id.* at 282-83. The Supreme Court majority did not mention the ancillary doctrine in resolving *Addyston*, but the *Joint Traffic* Court referred to the doctrine favorably. 171 U.S. at 560; L. Sullivan, Handbook of the Law of Antitrust, § 64, at 171 (1977).

16. 221 U.S. 1 (1911).

17. *Id.* at 60; *accord*, National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 688 (1978).

18. Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

19. Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958).

20. United States v. Topco Assocs., 405 U.S. 596, 607 (1972); United States v. Container Corp., 393 U.S. 333, 340 (1969) (Marshall, J., dissenting); *see* United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 221-23 (1940); F. Scherer, *supra* note 10, at 428.

A. *Vertical Restraints*

A vertical relationship exists when firms operating at different market strata act in concert. At the upper end of the system is the market supplier, usually a manufacturer. The bottom stratum is comprised of dealers or retailers. When the entire marketing system is comprised of only these two layers, it is referred to as a two-tier system. When an intermediate level exists, comprised of wholesalers or distributors, the system is said to be three-tiered. These two arrangements are the most common, but other multi-tier arrangements exist as well.

1. Resale Price Maintenance

With regard to resale price maintenance generally, a review of the cases reveals three basic patterns—those involving agreements between the market supplier and distributors and/or dealers,[21] those imposed unilaterally,[22] and those imposed pursuant to an agency-consignment contract.[23] The outcome of any challenge to a resale price maintenance program will depend on the program's classification into one of these three categories.

In the first situation, the courts have found an intent among dealers to form a cartel[24] and have held these arrangements per se illegal.[25] The second category, in contrast, occurs when the price maintenance is imposed unilaterally, as in *United States v. Colgate & Co.*,[26] which upheld the announcement of a price maintenance policy and a simple refusal to deal with noncomplying dealers.[27] The facts of *Colgate*, however, will be very difficult to duplicate in a three-tier market system[28] and are not easy to duplicate in a two-tier market

21. In Dr. Miles Medical Co. v. John D. Parke & Sons Co., 220 U.S. 373 (1911), the market supplier had fixed minimum resale prices of both wholesalers and retailers. The program required the signing of contracts that would ensure the maintenance of the price structure. *Id.* at 374-81.

22. In United States v. Colgate & Co., 250 U.S. 300 (1919), the market supplier unilaterally refused to sell to dealers failing to charge a *suggested* retail price.

23. United States v. General Elec. Co., 272 U.S. 476, 483-84 (1926).

24. *See* pt. II(A) *infra*.

25. *E.g.*, Dr. Miles Medical Co. v. John D. Parke & Sons Co., 220 U.S. 373 (1911). The decision in *Dr. Miles* borrowed the logic of Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899), in which a horizontal cartel was condemned. The Court likened the *Dr. Miles* arrangement to a horizontal cartel and condemned it per se without finding collusion between the market supplier and the dealers. 220 U.S. at 408; *see* notes 9-10 *supra* and accompanying text. Professor Posner points out that the *Dr. Miles* Court did not actually claim that the manufacturer was acting as an agent for a dealer cartel but nevertheless treated the case as if this were so. Posner postulates that, although the Court stated that all benefits of retail price maintenance inure to the dealer, some restrictions could result in some benefit to the manufacturer to which it was not entitled. R. Posner, Antitrust Law 151-53 (1976).

26. 250 U.S. 300 (1919).

27. *Id.* at 307. "In the absence of any purpose to create or maintain a monopoly, the act does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal." *Id.*; *see* note 22 *supra*.

28. The *Colgate* doctrine was limited by United States v. Parke, Davis & Co., 362 U.S. 29 (1960), which stands for the proposition that market suppliers cannot utilize wholesalers to police a resale price maintenance policy imposed on retailers. In a policing arrangement the market supplier's conduct is no longer unilateral but is cooperative and, therefore, equivalent to an express

system.[29] Generally, when a supplier engages in a program of refusing to deal, some extra activity on the part of the market supplier, such as policing, enables the court to find an implied agreement.[30] The Court in *Albrecht v. Herald Co.*[31] found more than a mere announcement and simple refusal to deal on the part of the market supplier in this two-tier market situation. This case was a further setback to resale price maintenance in that retail price ceilings were held illegal despite the arrangement's purpose of maintaining lower prices.[32] Consignment arrangements, the third category, will be per se illegal if they involve coercion.[33] Even in the absence of coercion, resale price maintenance in agency or consignment situations is probably suspect.[34]

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or implied agreement suppressing competition. *Id.* at 40-41, 44. The *Parke, Davis* decision was probably colored by the fact that the case had strong overtones of boycott—in and of itself a per se violation. United States v. General Motors Corp., 384 U.S. 127 (1966); Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959); Fashion Originators' Guild of America, Inc. v. FTC, 312 U.S. 457 (1941). *Parke, Davis* is difficult to reconcile with *Colgate*, which allows announcement and followthrough of a suggested retail price program. If the supplier uses wholesalers to police retailers, however, the program is per se illegal. Thus, a market supplier must police its resale price maintenance program itself. The only suppliers capable of doing this are those large enough to own their own wholesale network, that is, those large enough to operate in a two-tier system. If the market supplier lacks the wherewithal to handle its own wholesale distribution and, therefore, works within a three-tier system, it will be unable to enforce its announced policy and will be placed at a disadvantage compared with its larger competitors. R. Posner, *supra* note 25, at 155.

29. In a two-tier arrangement, one must beware of overzealous manufacturer representatives whose actions might transfer a unilaterally imposed suggested retail price program into an agreement to maintain prices.

30. In FTC v. Beech-Nut Packing Co., 257 U.S. 441, 454-56 (1922), for example, Beech-Nut secured the cooperation of distributors and dealers by having company agents and complying dealers identify and report dealers who were unwilling to comply with Beech-Nut's price policy. The Court found this arrangement to be no different from an express or implied agreement to achieve the same result. Similarly, in United States v. Bausch & Lomb Optical Co., 321 U.S. 707, 723 (1944), the Court found a conspiracy in the utilization of wholesalers to control retailers' compliance, even though the company and the wholesalers had no express agreement.

31. 390 U.S. 145, 149 (1968). Because Albrecht, an independent newspaper carrier handling home delivery, sold newspapers for more than the set maximum price, the publisher exercised his reserved right to compete with home deliverers who refused to comply with contract terms. The publisher subsequently obtained about 25% of Albrecht's customers and assigned them to a new carrier. By the time Albrecht brought suit, his contract had been terminated. Forced to sell his route with only 75% of his customers, Albrecht claimed to have suffered a loss. *Id.* at 147-48. The Court found an illegal combination between the new carrier and the publisher, analogizing the case to *Parke, Davis*. *Id.* at 149-50.

32. *Id.* at 152-53.

33. Simpson v. Union Oil Co., 377 U.S. 13, 24 (1964). Prior to *Simpson*, the Court had upheld a resale price maintenance program in a consignment arrangement that was free of coercion. United States v. General Elec. Co., 272 U.S. 476 (1926). *Simpson* involved an arrangement whereby a refiner sold gasoline on a so-called consignment basis to various service station dealers. Unlike a standard consignment arrangement, however, the refiner forced essential indicia of ownership, such as risk of loss and payment of insurance, upon the dealers. Furthermore, if dealers did not adhere to the set resale price, their annual leases to the service stations were not renewed. 377 U.S. at 24.

34. Professor Averill rightly finds the *Simpson* opinion elusive: "The only sure conclusion which can be made is . . . that upon [a] review of all the facts of the case, Simpson had shown an

Sylvania, which overruled the sales-agency distinction used to determine the legality of a vertical territorial restraint,[35] probably undermines the consignment distinction made with regard to resale price maintenance as well.

2. Nonprice Restrictions

Three of the most commonly employed vertical nonprice restrictions[36] are the closed or exclusive territory,[37] the unauthorized outlet or dealer location clause,[38] and the customer restriction.[39] Prior to *Schwinn*, the Supreme Court had taken a liberal view toward such restrictions. In *White Motor Co. v. United States*,[40] for example, the market supplier had imposed closed territorial and customer restraints in vertical franchise agreements with its dealers.[41] In refusing to sustain summary judgment against the market supplier, the Court said:

> We do not know enough of the economic and business stuff out of which [vertical territorial restrictions] emerge to be certain. They may be too dangerous to sanction or they may be allowable protections against aggressive competitors or the only practicable means a small company has for breaking into or staying in business . . . and within the 'rule of reason.' We need to know more . . . about the actual impact of these arrangements on competition to decide whether they have such a 'pernicious effect on competition and lack . . . any redeeming virtue' . . . [that they] therefore should be classified as *per se* violations of the Sherman Act.[42]

In contrast to the *White Motor* Court's focus on the competitive impact of the restriction, the Court later took a formalistic approach in *Schwinn*. In that case the market supplier had imposed customer and territorial restraints

actionable wrong under the antitrust laws." Averill, *Sealy, Schwinn and Sherman One: An Analysis and Prognosis*, 15 N.Y.L.F. 39, 43 (1969) (footnote omitted). At a minimum, however, courts can be expected to take a close look at any resale price maintenance situation. *Id.*

35. *See* notes 50-54 *infra* and accompanying text.

36. Averill, *supra* note 34, at 62.

37. In such an arrangement, the dealer has an exclusive right to operate within a territory. The market supplier relies upon the dealer's knowledge of and familiarity with the locale to determine the amount of sales effort, locations, and sales help necessary to develop the territory.

38. The market supplier in this situation allocates locations from which dealers may distribute its goods but leaves the dealers with less discretion as to coverage of territory. Courts generally view this type of restriction as less restrictive than exclusive territories in that these practices do not altogether eliminate intrabrand competition within each territory. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 59-60 (White, J., concurring).

39. Unlike other territorial restrictions, which are imposed upon vendors, the customer restraint places the restriction upon vendees in that the market supplier limits the customers with whom the retailer may deal. Specifically, the dealer is restricted either as to class of customer, that is, to particular retailers or wholesalers, or as to the location of the ultimate customer. As a result, a dealer may be unable to sell to an out-of-territory customer even though the customer approaches the dealer in his own territory. Of the nonprice restraints, customer restrictions will generally have the greatest impact on competition, and courts, therefore, evaluate them cautiously. *See id.* at 60-63.

40. 372 U.S. 253 (1963).

41. *Id.* at 255-56.

42. *Id.* at 263 (citations omitted). The Court deferred judgment on whether a rule of reason or per se rule should be applied until the case was heard on its merits. *Id.* at 261; R. Posner, *supra* note 25, at 159.

upon its licensed dealers and distributors.[43] The purpose of the restraints was to ensure that Schwinn bicycles were sold to consumers only through carefully chosen dealers. All of the dealers were bicycle repair shops whom the market supplier considered capable of providing vital services necessary to maintain the product's quality image and consumer satisfaction.[44] Rather than looking to the competitive impact of the restraint to determine whether a per se rule should be applied, the Court distinguished between bicycles sold to distributors for resale to dealers and those sold directly to dealers through a distributor-agent of Schwinn. In the first situation, because the market supplier had parted with title to and dominion over the bicycles, the majority reasoned that the Schwinn restrictions were a substantial restraint on alienation and therefore per se unlawful. When title did not pass from Schwinn, as in the second situation, the restraints were to be tested for reasonableness.[45]

The *Schwinn* holding had serious consequences both for the state of the law and for businessmen. From a legal point of view, courts were faced with the proposition that the same restriction imposed by the same market supplier on the same dealer could potentially be reasonable or, depending on the form of the transaction, have so pernicious an effect on competition as to be per se unlawful.[46] From a business standpoint, market suppliers would have difficulty preventing undesirable dealers from improperly selling the supplier's goods unless they were large enough to integrate vertically or to sell to consumers through dealers on a consignment basis.

Prior to *Schwinn*, courts often found vertical restraints to be per se illegal by analogizing the agreements between the supplier and his dealers to a horizontal conspiracy. In *Dr. Miles Medical Co. v. John D. Parke & Sons Co.*,[47] the fundamental precedent for extending the per se rule from horizontal conspiracy cases to vertical cases, the Court said that the market supplier could "fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other."[48] It was on this basis that Professor Posner criticized the *Schwinn* decision, arguing that in relying upon restraint on alienation the Court departed from the rationale used in deciding *Dr. Miles*. Furthermore, restraint on alienation is not protected by the Sherman Act.[49]

In 1977, the Supreme Court in *Sylvania* specifically overruled *Schwinn* and

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43. 388 U.S. at 370-71. For a more detailed discussion of the Schwinn restrictions, see notes 199-208 *infra* and accompanying text.

44. United States v. Arnold, Schwinn & Co., 237 F. Supp. 323, 335 (N.D. Ill. 1965), *aff'd in part and rev'd in part*, 388 U.S. 365 (1967).

45. 388 U.S. at 379-80.

46. Robinson, *Recent Antitrust Developments: 1974*, 75 Colum. L. Rev. 243, 271 (1975).

47. 220 U.S. 373 (1911), *discussed at* notes 21, 25 *supra* and accompanying text. The Court's reasoning in applying a per se rule in *Dr. Miles* applies equally to nonprice restraints.

48. *Id.* at 408.

