Chapters 13 & 14

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Horizontal Price Fixing and Market Division

THE subject of cartels lies at the center of antitrust policy. The law's oldest and, properly qualified, most valuable rule states that it is illegal per se for competitors to agree to limit rivalry among themselves. We have already discussed in Chapter 1 the great cases that established and elaborated this doctrine: *Trans-Missouri, Joint Traffic, Addyston Pipe & Steel,* and *Standard Oil,* to which may be added *Trenton Potteries,*[1] and *Socony-Vacuum.*[2] There are, of course, hundreds of other cases in which the doctrine of per se illegality for eliminations of rivalry (e.g., price fixing and market division) has been applied, and without doubt thousands of cartels have been made less effective and other thousands have never been broached because of the overhanging threat of this rule. Its contributions to consumer welfare over the decades have been enormous.

Yet it is also true that the rule has become somewhat skewed over time, and on occasion produces undesirable results. It can easily be shown that price fixing and market division are beneficial in certain circumstances. The rule should be restated so that it is illegal per se to fix prices or divide markets (or to eliminate rivalry in any other way) only when the restraint is "naked"—that is, only when the agreement is not ancillary to cooperative productive activity engaged in by the agreeing parties. Only then is the effect of the agreement clearly to restrict output. Many price-fixing and market-division agreements make cooperative productive activity more efficient, and these should be judged, according to the circumstances, by the standards applicable to internal growth of firms or by horizontal merger rules.

Both internal growth and horizontal merger eliminate rivalry, and they do so more permanently than do cartel agreements. Prices are fixed and markets allocated within firms. The reason we do not make these eliminations of rivalry illegal per se is that they involve integration of productive activities and therefore have the capacity to create efficiency. Contract integrations (including those integrations involving price-fixing and market-division agreements) are also capable of producing efficiency. The law of contract integration and of ownership integration should, therefore, be made symmetrical. There is no justification for suspending the per se rule in one area and not the other.

The legal doctrine necessary to the correct treatment of price-fixing and market-division cases is already at hand in the concept of ancillary restraints. This may most easily be expounded in the context of the partnership, one of the oldest examples in antitrust literature of lawful contract integration. Justice Peckham cited it as a valid elimination of rivalry in *Joint Traffic*.[3] Justice Holmes argued from its assumed legality, even though it eliminated rivalry, in *Northern Securities*.[4] Judge Taft, in *Addyston Pipe & Steel*,[5] went further and listed the explicit agreement of partners not to compete with the partnership as one of the five ancillary restraints legal at common law and, he strongly implied, also valid under the Sherman Act. Taft's opinion provides the best approach to the problem, as well as a respectable legal precedent for reforming the law in this area.

Taft held that naked agreements—those that do nothing more than eliminate competition—should be illegal per se, and he applied that conclusion to both the price-fixing and market-division aspects of *Addyston*. But he suggested a different rule when the elimination of competition was a means of creating efficiency. Thus, Taft argued that the elimination of competition inherent in the joining of men as partners was justified because "this effect was only an incident to the main purpose of a union of their capital, enterprise, and energy to carry on a successful business, and one useful to the community."

As Taft realized, the polar models in this area of law are the naked cartel and the partnership, one creating resource misallocation and the other efficiency. Yet both involve the agreed elimination of competition, frequently through price fixing and market division. The law must learn better how to assign the agreements of businessmen to the appropriate model. Currently, the courts too often assign arrangements that carry the economic benefits of partnerships to the category of per se illegality appropriate only for naked cartels.

Many people seem to think that the formation of a partnership or joint venture somehow does not involve an agreement on prices and markets. Yet many partnerships rely upon just such agreements, and we recognize their economic utility. The typical law partnership provides perhaps the most familiar example. A law firm is composed of lawyers who could compete with one another but who have instead eliminated rivalry and integrated their activities in the interest of more effective operation. Not only are partners and associates frequently forbidden to take legal business on their own (Taft's example of a valid ancillary restraint), but the law firm operates on the basis of both price-fixing and market-division agreements. The partners agree upon the fees to be charged for each member's and associate's services (which is price fixing) and usually operate on a tacit, if not explicit, understanding about fields of specialization and primary responsibility for particular clients (both of which are instances of market division).