49. R. Posner, *supra* note 25, at 163. A multitude of authorities have criticized *Schwinn* as being irrelevant to the question of competition, based on a faulty legal precedent, and in itself detrimental to competition. Editorial Note, *Territorial and Customer Restrictions: A Trend Toward a Broader Rule of Reason?*, 40 Geo. Wash. L. Rev. 123, 131 & nn.66, 67 & 68 (1971) [hereinafter cited as *Broader Rule of Reason*].

held that territorial restrictions are not illegal per se even if imposed pursuant to a sales contract.[50] In abandoning the status of title distinction as a criterion of legality, the Court intends that a rule of reason analysis based upon demonstrable economic effect,[51] that is, impact on competition,[52] be employed to determine whether the Sherman Act has been violated. Furthermore, a per se prohibition is justified only when the threshold of economic harm set forth in *Northern Pacific*[53] is reached.[54] At present, therefore, vertically imposed nonprice restraints must be tested under a reasonableness standard to determine their true impact on competition. Some plaintiffs, on the other hand, will attempt to color the nonprice restraints as an overall scheme to fix prices or as an agreement that is horizontal in nature in order to bring the restraint under a per se prohibition.[55]

B. *Horizontal Restraints*

A horizontal relationship exists between firms that operate at the same market stratum, that is, in competition with one another. Such a relationship could include combinations of two or more market suppliers, two or more distributors, or two or more dealers. A horizontal relationship may also exist when firms from different market strata operate at the same level with respect to the restriction in question. A market supplier and its dealers may operate at the same level if the supplier sells directly to consumers as well as to dealers in a so-called dual distribution arrangement. Courts have found such dual distribution arrangements to be horizontal in nature.[56]

United States v. Addyston Pipe & Steel Co.[57] and its progeny created a strict rule of per se illegality for horizontal restraints.[58] The rationale for applying the per se rule was that the party initiating the restraint usually had a purpose of lessening competition at the same level of distribution as those

50. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 58.

51. Pitchford Scientific Instruments Corp. v. Pepi, Inc., 435 F. Supp. 685, 686 (W.D. Pa. 1977) (interpreting Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977)).

52. National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 690-92 (1978).

53. *See* note 19 *supra* and accompanying text.

54. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 57-58.

55. *See* Oreck Corp. v. Whirlpool Corp., 579 F.2d 126, 130-31 (2d Cir.), *cert. denied*, 99 S. Ct. 340 (1978).

56. In United States v. McKesson & Robbins, Inc., 351 U.S. 305, 307-08 (1956), even though the relationship of defendant to its distributors was vertical, the nature of the restraints was horizontal in that the defendant operated at the same market level as its franchisees who were subject to a resale price maintenance policy. In American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230, 1254 (3d Cir. 1975), defendant's foreclosure of its franchisees from operating Holiday Inns or other motels in cities where defendant operated an inn without its permission constituted "market allocation agreements among competitors." A horizontal division of markets was found to exist between the market supplier and its licensees in Hobart Brothers Co. v. Malcolm T. Gilliland, Inc., 471 F.2d 894, 899 (5th Cir.), *cert. denied*, 412 U.S. 923 (1973), because the firms also were rival distributors.

57. 175 U.S. 211 (1899), *discussed at* note 15 *supra*.

58. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 58 n.28 ("no doubt" that horizontal restraints are per se illegal); White Motor Co. v. United States, 372 U.S. 253, 263 (1963) (horizontal restraints "are naked restraints of trade with no purpose except stifling of competition").

agreeing to the restraint.[59] Furthermore, in *United States v. Trenton Potteries Co.*,[60] the Court held that reasonableness of price was not a relevant defense to a Sherman Act attack on an agreement to fix or maintain prices.[61] "The aim and result of every price-fixing agreement, if effective, is the elimination of one form of competition."[62] In so holding, the Court distinguished price-fixing cases from other cases in which a rule of reason had been applied.[63] The Court, however, neglected to consider the ability of the defendants to carry out the price restraint policy. In addition, adherence to the policy was the exception, not the rule.[64] Nonetheless, this case is considered the keystone of price-fixing precedent.[65] Whenever a horizontal restraint could be classified as involving price fixing, it was deemed to be per se unlawful.[66]

Per se liability for horizontal restrictions on distribution evolved from cases involving aggregations of trade restraints.[67] In *United States v. Sealy, Inc.*,[68] for example, it was the aggregation of Sealy's territorial restraints with unlawful price fixing that was fatal to the entire program.[69] The Court would not analyze each restraint separately; rather, the entire plan was condemned because it included an element of price fixing.[70] Prior to *United States v. Topco Associates*,[71] the Supreme Court had never considered horizontal territorial restraints unaggregated with any other restrictions.[72] In this case, the per se rule, originally developed for the evils of price fixing, was extended to territorial restraints solely because they were horizontally imposed, and the

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59. Comment, *Restricted Distribution After "Schwinn"*, 9 B.C. Indus. & Com. L. Rev. 1032, 1040 & n.44 (1968) [hereinafter cited as *Restricted Distribution*].

60. 273 U.S. 392 (1927).

61. *Id.* at 396.

62. *Id.* at 397.

63. *See id.* at 396-98; F. Scherer, *supra* note 10, at 430.

64. F. Scherer, *supra* note 10, at 430.

65. *Id.* Six years after this case, the Court departed from the per se rule in finding price restraints imposed by a trade association for 137 coal producers reasonable in light of the depression's effect on the coal industry. Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933). The Court was influenced by the defendants' lack of power to fix prices for the entire industry; there was still competition from nonmembers. The restraints were seen primarily as abuse-correcting measures and thus reasonable. *Id.* at 373-74. The case, however, has not been given status as precedent. F. Scherer, *supra* note 10, at 431.

66. In United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940), the majority reiterated the proposition that price fixing had always been unlawful; a showing of competitive evils to be corrected is not a defense. *Id.* at 218-21. It is noteworthy that in making this statement, the Court discounted its prior holding in Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933), *discussed at* note 65 *supra*.

67. United States v. Sealy, Inc., 388 U.S. 350 (1967), Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951), and Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899), all involved market divisions aggregated with price fixing.

68. 388 U.S. 350 (1967). In this case, a group of mattress manufacturers had formed a trademark-holding corporation through which they allocated territories and set resale prices.

69. *Id.* at 357.

70. *Id.* at 356-57.

71. 405 U.S. 596 (1972), *discussed in* pt. V(A)(2) *infra*. *Topco* involved a trademark-holding corporation used by a group of small grocery chains to buy high quality private label products. Although the cooperative allocated territories among its members, it did not set prices.

72. *Broader Rule of Reason*, *supra* note 49, at 142; 28 Wash. & Lee L. Rev. 457, 465 (1971).

reasonableness of the restraints was considered irrelevant.[73] In an attempt to explain the harshness of its decision, the majority noted that courts are not adept at weighing difficult economic criteria to determine reasonableness.[74]

It is worthy of note, however, that in deciding *Sealy*, the Court stated: "We seek the central substance of the situation, not its periphery . . . ."[75] From the context in which this statement was made, however, it is evident that the Court intended to focus its inquiry on the identity, that is, market levels, of the parties participating in the restraint.[76] The unfortunate result of such an approach is that the inquiry nevertheless focuses on form—the identity of the actors—rather than substance—the objective of the parties in initiating the restraints.[77]

C. *Resulting Focus on Form Over Substance*

As shown above, the form of the relationship of the parties to the restraint—vertical or horizontal—or the form of the restraint itself—price or nonprice—determines whether a rule of reason or a per se rule applies. Horizontal restraints involving territorial and customer allocation and probably all price-related restraints are per se unlawful. The only distribution restraints that certainly are analyzed under the rule of reason are vertical nonprice restraints. It is possible, however, that *Sylvania* marks the beginning of a movement toward substantive analysis in distribution restraint cases. In its decision, the Court stated that the *Schwinn* restraints had not satisfied the *Northern Pacific* test[78] and that "departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than . . . upon formalistic line drawing."[79] Nevertheless, the Court unequivocally stated in the same decision that horizontal territorial restraints are illegal per se.[80] No economic theory, however, was offered to support this statement despite its inconsistency with the Court's holding.[81] Although differences in competitive impact may flow from the fact that a restraint is horizontally imposed, it is not altogether clear that all such restraints should be subject to a per se rule. In any event, notwithstanding the pronouncements that substance is more important than form and that departures from the rule of reason must be based on demonstrable economic effect, formalistic line drawing is still an important part of litigation involving restrictions on distribution.

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73. 405 U.S. at 608.

74. *Id.* at 609-10.

75. 388 U.S. at 353 (footnote omitted).

76. *Id.* Even though Sealy, Inc. had a vertical relationship with its members, the Court reasoned that the corporation was merely the instrumentality of its licensees. Therefore, even though the form of the agreement among the parties was vertical, it was in substance horizontal.

77. R. Posner, *supra* note 25, at 165-66.

78. "Certainly, there has been no showing . . . that vertical [territorial] restrictions have or are likely to have a 'pernicious effect on competition' or that they 'lack . . . any redeeming virtue.'" 433 U.S. at 58 (quoting Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958)).

79. *Id.* at 58-59.

80. *Id.* at 58 n.28.

81. Posner, *The Rule of Reason and the Economic Approach: Reflections on the* Sylvania *Decision*, 45 U. Chi. L. Rev. 1, 9 n.26 (1977) [hereinafter cited as *Reflections on* Sylvania].

One reason offered in support of formal distinctions is that they provide businessmen with predictable guidelines to help determine what conduct will violate the Act.[82] Although this is true in extreme cases, the distinctions drawn between different types of restraints are not always manifestly clear. For example, it is difficult to determine whether a vertical restraint has horizontal elements[83] or whether territorial restraints coupled with a manufacturer's suggested resale price is resale price maintenance. Thus, in practice, distinctions between different types of restraints may be hard to define, and, as such, these distinctions provide no more predictability than does a rule of reason approach. Moreover, generic distinctions do not go to the intent of the Act.[84] If the Court were to apply its rule of demonstrable economic effect across the board, businessmen would at least have the opportunity to show that their actions were meant to enhance their competitive viability.

II. ECONOMIC THEORIES UNDERLYING RESTRICTIONS ON DISTRIBUTION

Before establishing a test to be employed in determining the reasonableness of restrictions on distribution, it is essential to understand the economic theories that have historically influenced trade restraint litigation. The underlying question with respect to all restraints is: Why would a market supplier want to restrict competition among dealers?[85] It would seem that greater competition at the retail level would mean lower prices to the consumer. Sales should increase as prices decrease, resulting in greater volume for the market supplier.[86] Moreover, the market supplier has an inherent desire to maintain a low cost of distribution—the difference between his price to the dealer and the dealer's price to the consumer[87]—in order to encourage greater sales volume.[88] The apparent illogic of restrictions on distribution imposed by market suppliers has been explained on the basis of two economic theories—the dealer-cartel theory and the dealer-services theory.[89]

A. *The Dealer-Cartel Theory*

Until the *Sylvania* decision, the prevailing economic theory guiding trade-restraint litigation was the dealer-cartel theory. This theory presupposes that

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82. *See* F. Scherer, *supra* note 10, at 439.

83. *See* note 56 *supra* and accompanying text. Some courts have declined to find horizontal arrangements even though market suppliers competed on the same level as their dealers. *See* White Motor Co. v. United States, 372 U.S. 253, 260-61 (1963); Johnson & Johnson v. Avenue Merchandise Corp., 193 F. Supp. 282 (S.D.N.Y. 1961); Coca Cola Co., [1973-1976 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,010 (FTC initial decision, Oct. 8, 1975), *discussed at* notes 119, 237 *infra*. Because certain agreements will be considered essentially vertical, while very similar agreements will be deemed to be horizontal, meaningful guidelines are not available to businesses seeking to remain within the boundaries of the law.

84. *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 58-59

85. R. Posner, *supra* note 25, at 147; Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & Econ. 86 (1960).

86. R. Posner, *supra* note 25, at 147-48; Telser, *supra* note 85, at 86.

87. Telser, *supra* note 85, at 91.

88. R. Posner, *supra* note 25, at 147-48.

89. *Id.* at 148.

dealers form associations for the purpose of restricting competition among themselves. In furtherance of this purpose, dealers use their market supplier as the instrument of their cartelization.[90] Dealers who have sufficient market power may be able to influence manufacturers—probably under threat of losing valuable retail outlets—to allow the dealers to set monopoly prices by imposing "vertical" restrictions on distribution.[91] A simplified version of this agreement might exist when there is no principal market supplier, thus making the agreement truly horizontal.[92] Consider, for example, a situation in which six manufacturers of iron pipe, who are also involved in retail sales, agree to eliminate competition among themselves. They accomplish their desired goal by fixing prices and allocating territories.[93] An arrangement in pursuit of cartelization such as this one would, according to Judge Taft's opinion in *Addyston*, violate the Sherman Act.[94]

The dealer-cartel theory is deeply rooted in antitrust precedent and has been used by courts to justify per se rulings. The first case to apply the dealer-cartel theory to vertical restraints[95] was *Dr. Miles*,[96] in which the Court said: "[T]he advantage of established retail prices primarily concerns the dealers. The enlarged profits which would result from adherence to the established rates would go to them and not to the [market supplier]."[97] The Court went on to say that, under the antitrust laws, the market supplier could fare no better than the dealers if they themselves had formed the combination to achieve the same result.[98] As a result, later cases involving restraints of the same form were not analyzed for substance.