Nobody supposes that a law firm in New York fixes its fees or controls specialization and client contacts for the purpose of restricting output. Each firm faces the rivalry of scores or hundreds of other firms, so that output restriction is not a tenable hypothesis. The alternative hypothesis is that the partners believe the agreements make the firm more efficient. We have, therefore, a very common situation in which agreements fixing prices and dividing markets contribute to efficiency and certainly should not be held illegal.*

Though it would be perfectly proper to rest the case once it has been shown that an agreement cannot have been made for the purpose of restricting output, it may be more persuasive to suggest the means by which the agreements under discussion here create efficiencies.

Judge Taft suggested the theory of efficiencies when he stated: "Restrictions in the articles of partnership upon the business activity of the members, with a view of securing their entire effort in the common enterprise, were, of course, only ancillary to the main end of the union,

* Curiously, it is with respect to the legal profession that the law has made precisely the correct distinction between partnerships and cartels. The propriety of fee schedules ancillary to a partnership is taken for granted, but the Supreme Court struck down as violative of Section 1 of the Sherman Act a minimum fee schedule applicable to the entire bar of a state. *Goldfarb* v. *Virginia State Bar*, 421 U.S. 773 (1975). The distinction between price fixing within an integrated economic unit and price fixing among competitors who have integrated none of their productive activities could not be clearer. If the courts can generalize that distinction, the law in this area can be made rational.

and were to be encouraged." By "ancillary" Taft meant that the agreement was subordinate to the main transaction, the partnership, and contributed to its efficiency. This definition requires that the agreement eliminating competition be no broader than the need it serves.

It may be desirable, however, to be somewhat more specific about the nature of the causal relationship between agreement and efficiency than Taft was. (The subject of the efficiencies that may flow from both horizontal and vertical agreements fixing prices or dividing markets is treated more extensively in the Appendix to Chapters 13 and 14.) One obvious function of an agreement not to compete is the prevention of what has been called the "free ride" problem. One or more of the partners must be prevented from appropriating for personal profit the contributions made by other partners. If such appropriation occurs, or is suspected to be occurring, the partners who view themselves as victimized will certainly decrease or stop altogether their contributions to the partnership activity. The result will be a less effective partnership because the efficiencies of integration will be less completely realized. This decay of efficiencies is prevented by requiring each partner to agree not to compete with the firm. Each then feels free to contribute without fear of being victimized by others, and the partnership is a more efficient economic unit.

Free riding may deteriorate the efficiency of a law partnership in a variety of ways. In order to further the prosperity of the firm, for example, the various members may specialize in different lines, and each may make known to clients and to the community the excellence of the others in their specialties. If business comes to one partner because of a reputation so gained, and he takes it for his individual profit, he has taken a free ride upon the efforts and sacrifices of the other partners. It would often be difficult or impossible to segregate business engendered by the firm from that engendered by the individual, and to the extent that other partners suspect that such parasitical behavior is occurring, they will be less willing to leave areas of specialization to each other, to put their own clients in touch with other partners, and to advertise each other's merits. Partners will also be less willing to share assets such as specialized knowledge and competence, unique methods of practice, client contacts, and the like.

For the Sherman Act to allow the partnership (with its inevitable replacement of rivalry by cooperation) in the interest of increased efficiency, but to disallow the ancillary agreement that makes the integration more stable and complete, and hence further increases its efficiency, would be a pointless contradiction in policy. It would be like allowing a horizontal merger where there was no danger of restriction of output, and yet insisting that half the firms' operations not be integrated.

Taft's basic insight—one that the modern law would do well to rediscover—is that the fundamental criterion for determining the legality of agreed eliminations of competition (including agreements on prices and markets) is not their explicitness or implicitness, not the number or aggregation of restraints involved, and not the severity or thoroughness with which they are enforced, but simply their capacity for contributing to the efficiency of a contract integration. His doctrine of ancillary restraints offers the Sherman Act a formula for preserving socially valuable transactions by defining an exception to an otherwise inflexible prohibition of agreements eliminating rivalry. It provides as well a measuring rod for confining the exception to the scope of its reason for existence.

None of this analysis in any way detracts from the merit of the per se rule. It simply argues that the rule can be made more beneficial by confining its scope to its rationale. Price-fixing and market-division agreements (and any other horizontal agreements eliminating competition) should be illegal per se when they do not accompany a contract integration or are not capable of contributing to its efficiency. This is not to suggest that every ancillary restraint should be lawful. A showing that a restraint is ancillary, in the sense just stated, merely lifts it out of the per se category and subjects it to the other tests of the rule of reason: market share and specific intent. A finding of ancillarity merely proclaims the presence of an economic integration that entitles the restraint to be judged on the same terms as horizontal mergers or internal growth, the reason being that the same need to weigh possible efficiencies against possible restriction of output is present. We would then be treating economically identical phenomena in the same way, which is surely desirable.