As recently as *Albrecht v. Herald Co.*,[99] the dealer-cartel theory surfaced again—this time in the dissent. In this case, the defendant newspaper publisher allocated exclusive territories to newspaper deliverers in exchange for a promise not to exceed maximum resale prices. The majority found this arrangement to be a per se violation of section 1 of the Sherman Act.[100] In his dissent, Justice Harlan succinctly explained the dealer-cartel theory as follows:

> Resale price maintenance, a practice not involved here, lessens horizontal intrabrand competition. The effects . . . are the same whether the price maintenance policy takes the form of a horizontal conspiracy among resellers or of vertical dictation by a manufacturer plus reseller acquiescence. This means . . . it is frequently possible to infer a combination of resellers behind what is presented to the world as a vertical and

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90. *Id.*
91. *Id.*; Telser, *supra* note 85, at 88.
92. *E.g.*, Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951); Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899).
93. *See* Addyston Pipe & Steel Co. v. United States, 175 U.S. 211, 212-13 (1899).
94. 85 F. 271, 292-94 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899); *accord*, L. Sullivan, *supra* note 15, § 64, at 170.
95. R. Posner, *supra* note 25, at 151.
96. *See* notes 21, 25 *supra* and accompanying text.
97. 220 U.S. at 407.
98. *Id.* at 408.
99. 390 U.S. 145, 157-59 (1968).
100. *Id.* at 148-50; *see* notes 31-32 *supra* and accompanying text.

unilateral price policy, because it is the resellers and not the manufacturer who reap the direct benefits of the policy.[101]

On the basis of this rationale, Justice Harlan argued that setting a price ceiling could not be equated with setting a price floor via a "combination of resellers" or with a dealer cartel because price ceilings do not provide excess profits to the dealers.[102] Therefore, he claimed that a per se rule is not justified in such a case because it is inconsistent with the dealer-cartel precedent giving rise to the per se rule in vertical price maintenance cases.[103] Thus, no intent to cartelize or lessen competition could be inferred in *Albrecht*, as it had been in the earlier cases.

B. *The Dealer-Services Theory*

Another theory that explains why restrictions on distribution are imposed is the dealer-services theory.[104] Unlike the dealer-cartel theory, however, this theory may serve as justification for finding the restraints reasonable. The rationale of the dealer-services theory is that the market supplier imposes restrictions on distribution in an attempt to increase nonprice competition among its dealers to stimulate sales of its product at the retail level.[105] For example, the dealer may be given an exclusive territory to induce him to allocate resources to the territory's development, or a resale price may be set at a level high enough to cover the dealer's costs in providing sales services.[106] This nonprice competition usually takes the form of presale,[107] point-of-sale,[108] and postsale[109] services which dealers offer to customers to promote sales and to ensure satisfaction with the product. These services could include: maintaining a large showroom for adequate display of the product; stocking an extensive inventory to satisfy consumer demand; carrying an adequate spare or component part inventory; training sales personnel to instruct consumers as to proper product usage; employing and training repair personnel; purchasing tools to provide proper repair or servicing; and implementing local advertising.[110] Consider, for example, Professor Bork's national gas station chain hypothetical.[111] Provision of services is an essential part of the national marketing campaign because the main product, gasoline, is fungible. Furthermore, the national chains seem unable to undercut the independent operations.[112] Therefore, in order for a national chain to compete

101. 390 U.S. at 157 (Harlan, J., dissenting).
102. *Id.* at 157-59 (Harlan, J., dissenting).
103. *Id.* at 162-64 (Harlan, J., dissenting).
104. *See* R. Posner, *supra* note 25, at 165-66.
105. *Id.* at 148; *Reflections on* Sylvania, *supra* note 81, at 4; Telser, *supra* note 85, at 91.
106. *See* note 166 *infra* and accompanying text.
107. Telser, *supra* note 85, at 91.
108. R. Posner, *supra* note 25, at 148.
109. *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 55.
110. *See id.*; R. Posner, *supra* note 25, at 148; Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division* (pt. II), 75 Yale L.J. 373, 454-55 (1966) [hereinafter cited as Bork II]; Telser, *supra* note 85, at 91.
111. Bork II, *supra* note 110, at 454-56.
112. *See* Nazem, *A Penny-pinching Strategy Pays Off at the Gas Pumps*, Fortune, June 5, 1978, at 140. Many of the larger independents have kept services at a minimum for the purpose

effectively, its dealers may have to provide many auxiliary services. One such service is repair work, which requires at least one full-time mechanic, appropriate tools, an inventory of replacement parts, and a garage in which the repair work can be done.[113]

One might question why a national gas company would not allow individual dealers to determine the number of services they would offer.[114] The main reason is that the refiner's brand appeal on a national level depends upon uniformity of product and service.[115] The uniformity assures customers that they can expect quality products and services wherever they travel. Furthermore, traveling motorists who have been satisfied with the service of several of the refiner's dealers may be inclined to patronize their local dealers regularly.[116] The dealer-services theory, therefore, justifies more lenient treatment under the Sherman Act for restrictions imposed to encourage services that are an essential complement to the refiner's national advertising and marketing efforts.[117]

The dealer-services theory also recognizes that restraints on distribution may be necessary to protect dealers who supply valuable services to customers from other dealers who may try to obtain a free ride.[118] Consider, for example, a dealer who has made a substantial investment in local advertising to develop sales of a market supplier's product. These advertising costs must be incorporated into the dealer's resale price. If dealers competing in the same product were able to invade the market of the industrious dealer, they would not have to pay the costs of market development. The competitors, therefore, would be able to undercut the price of the dealer who had developed the market and would have a free ride on the goodwill generated for the product. Such unrestrained market incursions would deter local dealers from developing markets because recoupment of their investments would be subject to great risk.[119]

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of undercutting the majors. Customers of these cut-rate operations must pay in cash rather than credit cards, pump their own gas, and go elsewhere for repairs.

113. Even the simple service of repairing flat tires requires not only the appropriate supplies but also an adequate number of personnel to perform the service and to keep the gas pump working at the same time. The market supplier might also demand clean restroom facilities on each location thus requiring commercial space, maintenance, and supplies.

114. *See* Bork II, *supra* note 110, at 455.

115. *Id.* Another reason is that the refiner might trust his own business judgment more than that of the service station operators. *Id.*

116. *Id.* at 455-56. The dealer, however, benefits primarily from local customers; he will not be able to determine which customers are local and, therefore, potential repeaters. *Id.* at 456 n.161.

117. *See id.* at 474-75.

118. *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 55; R. Posner, *supra* note 25, at 149; Bork II, *supra* note 110, at 453-54; *Reflections on* Sylvania, *supra* note 81, at 6-7; Telser, *supra* note 85, at 91.

119. *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 55. An excellent example of the danger of free-rider incursion appeared in a recent case before the Federal Trade Commission (FTC) involving the Coca Cola Company. As part of its overall marketing policy, Coca Cola allocates to its bottlers exclusive territories, which the bottlers must develop fully. One method by which this is accomplished involves distribution of Coke through vending machines at various locations. After sampling the product from one of these conveniently located machines,

The Court in *Sylvania* specifically recognized the importance of the dealer-services concept and the need to protect those dealers who provide services from the adverse impact of free riders.[120] In addition, Justice White in his concurrence acknowledged the shift from the restraints on alienation concept to "the notions of 'free rider' effects and distributional efficiencies borrowed by the majority from the 'new economics of vertical relationships.'"[121]

Ironically, a dealer-services rationale was offered in *Albrecht* as a partial basis to justify imposition of a per se rule. The majority held that the maximum price might not allow dealers to provide essential services to consumers if the price were too low.[122] The flaw in this argument is that no market supplier would set a price ceiling so low as to preclude services essential for the sale of its product.[123] As such, inability to provide services should not be used to support imposition of a per se rule. Normally, a dealer-cartel rationale is applied to justify a per se rule in price restriction cases, while the dealer-services theory supports a rule of reason approach.

At this juncture, Professor Bork's forceful argument that restrictions should be allowed even absent a danger of free riding[124] is noteworthy. His argument, which is based on a dealer-services theory, primarily addresses arrangements in which a consumer cannot obtain services from one dealer and purchase the product from another because the services are an integral part of the total product, as in the national gas station chain hypothetical described above.[125] Without the ability to ensure that the services are performed, the marketer's national image may be damaged. Bork's position goes beyond the Court's dictum in *White Motors* regarding justification of vertical restrictions and probably even exceeds the Court's view in *Sylvania*.[126] However, the

consumers presumably will be inclined to purchase the product from supermarkets for home consumption. Thus, the company uses the machines as a sampling vehicle and as a means of maintaining top-of-mind awareness of its product. However, because the volume for each machine is so low and the costs of servicing so high, the dealer actually loses money selling the product in this manner. The investment is, nevertheless, recouped and profits are realized through increased grocery store sales, and, therefore, the grocery store price includes the costs of the vending machine program. A free rider who does not provide vending machine service could reduce his grocery store price and undercut the dealer who does offer such service. No dealer could afford to risk this type of free-rider problem. Therefore, Coca Cola would find it impossible to implement essential parts of its marketing programs which require dealer investment. Coca Cola Co., [1973-1976 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,010 (FTC initial decision, Oct. 8, 1975), *discussed in Reflections on* Sylvania, *supra* note 81, at 6.

120. 433 U.S. at 54-55.

121. *Id.* at 69 (White, J., concurring).

122. 390 U.S. at 152-53. The Court also noted that the maximum price could become the minimum price and that maximum resale price maintenance raised the possibility that distribution could be channelled through large or advantaged dealers who might otherwise have to contend with nonprice competition. *Id.* at 153.

123. R. Posner, *supra* note 25, at 158.

124. Bork II, *supra* note 110, at 454-56.

125. *See* notes 111-17 *supra* and accompanying text.

126. In addition to a situation in which free-rider incursion is present, the Court has indicated that vertical restrictions upon distribution may be justifiable in certain situations, as when small firms are fighting to stay in business or when firms are faced with aggressive competition. White Motor Co. v. United States, 372 U.S. at 263. It would be illogical, however,

proposition that dealer services must be protected if essential to competition, even absent a free-rider problem, may yet be valid, for the Supreme Court has never expressly rejected this position.

C. *Summary*

The reason for examining these two theories is to recognize that the mere existence of a restriction on distribution does not automatically imply that the restricting firms intend to exclude competition for the purpose of charging inflated prices. The dealer-services theory shows that restrictions can be used as a tool to increase interbrand competition.[127] On the other hand, if the dealer-cartel theory appropriately explains the behavior of the parties, an intent to reap monopoly profits may be inferred. As Justice Harlan explained in *Albrecht*, absent behavior which qualifies as a cartel among dealers, a per se rule is inappropriate. Therefore, it is imperative that restrictions be examined for their impact on competition,[128] and, as these two theories demonstrate, the form of the restriction cannot conclusively determine this impact.

III. The Proposed Test for Reasonableness

A. *Scope and Applicability*

At the present time, a rule of reason analysis can be applied only to nonprice vertical restrictions. Currently, no argument of reasonableness will save an arrangement in which the court has determined the existence of a horizontal conspiracy.[129] Moreover, if a court finds a territorial restraint to be ancillary to a price-fixing scheme, it will normally rule the territorial restraint per se unlawful as well.[130] Therefore, because the test proposed below can apply at present only to vertically imposed territorial restraints not tied to price-fixing, this discussion is limited to such restraints. Extension of the rule of reason analysis to other classes of restraints on distribution is discussed in Part V.

The *Sylvania* majority referred to the rule of reason test as the "prevailing standard of analysis."[131] Before this decision, however, application of the per

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to conclude that these situations are the only ones in which the Court will allow distribution restrictions, for to do so would shift determination of legality away from demonstrable economic effects and back to a formalistic distinction.

127. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 54-55. "Interbrand competition is the competition among the manufacturers of the same generic product . . . and is the primary concern of antitrust law. . . . In contrast, intrabrand competition is the competition between the distributors—wholesale or retail—of the product of a particular manufacturer." *Id.* at 52 n.19.

128. *Id.* at 58-59; *see id.* at 52 n.19.

129. "[T]he market supplier must avoid a finding or inference of horizontal or conspiratorial activity or purpose . . . . It should be noted that since the method of enforcing the vertical restriction may be determinative of whether horizontal activity is present, the market supplier must avoid any inference of joint effort with his distributors and retailers when enforcement is necessary." Averill, *supra* note 34, at 61.

130. *Id.* at 60-61.