In order to anticipate attack from the other direction, however, perhaps a word should be said in defense of the per se rule when price fixing or market division is naked, i.e., does not contribute to the efficiency of economic integration. That rule properly governed such cases as *Trans-Missouri, Joint Traffic, Addyston Pipe & Steel, Trenton Potteries,* and more recently, the prosecutions for price fixing in the electrical equipment industry and the plumbing fixture industry. All of these were cases in which the parties had engaged in no significant productive integration: the sole purpose of the agreements was to raise prices by restricting output.

Yet the propriety of any true per se rule—one which finds illegality on the face of the agreement without examining questions of market power and intent—is occasionally questioned. The most common objections seem to be that (1) even without the integration of productive economic activities the agreement may create efficiencies; (2) there can scarcely be inferred either a wrongful intent or effect from a naked price-fixing or market-division agreement between parties who lack market power; and (3) it seems unfair to punish persons who may have had a wrongful intent but whose conduct cannot conceivably have succeeded in harming consumers.

The efficiencies arising from a naked price-fixing or market-division agreement, if any ever do arise, must be so minor that the law is justified in ignoring them. Conceivably an agreement on prices could enable some of the firms to spend less on gathering price information (though they might spend more conferring on proper price levels and policing prices to make sure the agreement was kept), but the possibilities of saving seem minuscule compared to the certainty of output restriction.

Occasionally, price fixing will be accompanied by integration whose purpose is to enforce the agreement, and this may have the side effect of some cost reduction. The agreement in *Joint Traffic* provided for the creation of joint freight and passenger soliciting and contracting agencies, and these may have reduced some of the railroads' costs. The agreement was properly held illegal per se, however, because such joint agencies did not require a rate agreement to make them efficient, and also because the agreement for the equitable division of business showed that the main object was the elimination of competition. On its face, the integration was subordinate to the price fixing, and not the other way around. The efficiencies arising from a naked agreement eliminating competition may safely be ignored as either nonexistent or de minimis, while those integrations that are merely means of implementing the price fixing will usually be obvious from the terms of the arrangement. Those few that are doubtful may survive the per se rule, but they are very unlikely to survive the test of market power or the test of intent.

The other two objections may be illustrated and answered by taking a pair of hypothetical situations. Suppose that two realtors in New York City make an agreement to fix commissions but do not coordinate their activities in any other way. Two other realtors in the city form a partnership and agree upon the commissions they will charge. In neither case does it appear conceivable that the agreement will have any effect upon the general level of commissions.

The version of the per se rule defended here would result in automatic illegality for the first agreement but not for the second. The second agreement, once the small market share is shown or conceded, should be completely lawful. This difference arises from economic presumptions and considerations of efficient law enforcement. The economic presumptions differ because there is a contract integration to which the commission agreement is ancillary in one case and not in the other. It may be objected that, given the trivial market shares assumed, there is no likelihood of consumer detriment in either case, and so no occasion to invoke the law in either. But considerations of law-enforcement efficiency support the invocation of the per se rule against the naked commission-fixing agreement. There being no possibility of efficiency, nothing is lost to society by outlawing the agreement. If these parties were allowed to prove lack of market power, all parties would have that right, thus introducing the enormous complexities of market definition into every price-fixing case. A cartel in the steel industry could not be declared unlawful without a trial on the cross-elasticities of demand between steel, aluminum, copper, cement, wood, and so on. There would be no net gain from such trials. In fact, the only result would be to make the prosecution of output-restricting cartels much more difficult, rendering the law less effective. Very few firms that lack power to affect market prices will be sufficiently foolish to enter into conspiracies to fix prices. Thus, the fact of agreement defines the market. There is no unfairness in applying the per se rule to parties whose agreement was useless, since their intent was wrongful. This consideration bears more properly on prosecutorial discretion in bringing such cases and on judicial discretion in imposing penalties. The per se rule against naked price-fixing and market-division agreements is thus justified not only on economic grounds but also because of the rule's clarity and ease of enforcement.