131. 433 U.S. at 49.

se rule was expanding, while use of the rule of reason was becoming more limited.[132] Thus, Professor Posner rightly disputes the Court's pronouncement that a rule of reason analysis prevailed.[133] Prior to *Schwinn*, if restrictions on distribution were not deemed per se unlawful, they were made subject to a rule of reason analysis which generally meant that they were per se lawful.[134] As such, no single, structured approach has evolved to aid courts in determining whether practices are unreasonable. Therefore, the standard to be applied in determining the reasonableness of vertical territorial restraints will be, by and large, a new one, developed subsequent to *Sylvania*, under which findings of unreasonableness, as well as reasonableness, should be possible.[135]

B. *Basis for the Proposed Rule of Reason Test*

Application of a rule of reason approach is based upon the conviction that certain "practices may be justified if reasonable and ancillary to a legitimate business purpose, and if more beneficial to interbrand competition than detrimental to intrabrand competition."[136] The starting point for development of a test, according to the *Sylvania* Court,[137] would be the rule enunciated by Justice Brandeis in *Chicago Board of Trade v. United States*:[138]

> To determine [reasonableness] the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts.[139]

This formulation, in effect, directs attention solely to the history of the restraint in question to determine its competitive purpose and impact. Therefore, as Professor Posner astutely points out, Justice Brandeis' formulation does not provide usable criteria for the determination of illegality because the Brandeis inquiries are general and do not provide the structure of a test that would balance the harm to intrabrand competition against the benefit to interbrand competition.[140] What the formulation does provide is the proper

132. L. Sullivan, *supra* note 15, § 59, at 153.

133. "The Rule of Reason is rarely used to decide cases. Agreements among competitors are ordinarily condemned outright under the per se rule forbidding price fixing or its equivalents. Mergers are governed by reasonably specific rules evolved in decisions construing section 7 of the Clayton Act. Vertical restrictions other than mergers are governed by per se rules (for example, tie-ins), by rules developed in decisions interpreting section 3 of the Clayton Act (requirements contracts, for instance), or by rules developed in monopolization cases under section 2 of the Sherman Act." *Reflections on* Sylvania, *supra* note 81, at 14.

134. "The . . . Rule of Reason . . . is little more than a euphemism for nonliability." *Id.*

135. *See* Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division* (pt. I), 74 Yale L.J. 775, 781 (1965) [hereinafter cited as Bork I].

136. *Broader Rule of Reason*, *supra* note 49, at 126 (footnote omitted). Interbrand competition is the "primary concern" of antitrust law. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 52 n.19.

137. 433 U.S. at 49 n.15.

138. 246 U.S. 231 (1918).

139. *Id.* at 238.

140. *Reflections on* Sylvania, *supra* note 81, at 15; *see* Bork I, *supra* note 135, at 840.

focus for a rule of reason analysis—whether competition is merely regulated or promoted or whether it is suppressed or destroyed.

The *Sylvania* Court also directs attention to *White Motor Co. v. United States*,[141] which stands for the proposition that courts should inquire into "the actual impact . . . on competition."[142] The *White Motor* Court's reason for requiring this inquiry, however, was to determine whether vertical restraints should be subject to a rule of reason or per se analysis, and not to determine whether a specific restraint was reasonable in a given context. Any doubt as to application of the impact-on-competition concept as a basis for determining reasonableness, however, is dispelled by *National Society of Professional Engineers v. United States*,[143] in which the Court said: "[T]he inquiry [of reaonableness] is confined to a consideration of impact on competitive conditions."[144]

Posner argues, however, that competition should not be the only measure of whether a restraint is reasonable and that an additional inquiry should be whether efficiency is increased.[145] Otherwise, claims Posner, restraints that reduce competition but increase efficiency would be prohibited. A case in point would be a merger which, though resulting in a monopoly, enhances efficiencies such that prices drop below the levels reached in the previously competitive market.[146] The problem with this view that what benefits business benefits society is that it requires reliance on businessmen with complete market power to preserve society's interests. Yet, without competition there are no incentives for businessmen to hold prices down.[147]

Posner would structure a rule of reason approach based on the premise that a market supplier acting in his own interest is, in effect, serving the public interest. Specifically, he would inquire "whether the restriction is intended to cartelize distribution or, on the contrary, to promote the manufacturer's own interests."[148] Despite philosophical differences between Posner's approach and

141. 372 U.S. 253 (1963).

142. *Id.* at 263 (footnotes omitted), *cited in* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 50.

143. 435 U.S. 679 (1978).

144. *Id.* at 690 (footnote omitted).

145. *Reflections on* Sylvania, *supra* note 81, at 15. Posner also refers to Bork's view, *see* Bork I, *supra* note 135, at 830-38, that only practices which are economically inefficient should be condemned. *Reflections on* Sylvania, *supra* note 81, at 16.

146. *Reflections on* Sylvania, *supra* note 81, at 15.

147. In other words, while a company is amassing monopoly power, consumers benefit from the economies realized from the firm's efficiency. However, once interbrand competition is effectively eliminated, what forces will keep prices down? Certainly prices will not rise too high because at some point the increased profits will not compensate for the drop in demand. Nevertheless, there will be no external force to keep prices reasonable.

148. *Reflections on* Sylvania, *supra* note 81, at 17. Posner suggests a three part inquiry: "1. Does the restriction embrace so large a fraction of the market as to make cartelization a plausible motivation for the restriction? If not, the restriction should be held lawful. 2. If [yes], do dealers in the product in question provide any presale services? If not, the restriction should be deemed unlawful . . . . 3. If the answer to both . . . questions is yes, . . . did the manufacturer's output increase or decrease after imposing the restriction? If his output increased, the burden would shift to the government of showing that it increased for reasons unrelated to the restriction. If output fell after imposition of the restriction, the restriction would be deemed unlawful, unless . . . defendant could prove that he *intended* . . . to increase his output." *Id.* at 19.

the one proposed below,[149] his formulation is helpful in developing an analysis that is in accord with precedent and will make application of the rule of reason operational, for the criteria he posits are useful barometers of competitiveness.

C. *The Test*

The analysis proposed here is comprised of four parts: a determination of the restricting firms' market power; an inquiry as to the freedom of access to competitive goods; an examination of the economic justification of the restriction and its positive and negative effects on competition; and an evaluation of the excessiveness of the restraint.

1. Market Power

Because impact on competition is the central inquiry on which the analysis will be based, the relevant market must be defined, and the market power of the restricting firms, that is, their ability to affect competition within that market, must be shown.[150] Determination of the relevant market requires definition of both the geographic[151] and the product markets in which the restricting firms compete. The product market may range from a number of totally fungible or interchangeable goods to a unique product or brand forming a specialized market.[152] Actual power within the relevant market should be shown in the traditional way by determining percentages of sales in both dollars and units. The parties, however, also should be able to introduce additional evidence as to the degree of market power.[153]

Substantial power of firms[154] within a market could be indicative, though not probative, of an intent to obtain monopoly profits.[155] Conversely, the overall weakness of the restricting firms in the relevant market could indicate

149. The major difference is that Posner would condemn only those firms that have reached monopoly proportions and are shortsighted enough to let prices reduce output. *Reflections on* Sylvania, *supra* note 81, at 17.

150. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 64 (White, J., concurring); American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230, 1248 (3d Cir. 1975).

151. Geographic market is defined as the area in which the parties effectively compete. The area is not ordinarily definable with absolute precision. Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 331-32 (1961).

152. A product market includes those products which consumers would purchase as reasonable substitutes for the product in question. United States v. Grinnell Corp., 384 U.S. 563, 571 (1966); United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377, 395 (1956).

153. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 64 (White, J., concurring). Justice White notes that the traditional measures of market power are market share as well as product differentiation. The latter is referred to above as uniqueness of brand or product. *See* note 152 *supra* and accompanying text. Justice White cites both F. Scherer, Industrial Market Structure and Economic Performance 10-11 (1970) and P. Samuelson, Economics 485-91 (10th ed. 1976), for elaboration. 433 U.S. at 64 n.4 (White, J., concurring). It should be noted that if monopoly power or a tendency to monopolize exists, other parts of the antitrust laws might be invoked. *See, e.g.,* 15 U.S.C. § 2 (1976).

154. Usually the supplier's market power will be in issue; however, it may also be necessary to assess the dealers' power within their relevant market to use suppliers as tools for implementing dealer cartels.

155. *See* R. Posner, *supra* note 25, at 165-66; *Reflections on* Sylvania, *supra* note 81, at 19.

that restraints are imposed to improve competitive ability. In *Sylvania*, for example, a national television manufacturer's market share amounted to an insignificant one to two percent of national sales. If the dominant firm controlled sixty to seventy percent of a market comprised of one hundred manufacturers,[156] a weak firm may have a need to improve its competitive position by imposing restrictions on distribution.

Professor Posner would excuse from further antitrust scrutiny those firms which are too weak to collude effectively.[157] Posner goes on to assert that unless the manufacturer has a large market share, or unless all or most manufacturers have uniform restrictions, the dealer would not enjoy any monopoly power in the market place. The first problem with this reasoning is that Posner might never reach an inquiry into the existence of similar restraints imposed by other manufacturers because restricting firms with small market shares would be excused from further scrutiny.[158]

The second problem is that Posner would find cartelization violative only when interbrand competition is not a significant factor in the market, that is, when the restricting firms' market share is very large. His test, therefore, excuses firms that can cartelize at the intrabrand level in a highly competitive interbrand market. Although such a result would seem consonant with the Court's direction in *Sylvania*, it does not take into account such things as a unique brand, in itself a manifestation of market power. Because of brand differences perceived by consumers, lack of intrabrand competition, even when interbrand competition is substantial, could be a significant advantage to a dealer, particularly if another manifestation of market power, such as quality image, exists. Quality image, for example, may give the dealer all the help he needs in generating sales. Therefore, he has no need for protection of his position through limited intrabrand competition. Thus, to determine whether a particular firm falls into the category of those able to cartelize at the intrabrand level in a highly competitive interbrand market, it is necessary to evaluate the impact of all restrictions on interbrand and intrabrand competition. Specifically, one must ascertain whether the restricting firm has initiated the restraints in order to compete more effectively, or simply has tried to reap monopoly profits, even without monopoly power. Firms with little market power, therefore, should not be excluded from further inquiry.

2. Freedom of Access to Competitive Goods

The second part of the test asks whether the practices in question inhibit free access to existing competitive goods and thus result in untoward competitive effects. The examination of these practices should focus on both ends of the marketing system. Assuming that products of a like quality and character produced by other market suppliers exist, the primary question in all cases is whether such products are available to dealers or distributors.[159] Similar

156. *See* 433 U.S. at 38 & n.1.

157. *Reflections on* Sylvania, *supra* note 81, at 17; *see* note 148 *supra*.

158. *See Reflections on* Sylvania, *supra* note 81, at 17. The importance of determining whether other manufacturers impose similar restraints is covered in part two of the proposed test dealing with freedom of access to competitive goods. *See* notes 159-65 *infra* and accompanying text.

159. *See* United States v. Arnold, Schwinn & Co., 388 U.S. 365, 381 (1967); *Broader Rule of Reason*, *supra* note 49, at 126-27 & n.29.

products may exist but may be unavailable if all competing market suppliers have exclusive selling arrangements with their franchisees such that other dealers do not have access to those market suppliers' goods. Alternatively, the competing manufacturers could be vertically integrated and thus not need to sell to independents. If competitive goods are not available, restrictions imposed by the market supplier could impede competition by foreclosing access to competitive goods.[160] On the other hand, the availability of many goods to retailers and wholesalers could indicate a need on the part of the suppliers to promote more aggressive competition in the retail market.[161]

This inquiry should not be conclusive on the issue of competitiveness but rather should be part of a balancing process. For example, in the case of a new product's entry into the market, no similar product would be available, but the supplier who holds a weak market position might have to insist on restraints if successful marketing of the new product requires such treatment.[162] Thus, the availability of similar products must be weighed against, among other things, the restricting firm's market position.

A second question to ask when other brands are available is whether the dealer or the distributor, as part of his agreement with the market supplier, is prevented from dealing in other suppliers' brands by exclusive dealing arrangements.[163] Whereas the prior inquiry looked to lack of competing goods at the lower level of the market, this inquiry looks to whether the market supplier is attempting to exclude other market suppliers from the territories.[164] An exclusive dealing relationship combined with substantial market power would probably evidence a plan to exclude other market suppliers from the market and, therefore, would be an unreasonable restraint of trade. A weak competitor, however, might require the full attention of the dealer to compete adequately and may be able to induce this attention only by imposing distribution restraints that afford the dealer protection against free riders.[165]

160. This part of the test does not pertain to monopoly situations, which are covered in part one of the test. *See* notes 150-58 *supra* and accompanying text. Rather, this part deals with situations in which the dealer's access to goods is cut off because of exclusive contracts between other market suppliers and their dealers.

161. *E.g.*, Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977); United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967); *see* notes 156 *supra* and 194-97 *infra* and accompanying text.

162. The market supplier might have to rely on his distributor to develop the local market and to convince consumers that they need a product that has never existed before. Most newly developed small appliances fall into this category. Although national advertising can stimulate consumer inquiry, it is the dealer who usually consummates the sale.

163. United States v. Arnold, Schwinn & Co., 388 U.S. 365, 381 (1967). Exclusive dealing arrangements could also violate § 3 of the Clayton Act, 15 U.S.C. § 14 (1976), "where the effect . . . may be to *substantially* lessen competition or tend to create a monopoly in any line of commerce." *Id.* (emphasis added).

164. A bill had been proposed in the 92d Congress that territorial restraints be permitted if products "in free and open competition with products of like grade and quality produced by persons other than the supplier" are available to the dealer and that dealer is not prohibited from dealing in those products by his supplier. H.R. 370, 92d Cong., 1st Sess., 117 Cong. Rec. 180 (1971), *discussed in Broader Rule of Reason*, *supra* note 49, at 149 n.197.

165. Exclusive dealing arrangements also may be lawful in franchising arrangements that are not accompanied by unlawful tying. Siegel v. Chicken Delight, Inc., 448 F.2d 43, 47-52 (9th Cir. 1971), *cert. denied*, 405 U.S. 955 (1972).

3. Economic Justifications

The third part of the test requires defendants to justify their restrictive practices. Here, the first inquiry is whether the restricting firm has an economic need to prevent intrabrand competition. Specific questions to be answered in this part of the analysis are: Were valuable services reflected in the prices charged by dealers handling the product which could easily be undercut by encroaching dealers not providing those services?[166] Or, is interbrand competition so intensive that, even absent a need for costly sales services, the market supplier must necessarily give dealers and distributors a special incentive to promote that market supplier's product actively in order to gain effective distribution in the market place?[167] In other words, is the dealer given a premium for marketing advocacy?[168] Such an arrangement might have occurred in *Sylvania* where the supplier had an insubstantial share of the television market. Whether or not Sylvania's dealers were required to offer sales services, the Sylvania restrictions could have been necessary to gain retail-market advocacy.[169]

To determine whether the restraints were initiated to enhance competitive capabilities, courts should also look for evidence of coercion on the part of either market suppliers or distributors and dealers. The initiator of the restraint would not be able to exercise coercion, however, without having sufficient market power to enforce the restrictions. A showing of coercive practices could be probative of the existence of a dealer cartel.[170]

The success of the restraints, though not absolutely probative, is also part of the inquiry into economic justifications and should be tested by evaluating the practice's effect on output. If output has increased as a result of the restraints, it could evidence increased interbrand competition. If output has tended to decrease, it could well indicate that monopoly prices are being charged at the retail level.[171] A decrease due to monopoly prices, however, will occur only when the firms have substantial market power. Because the dealers in such a situation are content with the increase in profits that exceeds the revenue lost by the reduction in demand, decreased output could be

166. The restrictions could be imposed for the primary purpose of protecting the market supplier from free riders who would hurt the quality name of the market supplier by not providing essential services, even though they do not hurt those dealers who do provide such services. Adolph Coors Co. v. A & S Wholesalers, Inc., 561 F.2d 807 (10th Cir. 1977).

167. Price restraints have been explained on the basis that manufacturers do not want their products discounted because it impairs the quality image of the product among consumers. This reasoning assumes a certain degree of irrational consumer behavior. Telser, *supra* note 85, at 86 n.1.

168. It is conceivable that the proponents of the dealer-services theory would include local marketing advocacy as part of that theory, for the dealer must devote some selling time to gaining consumer acceptance.

169. Courts have recognized that small or failing firms should be allowed more leniency than powerful firms. *E.g.*, Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 64-65 (White, J., concurring); White Motor Co. v. United States, 372 U.S. 253, 263 (1963).

170. *See* Telser, *supra* note 85, at 88.

171. "The object of the dealers' cartel is to raise the price of the good above its previous (competitive) level. If this goal is attained, the amount of the good demanded, and hence supplied, will fall . . . ." *Reflections on* Sylvania, *supra* note 81, at 18.

probative of a dealer cartel. It must be stressed, however, that an arrangement may be unlawful regardless of the effect of the restraints upon output.

4. Excessiveness of the Restraint

The final part of the test goes to the excessiveness of the restraint: "whether the restriction 'exceed[s] the outer limits of restraint reasonably necessary to protect the defendant.'"[172] This inquiry, however, should not look for a less restrictive alternative.[173]

One problem with a "no less restrictive alternative standard" is that it would unnecessarily overburden businessmen because they would have to choose the least restrictive of all available alternatives rather than select a restriction "reasonably calculated to achieve the desired result without unduly hindering competition."[174] Moreover, courts would have to substitute their judgments for business decisions. Finally, hindsight almost invariably brings a less restrictive alternative to light, and, therefore, restraints which seem perfectly reasonable and unexcessive at the time would be invalidated solely on this basis.[175]

To avoid these problems, this part of the test should examine instead whether the chosen means are reasonably suited to achieve a desired lawful end—enhancement of interbrand competition. If businessmen have engaged in restraints for the purpose of improving their ability to compete, they have doubtless done so in response to perceived market pressures, and they should be willing and able to explain how the chosen restraints enhance their ability to compete without being excessive. The court essentially determines whether the restraint goes too far, thereby indicating an intent to cartelize.

IV. Application of the Test to the *Sylvania* and *Schwinn* Fact Patterns

In evaluating the facts of the *Sylvania* and *Schwinn* cases under the proposed rule of reason test, it should be noted that the reported decisions may not contain all the pertinent information called for in such an analysis. The purpose of this exercise is not to show how the actual cases should have been resolved, but to illustrate the balancing process that courts should undertake in evaluating the economic criteria and to suggest an outcome based only upon the facts considered.

A. Sylvania

Market power: The relevant market consisted of all television brands, some 100 in number, marketed in the entire United States. In 1962, when its new marketing policy was implemented, Sylvania products accounted for one to two percent of television sales.[176] For the sake of this analysis, it is assumed

172. American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230, 1249 (3d Cir. 1975) (footnote omitted) (quoting Walt Disney Prods. v. American Broadcasting-Paramount Theatres, Inc., 180 F. Supp. 113, 117 (S.D.N.Y. 1960)).

173. *See* 44 Geo. Wash. L. Rev. 436, 447-48 (1976).

174. *Id.* at 448 (footnote omitted).

175. *Id.*

176. 433 U.S. at 38 & n.1.

that both dollar and unit sales were at the one to two percent level. The opinion reveals no other manifestations of market power on the part of Sylvania or its retailers as a group.

Freedom of access to competitive goods: Of the numerous brands of televisions sold nationally,[177] it is likely that Sylvania's dealers could have carried at least some of them.[178] Moreover, Sylvania engaged in no exclusive dealing arrangements.[179]

Economic justifications: The number of dealers handling Sylvania products in a given area was limited, and dealers were allowed to sell only from approved locations. In the face of aggressive interbrand competition,[180] Sylvania limited the number of franchises in order to increase sales and market share by attracting aggressive and competent retailers.[181] Sylvania apparently perceived a need to restrict intrabrand competition in order to assure dealer loyalty, but there was no evidence of coercion. In fact, Sylvania refused to bow to pressure from Continental, one of its San Francisco distributors, to allow it to expand to another California market. The effect on output was that sales increased, giving Sylvania a five percent market share nationally and making it the nation's eighth largest producer.[182]

Excessiveness of restraints: Although Sylvania controlled the number of dealers serving a particular area, it gave no exclusive territories, nor did it impose customer restrictions. The location clauses that Sylvania imposed are regarded as the least restrictive of the three major nonprice restraints.[183]

Discussion: Initially, Sylvania was a weak competitor in the market, and its position was declining. In essence, the firm was fighting for its existence. Its withdrawal from the market, however, would have impaired interbrand competition for the simple reason that one competitor would have disappeared. Given its weakness, Sylvania had a need to attract aggressive retailers,[184] which it accomplished by offering limited retail locations.[185] Also, because of the fierce interbrand competition in the market, Sylvania needed to ensure the loyalty of its franchisees. The procompetitive intent of the plan was evidenced by the increased output and market share, by the absence of coercion on the part of either the dealers or the market supplier, and by the absence of exclusive dealing arrangements. Sylvania even seemed willing to increase the level of intrabrand competition for its products by increasing the

177. *Id.* at 38.

178. In fact, the decision indicates that Sylvania dealers could obtain other brands because plaintiff-dealer Continental placed a huge order with Phillips in protest of Sylvania's having granted a franchise to one of Continental's competitors at a nearby location. *Id.* at 38-39 & n.3.

179. *Id.* at 38 n.3.

180. The intensity of competition is evidenced by the fact that RCA had 60% to 70% of sales, and over 100 other manufacturers were competing for the remainder. *Id.* at 38 n.1.

181. *Id.* at 38-39.

182. *Id.*

183. *See* note 38 *supra* and accompanying text.

184. *See* White Motor Co. v. United States, 372 U.S. 253, 263 (1963) (firm's weakness may justify vertical territorial restraints); notes 40-42 *supra* and accompanying text.

185. For the purpose of this analysis, it should be noted that Sylvania made no claim that valuable sales services were required, nor did Sylvania claim that the reason for the restrictions was to protect dealers from free-rider incursion once the dealers made an investment in costly services.

number of dealers in an area where it was not satisfied with the performance of existing franchisees.[186]

On balance, interbrand competition increased significantly, whereas prior to the restraints, Sylvania was on the verge of becoming a nonentity in the market. Because intrabrand competition could not have existed to a great degree when sales were faltering, Sylvania's restrictions could not have reduced it substantially.[187] Thus, the increase in interbrand competition outweighs the harm to intrabrand competition. Finally, by antitrust standards, the Sylvania restraints were very minor.[188] Because the location clauses did not totally eliminate intrabrand competition within a given territory, it would seem that the purpose was to ensure dealer loyalty, and not to allow dealers to reap monopoly profits. Thus, the restraints seem consonant with the competitive pressures that Sylvania faced and reasonably calculated to fulfill Sylvania's needs. In sum, then, the type of practice exemplified by *Sylvania* should withstand a rule of reason analysis.

B. Schwinn

Market power: The relevant market in *Schwinn* was comprised of all bicycle brands sold in the United States by both foreign[189] and domestic manufacturers using either private labels or brand names. In 1951, the year before its new marketing policy was implemented, Schwinn was the nation's largest bicycle marketer[190] and its bicycles accounted for 22.5% of all sales in this market.[191] Schwinn was also known for the high quality of its bicycles.[192] The opinions revealed no other manifestations of market power, such as sole source of supply or unique brand. In fact, in 1965, Schwinn bicycles sold for less than they did in 1951,[193] thereby reflecting Schwinn's unwillingness to charge monopoly prices.

Freedom of access to competitive goods: Sources of bicycles for dealers were not scarce. There were nine domestic manufacturers with eleven plants in

186. Sylvania franchised an additional dealer in San Francisco because Sylvania's share of sales for that city was 2.5%, half the national average. Adding a new dealer located near an existing one would increase the intrabrand competition potential. 433 U.S. at 39 & n.4.

187. Justice White noted that "there is less potential for restraint of intrabrand competition [than in *Schwinn*]. Sylvania . . . did not restrict the customers to whom or the territories where its purchasers could sell . . . . [It also] had an insignificant market share . . . and enjoyed no consumer preference . . . ." *Id.* at 59 (White, J., concurring).

188. The Supreme Court majority noted the Ninth Circuit's finding that the Sylvania restrictions "had less potential for competitive harm than the [Schwinn] restrictions." *Id.* at 41. Justice White agreed with the circuit court's analysis. *Id.* at 59-63 (White, J., concurring).

189. Foreign-made bicycles accounted for 29.7% of sales in 1961. United States v. Arnold, Schwinn & Co., 388 U.S. at 369.

190. *Id.*

191. *Id.* at 368. The opinion does not indicate whether sales were measured in terms of dollars or units. For the sake of analysis, it is assumed that the market shares are reported in units and that Schwinn would have had a higher share of dollar sales.

192. The district court noted that Schwinn "prides itself on being called the Cadillac of the bicycle industry." United States v. Arnold, Schwinn & Co., 237 F. Supp. 323, 335 (N.D. Ill. 1965).

193. *Id.*

1962,[194] and, according to the district court, there had been twelve manufacturers after World War II.[195] Foreign bicycles were also sold in substantial numbers in the American market.[196] The lower court opinion indicates that most retailers took advantage of the availability of many brands by carrying several of them.[197] Schwinn, for its part, did not insist upon exclusive dealing arrangements, thereby leaving dealers free to carry as many different brands of bicycles as they chose.[198]

Economic justifications: Schwinn limited its dealers to bicycle repair shops, thus excluding mass merchandisers and hardware stores.[199] The mass merchandisers wanted to market Schwinn products under their own private labels at a price that would have forced Schwinn to cut back on quality and would have undermined its plans to maintain its product's reputable name. Hardware stores, as well as other mass merchandisers who operated largely by mail order, were unable to provide presale and postsale services that were essential to maintaining consumer satisfaction.[200] The bicycle repair shops were limited to specified locations for the purpose of ensuring that dealers adequately serviced their areas. The dealers carried sufficient inventories and aggressively promoted Schwinn bicycles.[201] Although the dealers could sell only to retail customers and not to unfranchised wholesalers, they could sell in other franchisees' territories.[202] Presumably, this customer-class restraint protected Schwinn from retailers who would discount the bicycles without offering requisite services and prevented the retailers themselves from being hurt by free riders.

Wholesalers were given exclusive territories and their customer sales were limited to franchised retailers within their territories.[203] The exclusive territories were provided to induce the wholesalers to promote the Schwinn line aggressively.[204] Customer sales to franchisees were limited exclusively to the distributor's territory to assure Schwinn that sales were made only to licensed franchisees.[205] The district court found no evidence of coercion.[206]

The effect of these restrictions was to increase output substantially, both in terms of dollars and unit sales.[207] Schwinn's market share, however, declined significantly to 12.8% by 1961, dropping it to second place behind Murray, which had a 22.8% share.[208]

Excessiveness of restraints: The limited number of dealer locations encour-

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194. 388 U.S. at 369.
195. 237 F. Supp. at 337.
196. 388 U.S. at 369.
197. *See* 237 F. Supp. at 338.
198. Apparently, Schwinn did not object to its distributors' or dealers' marketing other brands. *Id.*
199. *Id.* at 337-38.
200. *Id.* at 336-38.
201. *See* 388 U.S. at 370; 237 F. Supp. at 338.
202. 237 F. Supp. at 332-33.
203. 388 U.S. at 371.
204. 237 F. Supp. at 339-40.
205. *Id.* at 341.
206. *Id.* at 338-39.
207. 388 U.S. at 368.
208. *Id.* at 368-69.

aged dealers to promote Schwinn products aggressively and protected them from free riders. However, the customer restriction which confined dealers to retail sales appears to be excessive absent a showing that Schwinn had a major problem with dealers supplying nonfranchisees. Franchisees had an automatic incentive not to sell to unlicensed dealers because they would have undercut their own sales. Furthermore, an unlicensed retailer who had to buy from another retailer at other than the wholesale price would have had a difficult time undercutting franchisees. Finally, if Schwinn had a problem with a few franchisees selling to nonfranchisees, it could always terminate its agreement with those franchisees.