Justice Thurgood Marshall put the case for per se rules very well in his *Container Corp.* dissent:[6]

> *Per se* rules always contain a degree of arbitrariness. They are justified on the assumption that the gains from imposition of the rule will far outweigh the losses and that significant administrative advantages will result. In other words, the potential competitive harm plus the administrative costs of determining in what particular situations the practice may be harmful must far outweigh the benefits that may result. If the potential benefits in the aggregate are outweighed to this degree, then they are simply not worth identifying in individual cases.

Interestingly enough, many courts seem to realize that the present rules of per se illegality for all price-fixing and market-division agreements are out of kilter, that something valuable may be lost. These signs of doctrinal malaise are encouraging, but so far the courts have not adopted the one distinction—that between ancillary and naked restraints—that can make this area internally coherent.

The Supreme Court's 1967 decision in *United States v. Sealy, Inc.*[7] illustrates both the law's uneasiness and the needless destruction of an efficiency-creating system of ancillary restraints. Sealy and its predecessors had for over forty years engaged in the business of licensing manufacturers of mattresses and bedding products to make and sell such products under the Sealy name and trademark. At the time of the trial there were about thirty Sealy licensees distributed across the nation. These manufacturer-licensees owned substantially all of Sealy's stock; according to Sealy's bylaws, each of its directors had to be a stockholder or a stockholder-licensee's nominee. This control of Sealy by its licensees caused the Supreme Court to decide, without doubt correctly, that the restraints could not be classified as vertically imposed but were horizontal restraints between the controlling manufacturer-licensees.

The Sealy licenses required the bedding-product manufacturers to follow promulgated standards and specifications in order to ensure the uniformity of the products appearing under the licensed name and marks. Both price fixing and market division were features of the arrangement. The manufacturers agreed, through Sealy, to impose resale price maintenance upon their outlets—a horizontal agreement between firms at the same level of the industry. They further agreed that each manufacturer should sell Sealy-brand mattresses and bedding products only within a designated territory, though each manufacturer remained free to make and sell other bedding products under other names anywhere it might choose. Funds for national advertising of the Sealy-brand products were contributed by the manufacturer-licensees.

The primary purpose of this cooperative effort by geographically dispersed bedding-product manufacturers seems to have been the national distribution of a uniform product in order to make possible the advantages of national advertising and promotion. Certainly, nothing about the plan resembled an attempt to eliminate competition in the bedding-product market. New licenses were issued only to manufacturers in territories not already served by an existing licensee or which were deemed inadequately served. Geographical coverage was the main concern, and there was no attempt to bring into the group any manufacturer competing with an existing licensee, as there would have been if the suppression of competition had been the object. There was no attempt to bring in all or even a substantial proportion of existing manufacturers. There was at least one national manufacturer and seller of such products, along with several other groups organized on principles similar to Sealy's. There were also many local manufacturers not involved in any group. It is thus impossible to see the Sealy group as organized for the purpose or with the effect of restricting output. But that basic observation seems to have played almost no part in the decision of the case.

The government's posture in the trial court reflected a devotion to semantic labels rather than to economic analysis. Government counsel insisted that price fixing and market division are always and everywhere illegal.[8] Rejecting the suggested application of Judge Taft's ancillarity concept (which was cited but not explored by defense counsel), the government urged upon the trial court the flat and unexplained proposition that "price fixing and territorialization are not and cannot be ancillary to anything." That bold assertion was not plausibly maintained. The district court recognized that something other than a mere cartel was before it,[9] but the resources of current doctrine were not adequate to cope with the situation. The court applied the standard doctrine of per se illegality to the price-fixing agreement, but rejected, rather inconsistently, the per se doctrine as applied to market division. On this branch of the case, the district court found there was no "central conspiratorial purpose," which was of course equally true of the resale price agreement. Relying entirely upon evidence introduced by the government, the court ruled:

> Plaintiff's evidence, read as a whole, conclusively proves that the Sealy licensing arrangements were developed . . . for entirely legitimate business purposes, including royalty income . . . and the benefits to licensees of joint purchasing, research, engineering, advertising and merchandising.

Sealy did not appeal the adverse decision on the horizontal agreement to employ resale price maintenance, its counsel no doubt concluding, and with good reason, that such an appeal would have been fruitless (given the mood of the Supreme Court at that time) and could only prejudice its attempt to salvage from the wreck the district court's holding that the market division was reasonable and lawful.