With respect to distributors, granting exclusive territories would logically encourage them to maximize sales to retailers. The restrictions compelling distributors to sell only to franchised dealers ensured that Schwinn's plan to maintain services at the dealer level would not be threatened and protected the franchised dealers from free riders. On the other hand, it is difficult to see how further restrictions of distributors' sales to customers in their own territories did anything more to protect Schwinn from indiscriminate sales to nonfranchisees. As such, the restriction of sales solely to retailers within the territory seems excessive.[209]

Discussion: Schwinn seemingly had a strong market position as evidenced by the fact that it was the market leader in 1951. Substantial changes were taking place in the market, however, making it difficult for Schwinn to maintain both its market share and the quality of its product. The number of low cost private label brands was increasing, and Schwinn could not supply private label mass merchandisers at a profit.[210] Schwinn's overall decline in market share, despite increased efficiencies that allowed it to reduce rather than increase prices,[211] evidenced Schwinn's lack of market power. That sales increased substantially as a result of the restrictions shows that Schwinn was doing its best to be competitive in a highly competitive market.

Given the very active competition, much of which was low price competition, Schwinn's franchise plan was reasonably calculated to maintain its quality image and to ensure that essential services were provided. Without these services, consumers may not have wanted to purchase Schwinn bicycles, and even those consumers who had bought the bicycles may have become dissatisfied with the lack of services.[212] As the district court stated: "The

209. It does not appear from the district court decision that Schwinn argued that the purpose of this restriction was to alleviate a substantial free-rider problem among distributors who otherwise might invade one another's territory. If this were the purpose, as might be inferred from some of the background material, the restraint may have been justifiable. *See* 237 F. Supp. at 339-41.

210. *Id.* at 336. The reason for this is that Schwinn refused to sacrifice quality for the lower costs necessary to make a profit selling to mass merchandisers.

211. "By franchising the local cycle outlets and dealing with them only, Schwinn has remained in business and is still furnishing the best grade bicycle at prices now below those of 1951 and still making a profit." *Id.* at 335.

212. "Adequate service and repair is an absolute essential for any bicycle manufacturing company." If the services are not provided, the "customer is likely to look for a brand or make of bicycle where he can be assured of service, repairs and replacements. He will also make a similar recommendation to his friends." *Id.* at 338.

evidence is abundantly clear that Schwinn's [franchise plan] has greatly enhanced trade in Schwinn bicycles and has in fact been the salvation of Schwinn . . . ."[213]

The dealer location restraint and the distributor's exclusive territory restraint were both reasonable and necessary to protect the dealers and distributors from free riders and to assure that vital services were provided. The distributor customer-class restraint was necessary for Schwinn to police its program of selling only through bicycle repair shops. If Schwinn were enjoined from imposing this type of restraint, other market suppliers, who could afford to handle distribution without outside dealers, would have had an unfair advantage over market suppliers like Schwinn who could not afford this alternative. Furthermore, a prohibition against customer-class restraints encourages vertical mergers and could eliminate many independent distributors. The dealer customer-class restraint and distributor in-territory customer restraint, on the other hand, seem excessive with respect to the competitive conditions that brought about their initiation. In sum, most of the Schwinn restrictions would be permissible under a rule of reason approach. Rather than disallowing the entire program because two parts of it were excessive, those parts should be severed from the rest and eliminated.

V. Extension of the Rule of Reason to Other Restrictions on Distribution

A. *Horizontally Imposed Restrictions on Distribution*

1. Justification of the Rule of Reason Application

In overruling *Schwinn*, the *Sylvania* Court acknowledged that vertical restrictions on distribution are widely used in a free market economy[214] and cited substantial authority to support their economic utility.[215] In dictum, however, the Court, without elaborating upon its rationale, deemed such restraints to be per se unlawful when horizontally imposed.[216] This per se rule for horizontal restrictions developed because courts discovered that, with rare exception, the purpose of the parties was to lessen competition at the market level of those initiating the restraint.[217] These restraints are said to stifle competition by depriving competitors of required goods or by eliminating competition among the participants.[218] Because of the supposed rarity of lawfully inspired horizontal restrictions and the need for judicial economy, a per se rule is applied.[219] The problem in applying a per se rule to horizontal restrictions on distribution solely because of a generic distinction is that the early cases on which the per se rule is based contained price fixing, group

213. *Id.*

214. 433 U.S. at 57.

215. *Id.* at 54-58.

216. "There may be occasional problems in differentiating vertical restrictions from horizontal restrictions originating in agreements among the retailers. There is no doubt that restrictions in the latter category would be illegal *per se* . . . ." *Id.* at 58 n.28 (citations omitted).

217. *See Restricted Distribution, supra* note 59, at 1040; note 62 *supra* and accompanying text.

218. *Restricted Distribution, supra* note 59, at 1040.

219. *Id.* at 1040-41.

boycotts, and concerted refusals to deal as dominant themes.[220] Not until *United States v. Topco Associates*[221] did the Court decide a case that involved horizontally imposed territorial restraints alone, that is, without the presence of price fixing or boycotts.[222] The Court apparently did not so view the case, however, because it refused to differentiate *Topco* from the prior cases containing more severe restraints.[223]

Topco was a nonprofit buying and trademark-holding cooperative, which distributed high quality private label food and nonfood items to its member-licensees—twenty-five independent firms, most of which were regional grocery chains.[224] As to the territorial restraints imposed, the district court found that the harm to intrabrand competition was outweighed by the benefit to interbrand competition.[225] The Supreme Court, however, reversed and remanded on the ground that the restrictions were horizontally imposed and, therefore, per se violations of the antitrust laws.[226]

The timing of *Topco* was unfortunate in that it followed *Schwinn*.[227] Therefore, even if the Topco restraints had been vertically imposed, they would have been illegal per se under the doctrine of prohibition against restraints on alienation adopted by the *Schwinn* Court. The *Topco* Court had no problem extending the horizontal restraint per se rule to territorial limitations alone because horizontal restraints historically have been scrutinized more closely and dealt with more severely than vertical restraints.[228] The Court, therefore, was compelled by the history of section 1 of the Sherman Act to deal harshly with Topco.

The anomaly of *Topco* is that the Government brought the action under the per se rule, though it admitted to the district court that the arrangement had a beneficial interbrand competitive effect.[229] The Government further acknowledged that, were Topco a vertically integrated national chain, it would not have violated the antitrust laws.[230] Once the Supreme Court decided that the Topco restraints were horizontal and therefore per se illegal, however, it characterized these claims of reasonableness and procompetitiveness as "irrelevant to the issue."[231]

It is difficult, however, to understand how a commercial practice that

220. *Broader Rule of Reason*, *supra* note 49, at 136-37; 28 Wash. & Lee L. Rev. 457, 465 (1971). For example, United States v. Sealy, Inc., 388 U.S. 350, 357 (1967), Timken Roller Bearing Co. v. United States, 341 U.S. 593, 596, 598 (1951), and Addyston Pipe & Steel Co. v. United States, 175 U.S. 211, 240 (1899), all involved market divisions coupled with price fixing. United States v. General Motors Corp., 384 U.S. 127, 145-47 (1966), Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207, 212-13 (1959), and Fashion Originators' Guild of America, Inc. v. FTC, 312 U.S. 457, 465 (1941), all involved group boycotts.

221. 405 U.S. 596 (1972).

222. *Broader Rule of Reason*, *supra* note 49, at 142; 28 Wash. & Lee L. Rev. 457, 460 (1971).

223. 405 U.S. at 608.

224. United States v. Topco Assocs., 319 F. Supp. 1031, 1032-33 (N.D. Ill. 1970).

225. *Id.* at 1043.

226. 405 U.S. at 608.

227. *Topco* was decided in 1972, approximately five years after *Schwinn*.

228. *See Restricted Distribution*, *supra* note 59, at 1040-41.

229. 319 F. Supp. at 1040.

230. *Id.*

231. 405 U.S. at 609.

enhances competition can at the same time have a "pernicious effect on competition and lack . . . any redeeming virtue."[232] Just as the Court in *White Motor*[233] refused to extend the per se rule to vertical territorial restraints unless the *Northern Pacific* test was met,[234] the *Topco* Court should have accorded the same consideration to the Topco restraints because they, too, differed from those found in prior cases. Instead, the majority in *Topco* considered only the form of the restraint in rendering its per se ruling. In refusing to consider the competitive impact of the Topco restraints, the majority stated: "[C]ourts are of limited utility in examining difficult economic problems. Our inability to weigh, in any meaningful sense, destruction of competition in one sector of the economy against promotion of competition in another sector is one important reason we have formulated *per se* rules."[235]

Five years later, however, the *Sylvania* majority criticized the *Schwinn* Court for not distinguishing between "potential for intrabrand harm [and] interbrand benefit."[236] Presumably, if such a balancing approach can be undertaken with respect to vertically imposed restraints, it could likewise be done in horizontal situations.[237] Fortunately, however, the *Topco* Court seemingly stepped back from its absolute condemnation of horizontal restrictions on distribution by affirming per curiam the district court's grant on remand of modified restraints.[238]

These modified restraints allowed Topco to use primary responsibility and pass-over clauses to ensure proper development of retail markets. Primary

232. Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958). "*Per se* rules of illegality are appropriate only when they relate to conduct that is manifestly anticompetitive." Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 49-50.

233. 372 U.S. at 263.

234. *See* notes 40-42 *supra* and accompanying text.

235. 405 U.S. at 609-10 (footnote omitted).

236. 433 U.S. at 52.

237. One possible reason why courts have avoided finding arrangements to be horizontal or have ruled that restrictions are primarily vertical even when they have horizontal elements is that these courts find the per se prohibition on horizontal restrictions to be too harsh. For example, the district court opinion in *Topco*, in a departure from precedent, considered the territorial restrictions without distinguishing between horizontal and vertical restraints. Unfortunately, the Supreme Court was quick to point out this omission: "The District Court failed to make any determination as to whether there were *per se* horizontal territorial restraints . . . and simply applied a rule of reason . . . ." 405 U.S. at 608.

In *White Motor*, however, the Supreme Court avoided finding a horizontal relationship when the market supplier restrained its dealers from selling to certain classes of customers, retaining those customers for itself. 372 U.S. at 258. This meant that the market supplier and the dealers were operating at the same level and allocating customers among themselves. The Court nevertheless treated the arrangement as a vertical restriction on distribution. *Id.* at 261. Similarly, the FTC refused to find horizontal customer allocation between the Coca Cola Company and its bottlers unreasonable even though the company also operated bottling facilities. Coca Cola Co., [1973-1976 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,010 (FTC initial decision, Oct. 8, 1975). Another court refused to find Johnson & Johnson to be in competition with its dealers even though it sold directly to one large ultimate customer. Johnson & Johnson v. Avenue Merchandise Corp., 193 F. Supp. 282 (S.D.N.Y. 1961). For a discussion of these cases, see 44 Geo. Wash. L. Rev. 436, 450 (1976).

238. United States v. Topco Assocs., 1973-1 Trade Cas. (CCH) ¶ 74,485 (N.D. Ill.), *aff'd per curiam*, 414 U.S. 801 (1973).

responsibility clauses define geographic areas for each dealer to develop and allow for the termination of any dealer whose efforts in that regard are inadequate. Profit pass-over clauses require a dealer who encroaches on another's territory to share the portion of his profits that covers the costs of services necessary to develop the territory.[239] Such clauses make it unprofitable to some degree for dealers to cross territorial lines. By granting this remedy, the district court, in effect, indirectly allowed what the Supreme Court would not. The district court's ruling probably stemmed from its desire to avoid eliminating Topco as a going concern.[240]

The problem with the remedy granted, however, is that profit pass-over clauses may not provide dealers with enough protection. Rather than merely recouping some of his expenses, a dealer who develops a territory wants to reap the full benefits of his investment in the form of profits. Furthermore, pass-over clauses cause administrative problems because many sales will be hard to trace. Notwithstanding the modified nature of the new restraints, it is difficult to understand why the court-approved restrictions were not illegal themselves in light of the horizontal aspects of the arrangement.[241] These problems could be avoided by applying a rule of reason to such restrictions. It should be "axiomatic that any test of legality [under section 1 of the Sherman Act] for a territorial or customer restriction should be responsive to the restriction's actual effects upon competition."[242] The *Sylvania* Court recognized this in striking down the *Schwinn* sales-agency distinction.[243]

Posner argues forcefully that plaintiffs should be required to prove that a dealer cartel in fact exists[244] because determination of legality based on a vertical-horizontal distinction does not go to the objective of the challenged restriction.[245] Identification of the source of the restriction as the basis of liability does not recognize dealers' "legitimate, nonmonopolistic interest in seeking to overcome through joint action serious free-rider problems."[246] It also places form over substance.[247] Another reason that the per se rule is inappropriate as a blanket condemnation of horizontal distribution restrictions is that it effectively favors larger firms. Imposition of a per se rule prohibits

239. *Id.*

240. In his dissent to the original Supreme Court decision, Chief Justice Burger predicted that absent congressional action, private label grocery items would be available only to large national chains. 405 U.S. at 624 (Burger, C.J., dissenting).