Even that limited aspiration proved beyond reach, however, for the price-fixing scheme poisoned the market-division agreement, and the Supreme Court struck the latter down. And that is the interesting part of the case. The Court could easily have said, with perfect accuracy so far as precedent was concerned, that horizontal agreements allocating markets had been illegal per se for years and remained so in this case. But it took a different tack, apparently precisely to avoid holding that market division between competitors is invariably unlawful. Instead of relying upon the quick and easy (though economically inapposite) formula of per se illegality, the Court argued that the case presented an "aggregation of trade restraints," citing *Timken Roller Bearing* for the proposition that such aggregations are unlawful.[10] The aggregation in Sealy consisted of a string of agreements, all of which boiled down to an agreement that resale prices should be maintained and that the maintained prices should be advertised and enforced. The Court said these activities violated the Sherman Act. "Their anticompetitive nature and effect are so apparent and so serious that the courts will not pause to assess them in the light of the rule of reason." Which was really too bad, because no anticompetitive effect is visible at all in the price agreements. They were horizontal agreements to employ vertical price fixing. The horizontal agreements could not restrict output because the group engaged was not a sufficiently large segment of the market. And as we shall see in the next chapter, vertical price fixing can never restrict output and should never be illegal.

The Supreme Court, however, has a fixed aversion to all price fixing and condemned the market division because it was related. "The territorial restraints . . . gave to each licensee an enclave in which it could and did zealously and effectively maintain resale prices, free from the danger of outside incursions. It may be true, as appellee vigorously argues, that territorial exclusivity served many other purposes. But its connection with the unlawful price-fixing is enough to require that it be condemned as an unlawful restraint. . . ." The Court was thus able to avoid analyzing the economic consequences of either the price fixing or the market division. Which makes it especially difficult to know what may have been intended by the Court's deliberate mention that some forms of market division may be lawful:

It is urged upon us that we should condone this territorial limitation among manufacturers of Sealy products because of the absence of any showing that it is unreasonable. It is argued, for example, that a number of small grocers might allocate territory among themselves on an exclusive basis as incident to the use of a common name and advertisements, and that this sort of venture should be welcomed in the interests of competition, and should not be condemned as *per se* unlawful. But condemnation of appellee's territorial arrangements does not require us to go so far as to condemn that quite different situation, whatever might be the result if it were presented to us for decision. For here, the arrangements for territorial limitations are part of an "aggregation of trade restraints" including unlawful price fixing and policing. . . . Within settled doctrine, they are unlawful under § 1 of the Sherman Act without the necessity for an inquiry in each particular case as to their business or economic justification, their impact on the marketplace, or their reasonableness.

Quite obviously, the *Sealy* opinion will not wash. Why is the Sealy arrangement "quite different" from the hypothetical small grocers' case? No real answer is given because none exists. The "aggregation of trade restraints" distinction is meaningless. Suppose the small grocers want to advertise a sale and so agree on a discounted price to be offered through the newspapers. Would the addition of that price agreement so infect the market division that the court need "not pause to assess them in the light of the rule of reason"? Why? Suppose the small grocers offer to show that each restraint in the "aggregation" serves a different efficiency-creating function. Can the rule be that an "aggregation of efficiencies" is illegal? Even on its own terms the "aggregation" theory is nonsensical. If the price fixing was anticompetitive (though that was not shown or even discussed) and if it has been forbidden, why cannot the market division continue without the price fixing unless it is shown to be evil by itself?

The "aggregation of trade restraints" doctrine merely sidesteps the question of whether the restraints, singly or collectively, create efficiencies or restrict output. An aggregation of restraints that does not restrict output is simply a somewhat more complex system of restraints ancillary to a contract integration. In such a case, the more restraints, the more efficiency.

The *Sealy* case illustrates that principle. The case is in fact an exact parallel to the partnership situation we have discussed. The separate mattress manufacturers, as the record showed, found that national advertising was a distinct advantage but that it required a scale of operations which no one of them could achieve alone—hence the idea of a group distributed across the nation using identical brands, names, and product specifications. But why the market division and agreement to maintain resale prices? The problem of the "free ride" offers one obvious explanation. (Others are offered in the Appendix to Chapters 13 and 14.) The need for market division very likely arose from the fact that each member also engaged in considerable individual local sales and promotional effort. Such efforts may range from local advertising to the employment of salesmen, the provision of information to prospective customers, and so forth. Local sales and promotional efforts cost money that can be recaptured only in the price at which the products are sold. The firm that is large enough to distribute nationally under its own trademark will measure such local efforts and expenditures simply by their relation to expected sales and revenues.

The member of a contract-integrated group has a special problem, however. Because the Sealy licensees were selling identical products, it would have been possible for one member of the group to let his neighbor spend the money and time convincing prospective purchasers that the Sealy mattress was preferable to others, and then offer a lower price that did not have to recapture those necessary expenditures. The underselling firm would thus get a free ride, and this very fact might be what enabled it to undersell profitably. The objection to this behavior from the consumer's point of view is not that the practice is unfair but that, if it persists, manufacturers in the system will decrease the amount of local sales and promotional effort they are willing to do. To that extent, the group becomes a less efficient marketer than a single, fully integrated firm of the same size. The Sealy system, that is to say, would not contain the optimal amount of local effort and would be less efficient.

Market division solves the problem and leaves each member free to do the amount of local selling appropriate to his market. In *Sealy*, market division may not entirely have solved the problem because the manufacturers sold to retailers who might cross-sell, particularly since the agreement did not control the price the manufacturer charged his retailers. Perhaps the agreement to maintain resale prices was a means of reinforcing the market division by making sure that a reseller given a low price in order to meet the competition of manufacturers of other brands could not sell in the territory of another manufacturer. There are, as we shall see, other explanations for vertical price fixing that might have been operative in the Sealy system.

The *Sealy* case thus involved a contract integration whose challenged restraints were clearly capable of creating efficiency. The Supreme Court's best course would have been to remand the case for trial on the issue of market size. Since Sealy apparently did not have market control or even a very large share of the market, it should probably have received a favorable judgment. Instead, it and similar cooperative groups had efficiency-creating agreements dismantled by inappropriate legal doctrine.

The faint hint of the birth pangs of doctrinal reform contained in *Sealy*'s small grocer example was, most unfortunately, shown to be a false labor by the Court's subsequent decision in *United States* v. *Topco Associates, Inc.*[11] Topco was a cooperative association of twenty-five small and medium-sized regional supermarket chains operating stores in thirty-three states. Topco functioned as a purchasing agent for its members, ensured quality control on purchased products, developed specifications for certain types of products, and performed other tasks that gave members the efficiencies usually attainable only by large chains.

Topco's stock was owned by its members, and indeed its structure and method of governance was very like Sealy's. Members were geographically dispersed and had varying market shares in their respective areas. The range, the Court noted, was from 1.5 percent to 16 percent, with the average about 6 percent. Sales volume was exceeded by only the three largest chains, A&P, Safeway, and Kroger.

Topco's legal difficulties arose from its private-label program. The Court remarked that the founding members of Topco were experiencing difficulty in competing with larger chains and that this problem was to some degree attributable to the larger chains' ability to develop their own private labels. The opinion sets out some of the efficiencies of private labeling:

> It is obvious that by using private-label products a chain can achieve significant cost economies in purchasing, transportation, warehousing, promotion, and advertising. These economies may afford the chain opportunities for offering private-label products at lower prices than other brand-name products. This, in turn, provides many advantages of which some of the more important are: a store can offer national-brand products at the same price as other stores, while simultaneously offering a desirable, lower priced alternative. . . . Other advantages include: enabling a chain to bargain more favorably with national-brand manufacturers by creating a broader supply base of manufacturers, thereby decreasing dependence on a few, large national-brand manufacturers. . . .

The Court noted that Topco members were frequently in as strong a competitive position in their respective areas as any other chain and that this strength was due, in some measure, to the Topco-brand products the association supplied its members. This was true even though only about 10 percent of the total goods sold by members bore the Topco name.

The problem, in the eyes of the Antitrust Division, was that members could only sell Topco-brand products in designated territories, and these were usually exclusive. Member chains could expand into each other's territories, and did, but they could not sell the Topco brand if another member held the rights for that territory. This restraint had a very plausible connection with efficiency. As Topco's answer said, "Private label merchandising is a way of life in the food retailing industry, and exclusivity is the essence of a private label program; without exclusivity, a private label would not be private." Topco noted that each national and large regional chain had its own exclusive private-label products. "Each such chain relies upon the exclusivity of its own private label line to differentiate its private label products from those of its 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 and large regional chains without also offering their own exclusive private label products." The reason, probably, was very similar to that in *Sealy*: effective promotion of a particular product line can be had only when the firm asked to incur the expense also reaps the benefit of the promotion.