241. In this regard the district court determined that the per se prohibition was invoked by reason of the exclusivity of territories offered by Topco to its members. 1973-1 Trade Cas. at 94,154. The court overlooked, however, the invalidation of Topco's coextensive and nonexclusive territories.

242. *Broader Rule of Reason*, *supra* note 49, at 142.

243. 433 U.S. at 57.

244. R. Posner, *supra* note 25, at 165.

245. *Id.* at 165-66; *Broader Rule of Reason*, *supra* note 49, at 144-45.

246. R. Posner, *supra* note 25, at 165.

247. Posner maintains that in United States v. Sealy, Inc., 388 U.S. 350 (1967), *discussed at* notes 68-70 *supra* and accompanying text, the member-licensees did not divide territories for the purpose of obtaining monopoly prices. They did so to protect their members' investments in developing territories from incursion by other member-licensees taking a free ride. R. Posner, *supra* note 25, at 165-66; *Reflections on* Sylvania, *supra* note 81, at 9-10.

arrangements such as the one in *Topco*, which enhance interbrand competition,[248] benefit consumers,[249] enable small businessmen to compete with large chains,[250] and provide markets for small manufacturers that they ordinarily would not have.[251] Large firms that can afford to integrate vertically, however, may achieve these goals without violating section 1 of the Sherman Act.[252]

It is suggested here that these failings of the per se rule as applied to horizontal restraints can be avoided by using a rule of reason analysis. In this way, courts will inquire into substance rather than form—a stated goal of the Court in *United States v. Sealy, Inc.*[253]—and can effectively determine the competitive impact of these restraints.[254]

2. Application of the Rule of Reason Analysis to *Topco*

Market Power: The market was comprised of all grocery store products sold in 33 states.[255] The market shares of the various Topco members ranged from 1.4% to 16.3% of dollar sales; 5.87% was the average.[256] Topco members' combined retail sales in 1967 placed them fourth in terms of sales behind A & P, Safeway, and Kroger.[257] There were no other manifestations of market power.

Freedom of access to competitive goods: Private label products of the quality and character of the Topco brands were available to large chains.[258] Unless they belonged to buying cooperatives, smaller chains and independents had to settle for products of a like character but less consistent quality.[259] Nationally

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248. 319 F. Supp. at 1040.

249. Healthy interbrand competition usually keeps prices down and thereby benefits consumers. *Id.* at 1035.

250. *See* notes 258-63 *infra* and accompanying text.

251. "Smaller manufacturers, the most common source of private label products . . . benefit from private label use by the assurance of a substantial market for their products . . . ." 319 F. Supp. at 1035.

252. The Government conceded that an integrated national chain could legally do what Topco could not. *Id.* at 1040.

253. 388 U.S. 350, 352-53 (1967).

254. It is quite possible that under the proposed rule of reason analysis, the Sealy restraints would be found excessive because territories were allocated and resale prices were set. Such an arrangement would have the potential to eliminate all intrabrand competition without a need to do so. It is difficult to predict the outcome, however, merely by isolating a few of the facts out of context.

255. 319 F. Supp. at 1039. Definition of market is not intended to be an issue in this analysis. The district court's statement of facts relevant to defining the market is accepted here.

256. *Id.* at 1033. Defining market share in terms of units would not be meaningful given the vast quantity of different products sold at differing unit costs.

257. In 1967, combined sales exceeded $2.3 billion. Individual vendors' sales volumes ranged from $1.6 million to $182.8 million, and 18 of the 26 members had annual sales of less than $100 million. *Id.* Volume of individual members' sales is significant in that once a member grew to a point where it could afford a private-label program of its own—usually when sales volume was $250 million or more—it withdrew from Topco. *Id.* at 1039.

258. *Id.*

259. *See id.* at 1036.

advertised brands were available to all competitors, and Topco members were not prevented from acquiring and selling other brands, whether nationally advertised or private-labelled. Topco also obtained other private labels and unbranded products for its member-licensees.[260]

Economic justifications: Topco members were granted exclusive territories, nonexclusive territories, and coextensive territories.[261] There was considerable competition from large national and regional chains having the benefit of private label programs.[262] Consequently, Topco members had a need for similar programs.[263] Each Topco member was responsible for developing its own territory by providing local services.[264] In these circumstances, Topco members needed to protect the goodwill they had generated for the Topco brand from free riders.[265] Topco exercised no coercion upon its members, yet output[266] increased substantially. In 1940, the cooperative was very modest, but by 1967, members' combined sales amounted to $2.3 billion.[267]

Excessiveness: Granting exclusive territories to dealers who spend their own capital to develop the local market for given products seems reasonably calculated to allow those dealers to reap the reward of their investment.[268] In this regard it was necessary for members to have control over the admission of new members.[269] But Topco also granted exclusive marketing rights to members in territories in which they did not compete,[270] and such a practice is unnecessarily exclusive.

Discussion: The Topco arrangement, for the most part, would stand rule of reason muster. Association members were very often a strong force in the market but did not dominate it.[271] Each member engaged in active competi-

260. *Id.* at 1032.

261. *Id.* at 1036.

262. *Id.* at 1034-36.

263. The grocery industry was becoming increasingly competitive; markets were saturated with outlets, profit margins were slim, and large chains were succeeding in eliminating the independents. *Id.* at 1034.

264. *Id.* at 1042.

265. "Many of the Topco members would not have joined Topco and many prospective members will not join Topco without the assurance of exclusive use of the Topco private labels in their primary marketing areas." *Id.* at 1036.

266. Lack of coercion is evidenced by the fact that Topco did not interfere in the management of its members' local operations or buying activities. *Id.* at 1032.

267. 405 U.S. at 599-600.

268. *See* 319 F. Supp. at 1042.

269. An applicant for membership had to obtain approval by the board of directors and the affirmative vote of 75% of the members to become a licensee. If, however, a member within 100 miles of the applicant voted to disaffirm, then an 85% affirmative vote of the members was required. 405 U.S. at 602.

270. 319 F. Supp. at 1037.

271. The Supreme Court noted Topco members' strong competitive positions in their individual markets but made no claim that any of the members were dominant. 405 U.S. at 600. Lack of adequate statistics for each competitor makes precise evaluation of the market position difficult. It is very likely, however, that Topco members generally did not dominate their respective markets insofar as competition within markets was intense. *See* note 263 *supra*. Furthermore, when Topco members reached substantial sales volumes, they generally withdrew from the cooperative and established their own private-label programs. *See* note 257 *supra*.

tion with one or more of the large national or regional chains as well as with many small chains and independents.[272] In fact, interbrand competition was intense with the major force being the large chains. These major competitors had access to comparable quality private labels that enabled them to compete effectively.[273] The success of these major competitors contributed to the disappearance of smaller competitors.[274] In the face of this competition, Topco members' increases in output subsequent to the association's incorporation[275] evidenced their increased ability to compete at a time when other smaller competitors were being eliminated.

In light of the interbrand competition and the substantial investment required of the members to develop their own territories, grants of exclusive territories were essential to protect those investments and to enhance competitive abilities.[276] Had Topco members used this exclusivity as a license to charge monopoly prices, they would have lost their competitive parity with national chains by effectively forcing consumers to select the nationally advertised brands sold in member stores instead of the Topco brands.[277] Thus, because the low prices of private labels act as an inducement to consumers, price gouging would have defeated the purpose of such a program.

Reserving territories for future expansion, therefore, was the only excessive practice. These restraints should have been severed from the arrangement and struck down. The entire arrangement, however, should not have fallen as a result of this one excessive practice because the Topco restrictions were not part of an aggregation of trade restraints.[278] Nor were they an integral part of "a broad anticompetitive plan."[279] The fundamental purpose of the restrictions was to improve Topco members' ability to compete on the interbrand level,[280] and the major portion of the Topco arrangement was designed to achieve this goal. It would be imprudent to overrule the entire plan when only a minor part of it was excessive.

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272. 319 F. Supp. at 1033.

273. *Id.* at 1039-40.

274. *See* note 263 *supra*.

275. *See* note 267 *supra* and accompanying text.

276. *See* 319 F. Supp. at 1040.

277. Use of private labels allowed the stores to compete among themselves on the basis of price. Stores could attract customers by discounting private labels or by using profits from high-margin private labels to offset discounts on national brands. 405 U.S. at 599 n.3. If members failed to use Topco brands in one of these ways, they would have lost customers to their competitors who did.

278. *See* notes 220-23 *supra* and accompanying text.

279. *Broader Rule of Reason*, *supra* note 49, at 147.

280. "[E]xclusivity is the essence of a private label program . . . . Each national and large regional chain . . . relies upon the exclusivity of its own private label line to differentiate [itself from] competitors and to attract and retain the repeat business and loyalty of consumers. Smaller retail grocery stores and chains are unable to compete effectively with the national . . . chains without also offering their own exclusive private label products." 405 U.S. at 604-05 (quoting Topco's answer to the Government's complaint).

B. *Resale Price Maintenance*

1. Restrictiveness of the Restraint

It is arguable that allocation of exclusive territories, which the Supreme Court has indicated can be reasonable,[281] is in certain cases more restrictive of competition than resale price maintenance.[282] When exclusive territories are assigned, dealers need not engage in nonprice competition[283] because they, in effect, have monopolies in their respective territories.[284] However, when dealers are not totally insulated from competition by such territorial protections, but are subject to resale price maintenance programs instead, the dealers are compelled to compete among themselves on a nonprice level.[285] Thus, as each dealer competes for more sales, nonprice intrabrand competition will increase. Presumably, the effect of this nonprice intrabrand competition will be to increase sales, the market supplier's output, and competition at the interbrand level.

Resale price maintenance programs may also serve to promote interbrand competition with regard to both services and price, for even though one market supplier sets a retail price[286] another may not follow or may set a different price. Contrasted with this situation is that of a market supplier allocating exclusive territories. The purpose for the territorial restriction may be to encourage dealers to provide presale services so that interbrand competition increases and the market supplier becomes a more viable competitor in the total marketplace. Within each territory, however, there is virtually no intrabrand competition.[287] In other words, intrabrand competition is sacrificed altogether for the purpose of improving the market supplier's interbrand competition potential. As a result, resale price maintenance would seem somewhat less restrictive of overall competition than would grants of exclusive territories.[288]

Notwithstanding the fact that resale price maintenance, when imposed to ensure presale services, can be less restrictive of intrabrand competition than territorial restrictions, courts regard all types of resale price maintenance as per se unlawful.[289] As Justice Harlan explained in *Albrecht*, the rationale for a per se prohibition is that dealers combine to force the market supplier—as in

281. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 57-58.

282. *Broader Rule of Reason*, *supra* note 49, at 146.

283. R. Posner, *supra* note 25, at 159. If, however, these territories were allocated by market suppliers desirous of stimulating sales services, the dealer would jeopardize his franchise by failing to offer those services.

284. Naturally, in localities where consumers are highly mobile, exclusive territories do not offer great potential for dealers to exploit consumers by charging monopoly prices. *Id.*

285. Bork II, *supra* note 110, at 454.

286. In essence, the market supplier relies upon his own judgment to set prices rather than on that of the individual dealer. Bork II, *supra* note 110, at 455.

287. *See* notes 283-84 *supra* and accompanying text.

288. Location clauses would usually be less restrictive than resale price maintenance or exclusive territories. *See* notes 37-39 *supra* and accompanying text.

289. *See* pt. I(A)(1), (B) *supra*. The exception to the per se rule against resale price maintenance applies to restrictions imposed unilaterally as in *Colgate*. *See* notes 22, 26-27 *supra* and accompanying text.

a dealer cartel—to impose resale prices.[290] The rationale that Harlan articulated, however, ignores the fact that dealers would have to wield great power in order to force market suppliers to set resale prices.[291] A market supplier serves no self-interest by fixing resale prices at a high level for the purpose of assuring dealers high profits;[292] this tactic would reduce output without increasing the supplier's profits.[293]

With respect to excessiveness, it is arguable that cases of resale price maintenance should be viewed with stricter scrutiny than cases of territorialism. This might result from the conviction that nonprice compotition is not as beneficial to the mass of consumers as price competition. Price competition, however, is not eliminated on the interbrand level; it is only restricted on the intrabrand level. Therefore, resale price maintenance should not be deemed to be per se unlawful; if a beneficial effect on competition can be shown, and if the initiator of the restraint can justify imposition of this type of restraint, the spirit of the antitrust laws has not been violated.