Despite considerable economic argumentation that had persuaded the district court to uphold the restraint, a majority of the Supreme Court held the agreement illegal in an uncritical application of the per se concept: "We think that it is clear that the restraint in this case is a horizontal one, and, therefore, a *per se* violation of § 1 [of the Sherman Act]." The case was governed by *Sealy*, the majority said, and the opinion went on in a footnote to iron out any wrinkles left in that case's doctrine: "It is true that in *Sealy* the Court dealt with price fixing as well as territorial restrictions. To the extent that *Sealy* casts doubt on whether horizontal territorial limitations, unaccompanied by price fixing, are *per se* violations of the Sherman Act, we remove that doubt today."

It is correct, of course, to treat price fixing and market division similarly, since they are simply different means of eliminating rivalry, but it is not correct to apply a per se rule to a case like *Topco*. The fashioning of a per se rule for such cases does not meet the criterion laid down by Justice Marshall in his *Container Corp.* opinion that the gains from the rule far outweigh the losses. The *Topco* majority seemed troubled by this, for the balance of the opinion is largely taken up with an argument that the Court cannot escape the per se rule when price fixing and market division are involved. It asserts that courts are of limited utility in examining difficult economic problems and that "without the *per se* rules, businessmen would be left with little to aid them in predicting in any particular case what courts will find to be legal and illegal under the Sherman Act. Should Congress ultimately determine that predictability is unimportant in this area of the law, it can, of course, make *per se* rules inapplicable in some or all cases and leave courts free to ramble through the wilds of economic theory in order to maintain a flexible approach."

In this view the Court majority was clearly misled by a misunderstanding of the alternatives open to the law. The choice was not between a per se rule and a "ramble through the wilds of economic theory," nor is the problem too difficult for courts. The entire attempt of this book is to demonstrate that correct antitrust rules require only basic economics and that they are capable of easy and precise application by courts. In this instance the Court had only to note the difference between partnerships and cartels (which is the difference between ancillary and naked restraints, which is in turn the difference between eliminations of rivalry essential to economic integration and efficiency, and eliminations of rivalry whose sole object must be the restriction of output). Since the Topco division of territories accompanies a joint effort to achieve the scale necessary to obtain the business efficiencies of a private-label program, the restraint was clearly ancillary. That being true, the per se concept, which makes sense only with respect to naked restraints, should not be applied. The restraint should have been tested on the other criteria of the rule of reason: market power and intent. These distinctions (which are already used in the law of mergers and elsewhere) are by no means too difficult for courts, and they provide the predictability that businessmen and their counsel desire.

Perhaps the Court majority was put off by a misperception of the task required if a per se rule were not applied:

> 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. . . . If a decision is to be made to sacrifice competition in one portion of the economy for greater competition in another portion, this too is a decision that must be made by Congress and not by private forces or by the courts. Private forces are too keenly aware of their own interests in making such decisions and courts are ill-equipped and ill-situated for such decision-making. To analyze, interpret, and evaluate the myriad of competing interests and the endless data that would surely be brought to bear on such decisions, and to make the delicate judment on the relative values to society of competitive areas of the economy, the judgment of the elected representatives of the people is required.

When the problem before the Court is properly understood, however, no weighing of values or of the merits of competition in different sectors of the economy is required. The integration of Topco's members in the private-label program is exactly the same as the integration of persons in a corporation or partnership. These integrations create productive efficiencies. Courts do not have to engage in a delicate weighing of values when they decide that it is lawful under the Sherman Act that corporations and partnerships exist. They do not have to sift through endless data.

When it is seen that no power to restrict output is involved, the law allows the firm or partnership to decide how much rivalry shall be eliminated internally. Absent the power to restrict output, the decision to eliminate rivalry can only be made in order to achieve efficiency. The per se principle applied to Topco, if it were consistently invoked, would destroy all firms and economic integrations in the society. Surely a law capable of avoiding that disaster is capable of using the same principle of avoidance in cases of contract integration. All the court need do is decide that an economic integration capable of producing efficiencies is before it, determine whether the restraint (price fixing, market division, or other) is capable of adding to the efficiencies, and then decide the case on the basis of market power and intent rather than a per se proscription. That procedure would have upheld the restraints in both *Topco* and *Sealy*. It would have spared the Court the uncomfortable knowledge that it was destroying efficiencies, a form of discomfort that seems apparent in the majority opinion and becomes explicit in Justice Blackmun's concurrence and Chief Justice Burger's dissent. The Justices feel that this sort of case is different from the garden variety price-fixing ring, and they are right. The law should have the resources to make that felt difference explicit and operative.