2. Rationale for Resale Price Maintenance

Absent coercion by the dealers, the most logical reason that a market supplier would have for setting resale prices is to induce interbrand competition among dealers in the mode of essential sales services.[294] The purpose of such restraints, therefore, is to increase the market supplier's interbrand competition potential.[295]

As discussed above, allocation of territories and/or customer restrictions can be used by market suppliers to increase sales services.[296] Therefore, the crucial question to ask with regard to resale price maintenance is why it should be permitted when nonprice restraints can accomplish the same business objectives. First, as shown above, resale price maintenance will sometimes be less restrictive of interbrand competition than will territorial restraints.[297] Second, price maintenance will be preferable in certain situations, such as those in which effective marketing requires thorough coverage of a geographic area.[298] Consider, for example, the position of a manufacturer of small pocket calculators. Given the nature of the product, numerous outlets covering the intended market are necessary in order for the manufacturer to generate a substantial sales volume. Because territories would only be a few blocks apart, a significant free rider problem could exist despite the imposition of exclusive territorial restrictions. As such, certain dealers could offer services and yet lose sales to nearby dealers who discount prices and offer no services. If wider territories were allocated, the market supplier could not

290. 390 U.S. at 157 (Harlan, J., dissenting).

291. Telser points out that this rationale is based on the assumption that there is "perfect competition" among market suppliers and that dealers, "though powerless singly, collectively have monopoly power." Telser, *supra* note 85, at 88.

292. *See Reflections on* Sylvania, *supra* note 81, at 4.

293. R. Posner, *supra* note 25, at 147-48.

294. *See* notes 104-09 *supra* and accompanying text.

295. *See* notes 111-13 *supra* and accompanying text.

296. *See* notes 104-10 *supra* and accompanying text.

297. *See* notes 281-88 *supra* and accompanying text.

298. Bork II, *supra* note 110, at 454.

hope to have an output sufficient to keep him in business. Resale price maintenance is a practicable means available to such a market supplier for encouraging its dealers to provide presale services and for protecting those dealers from free riders.[299] As a result, the dealers in the area would be forced to compete with one another on nonprice levels, and the market supplier would be assured that essential services are provided.

Resale price maintenance may also be necessary when the product and the services are intertwined, even if free riding is not a problem.[300] In such situations, consumers would not be expected to obtain desired services from one dealer and buy the product from some other dealer.[301] Nonetheless, because service is an essential component in marketing of the product, the market supplier must be assured that the services are being offered, or he will risk losing sales to competitors who do effectively offer the services.[302]

3. Applicability of the Rule of Reason Analysis

Because resale price restraints can be used to enhance interbrand competition, they should be analyzed under a rule of reason. "The fact that resale price maintenance might sometimes be used to bolster a cartel does not support the conclusion that it has a 'pernicious effect on competition,' which implies something more than a mere possibility of abuse."[303] Despite the *Sylvania* majority's claim to the contrary,[304] its analysis nevertheless supports application of the rule of reason to resale price maintenance insofar as many of the economic justifications for nonprice restraints also apply to price maintenance.[305]

Given the potential of such restraints for increasing interbrand competition while only reducing and not eliminating intrabrand competition, they do not satisfy the "lack of any redeeming virtue" test of *Northern Pacific*.[306] Thus, their illegality should not be conclusively presumed. Whether resale price maintenance results from a dealer cartel can be tested under the rule of reason analysis recommended above.

4. Hypothetical Marketing Problem

A market supplier is often compelled to impose restrictions upon its dealers to ensure that its product is properly marketed. Nonprice restraints, however,

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299. *Reflections on* Sylvania, *supra* note 81, at 9-10.

300. Bork II, *supra* note 110, at 454.

301. For a discussion of a national gas station hypothetical, see notes 111-17 *supra* and accompanying text. For a brief exposition of Professor Bork's position relative to products and services, see notes 124-26 *supra* and accompanying text.

302. *See* Bork II, *supra* note 110, at 456 n.161.

303. *Reflections on* Sylvania, *supra* note 81, at 8.

304. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 51 n.18.

305. Both Justice White, in his concurrence to the Supreme Court decision in *Sylvania*, 433 U.S. 36, 63-71 (1977) (White, J., concurring), and Judge Browning, in his dissent to the Ninth Circuit decision, GTE Sylvania Inc. v. Continental T.V., Inc., 537 F.2d 980, 1019 (9th Cir. 1976) (Browning, J., dissenting), acknowledged, with hesitation as to the far-reaching implications, that the economic analysis which justifies territorial restraints can likewise be used as a justification for resale price maintenance.

306. *See* note 19 *supra* and accompanying text.

will not be suitable in every situation. Consider, for example, a manufacturer of home-use food storage containers that is in danger of failing. Its sales are declining steadily and its market share—approximately two percent of unit and dollar sales of such products in New York and New Jersey—is already so small that the market supplier has difficulty meeting expenses. The manufacturer's problem stems from a perceived deficiency in its product; consumers believe that the containers are not airtight and, therefore, allow foods to spoil rapidly. The lack of satisfaction accounts for the reduced sales because consumers neither recommend the product to friends nor make repeat purchases. In actuality, the product, when used properly, creates a vacuum seal, thereby retarding spoilage at least as effectively as products of like character and quality.

The solution to the manufacturer's problem is to educate the consumer as to the proper usage of the product. The only cost-effective method for accomplishing this task is a time-consuming demonstration by properly instructed sales personnel. The market supplier has to rely upon the local dealers for these demonstrations because it cannot afford television coverage of its entire market. Without the capital to advertise effectively, the market supplier also relies on dealers to generate product inquiries. Generally, a rather large point of purchase display is best suited to this purpose. Past history indicates that when retailers engage in local advertising, the market supplier's sales are boosted substantially.

Distribution has to be widespread for sales to reach significant proportions. Market research indicates that most consumers purchase food containers while shopping for other types of products, and that no one type of retail outlet is associated with the sale of such products. Competitors, however, enjoy broad market penetration. Therefore, the market supplier has to induce its dealers to provide the necessary presale services crucial to the successful marketing of its product. At the same time each dealer wants its investments in promoting the product and educating consumers to be protected from free riders.

Nonprice restraints would not accomplish these goals effectively. Granting exclusive territories to protect dealers would deny the supplier the market penetration required to stay in business. Location clauses would be meaningless, for if the supplier is to succeed, the locations would have to be too close together. The dealer, therefore, would have no protection from free riders. Customer allocation would also be impracticable because consumers tend to shop in different locations: some shop near their homes; others go to business districts; and still others frequent shopping centers. Yet, all of these people could live on the same block. Profit pass-over clauses, whereby a dealer selling to an out-of-territory customer compensates the dealer from whose territory the customer comes, would fail in this type of marketing situation because the administrative problems in tracing customers would be overwhelming.

Therefore, the supplier elects a resale price maintenance plan because it would encourage dealers to provide sales services while protecting them at the same time against free-rider incursion. The more services the dealers offer, the more likely they will generate sales for themselves. Each dealer determines the amount of presale services it can afford, within the framework of the set retail price, to compete effectively on an intrabrand level. As a result of the dealers' newly found enthusiasm after the supplier initiates the price restraints, output increases so that in two years the supplier has captured a five percent market share in terms of both dollars and unit sales.

5. Application of the Rule of Reason Analysis

Market power: The relevant market consists of all brands of home-use food storage containers sold in New York or New Jersey. At the time the restrictions were implemented by the market supplier, it had a two percent share of unit and dollar sales, which had been declining steadily. There are no other manifestations of market power. In fact, the brand's sales suffer from a perceived defect.

Freedom of access to competitive goods: In the relevant market there are numerous suppliers of products of like character and quality, many of which have widespread market distribution. Most dealers carry more than one brand of these products, and the market supplier has not insisted upon exclusive dealing arrangements.

Economic justifications: Dealers are limited as to the amount they can charge for the market supplier's product. They are entitled, however, to sell from any location in which they operate a business and to whomever they choose. The restriction as to price was interposed to ensure that certain sales services essential to the success of the product are offered. Although competition is not aggressive, there are ample substitute products available. Given the proximity of one dealer to another, there is a substantial free-rider threat.

The dealers have not coerced the market supplier, who was in no position to coerce the dealers. As a result of the restrictions, the market supplier captured a five percent market share of both dollar and unit sales, thereby increasing its output substantially.

Excessiveness of restraints: Because of the significant free-rider problem and the crucial need for sales services, some type of restraint was necessary to protect dealers and to ensure that those services would be provided. Resale price maintenance would logically serve as an inducement to dealers to try to maximize sales by offering services to consumers and would protect against free-rider incursion. In light of these economic justifications, it can readily be stated that the means were reasonably calculated to achieve the desired end. Furthermore, because dealers were not precluded from obtaining available competing goods, the restriction was not excessive. In fact, it is difficult to conceive of any other solution available to this manufacturer and within its means.

Discussion: The restrictions in this hypothetical should withstand rule of reason scrutiny. This market supplier can be categorized as a failing firm. As was the case in *Sylvania*, the market supplier's withdrawal would have impaired interbrand competition.[307] The ready availability of substitute products was accelerating the decline of the market supplier's sales. Imposition of price restrictions to induce dealers to provide services caused the supplier's market share to increase. The absence of coercion is also an important indication of competitive intent.

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307. *See* notes 184-88 *supra* and accompanying text.

CONCLUSION

The *Sylvania* decision may mark a bold first step in the break away from the formalistic approach evident in the majority of antitrust precedent concerning distribution restrictions. Throughout antitrust history, courts have developed generic distinctions in an apparent attempt to pigeonhole restrictions on distribution into one of two broad categories: those that are per se unlawful and those that must be tested for reasonableness.[308] Thus, by the time *Sylvania* came before the Court, all distribution restraints that were essentially horizontal, most vertical practices that involved price fixing or price maintenance,[309] and all vertical nonprice restrictions imposed in a sale after title had passed were automatically thrown into the per se category. *Sylvania*, however, eliminated *Schwinn's* sales-agency distinction in cases of vertical territorial restraints and ruled that all vertical nonprice restraints should be tested under a rule of reason.[310] Although the *Sylvania* rationale is arguably applicable to vertical resale price maintenance,[311] the Court nevertheless said in dicta that all such practices are per se unlawful.[312] Finally, the Court said that all horizontal restrictions were to remain in the per se category.[313] Thus, the case that decried formalistic distinctions[314] preserved them at the same time.

The danger of retaining these distinctions is that practices can be, and are, deemed to be per se unlawful simply because of their form, even if all parties admit that the practices are in fact procompetitive. The failing of these simplistic distinctions giving rise to the per se rule, however, is that they have not provided meaningful guidelines to businessmen as to the scope of legal conduct because the boundaries between the distinctions are somewhat amorphous.[315] Thus, although it may be true that certain practices affect competition so perniciously that they are inherently unlawful, the judicial system has not yet found a satisfactory test for separating procompetitive practices from inherently anticompetitive ones.

One might ask, then, why *Sylvania* is so important if its dicta preserve the bulk of the formalistic distinctions previously used to decide cases involving restrictions on distribution. For one, the decision saved the rule of reason from almost total elimination.[316] Moreover, the Court recognized, at least in principle, that deviation from the rule of reason standard is permissible only on a showing of a demonstrable or pernicious effect on competition.[317] In so

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308. *See* pt. I(C) *supra*.

309. Price restrictions imposed pursuant to a consignment plan had been upheld if there was no coercion. *See* notes 33-35 *supra* and accompanying text.

310. 433 U.S. at 58-59, *discussed at* notes 50-54 *supra* and accompanying text.

311. *See* notes 303-05 *supra* and accompanying text. The effect of *Sylvania*, however, may be to break down the sales-consignment distinction in price maintenance cases as well, making all such restrictions unlawful.

312. 433 U.S. at 51 n.18.

313. *Id.* at 58 n.28.

314. "We are unable to perceive significant social gain from channeling transactions into one form or another." *Id.* at 58 n.29.

315. *See* notes 82-84 *supra* and accompanying text.

316. *See* notes 131-34 *supra* and accompanying text.

317. 433 U.S. at 58-59.

doing, the Court reestablished the rule of reason as the standard method of analysis and the per se rule as the exception. At the same time, it directed judicial inquiry to competitive impact rather than form, even when determining whether to apply a per se rule or a rule of reason.

At present, these practical effects of *Sylvania* will have an impact only on vertical territorial restraints.[318] Defendants will have the opportunity to justify their restrictions on the basis of market pressures to which the defendants reacted. It is suggested that, at least in the case of vertical nonprice restraints, courts balance this evidence under the rule of reason test proposed above. With a test that focuses the court's attention on market power, freedom of access to competitive goods, economic justifications, and the excessiveness of the restraint, a body of case law should evolve that will in time provide meaningful guidelines to businessmen trying to compete fairly yet aggressively in a complex market. In addition, the proposed test is functional in that its application does not automatically result in a finding of legality, and because it is designed to distinguish procompetitive and anticompetitive practices.

The unfortunate probability arising from *Sylvania* is that many plaintiffs will continue to force their challenges into the per se categories retained by *Sylvania* in an attempt to obtain a sure victory.[319] Acceptance of the dealer-services theory, however, paves the way for abolition of the per se categories of horizontal restraints and resale price maintenance schemes. On the basis of this theory, which adequately explains the purpose and competitive effects of certain practices, courts should be able to recognize, without being strapped by formal labels, that a group of small manufacturers may have the same interest in imposing restraints to obtain dealer services as does a single large manufacturer and that, in many situations, resale price maintenance may be preferable to territorialism. As the judicial system becomes more comfortable with a functional rule of reason—one that is not synonymous with per se legality—it is hoped that these other per se precedents left intact by *Sylvania* will fall.

B. J. Douek

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318. *Id.* at 55-56.

319. *See* note 55 *supra* and accompanying text.