It has been suggested here that contract integrations and ancillary price-fixing and market-division agreements should be treated, according to circumstances, either like single firms or like horizontal mergers. Since the legal results will be very different, this observation requires a word of explanation. When the parties are capable of operating alone, they should be permitted to join and employ ancillary restraints only if the share of the market they would then control would pass muster under rational horizontal merger standards. Thus, we should have no trouble with a group of small grocers, having only, say, 30 or 40 percent of a relevant market, who pool their advertising funds to advertise jointly using media they could not afford individually, and who agree upon prices that will be advertised and charged. Rational merger law would permit them to merge, and so they should be permitted an ancillary restraint that makes very limited merger of their activities effective.

On the other hand, some activities can only be carried out jointly. Perhaps the leading example is league sports. When a league of professional lacrosse teams is formed, it would be pointless to declare their cooperation illegal on the ground that there are no other professional lacrosse teams. In this case the league is best viewed as being the firm, and horizontal merger limitations are inappropriate. Such limitations may become appropriate, of course, when leagues seek to merge.

The upshot is that when the integration is essential if the activity is to be carried on at all, the integration and restraints that make it efficient should be completely lawful. But when the integration may be useful but is not essential (in the sense that cooperation is not the essence of the activity), then the joint venture and its ancillary restraints (including price fixing and market division) should be lawful when three conditions are met:

(1) The agreement fixing prices or dividing markets is ancillary to a contract integration; that is, the parties must be cooperating in an economic activity other than the elimination of rivalry, and the agreement must be capable of increasing the effectiveness of that cooperation and no broader than necessary for that purpose.

(2) The collective market share of the parties does not make the restriction of output a realistic danger (judged by rational horizontal merger standards).

(3) The parties must not have demonstrated a primary purpose or intent to restrict output.

Where any one of these conditions is not met, the horizontal agreement should be unlawful. Where there is no coordination of productive activities, the first condition is violated; such an agreement is naked rather than ancillary and should be illegal per se.

14

Resale Price Maintenance and Vertical Market Division

THE law of resale price maintenance and vertical market division is not only at war with sound antitrust policy but is decidedly peculiar even on its own terms. Vertical price fixing (a phrase here used interchangeably with resale price maintenance) has been illegal per se since Justice Hughes's 1911 opinion in the *Dr. Miles* case,[1] discussed in Chapter 1. Vertical market division has the same economic impact as vertical price fixing, the same relation to competition and consumer welfare, and yet the law does not treat it with equal severity. The Supreme Court has recently widened this anomalous gap by easing, as it should have, the law's strictures on a manufacturer's division of its dealers' markets.

The law of resale price maintenance has become increasingly severe through a long series of Supreme Court decisions. The *Colgate* doctrine[2] appeared to create an exception to *Dr. Miles* per se rule by allowing a manufacturer or other supplier to control resale prices by announcing his wishes on the subject and simply refusing to sell to any retailer who did not comply. The idea was that in such cases there was lacking the agreement essential to a Sherman Act contract, combination, or conspiracy. The *Colgate* rule was of quite limited commercial use, however, since the fatal element of agreement might be created by any manufacturer's discussion of his price condition with a retailer, by the retailer's unsolicited assurance that he would abide by the condition, or even by the reinstatement of an errant retailer after a period of disciplinary nondealing (since it would appear that at least a tacit agreement to comply existed). The only effective course clearly within the law was for the manufacturer to drop the best-known price cutters without warning or discussion and refuse to deal with them indefinitely. Though the example made of such retailers might persuade the rest to abide by the manufacturer's wishes, the best-known discounters were often also the manufacturer's biggest customers. That lessened enthusiasm for price maintenance under the *Colgate* doctrine.

Doubt was cast on the legality of even this course of action by the Supreme Court's opinion in *Parke, Davis.*[3] The majority opinion suggested that any method of securing compliance with announced resale prices that was as effective as an agreement would be an unlawful "combination" under Section 1 of the Sherman Act, even though no actual agreement was present. Alternative means of controlling outlets' prices have also been declared illegal. Control cannot lawfully be accomplished by use of agency contracts, nor (when a widespread marketing plan is involved) by the use of consignment contracts which leave legal title to the goods in the manufacturer.[4] It was true, prior to the repeal of the Miller-Tydings and McGuire acts, that a manufacturer could control resale prices with safety if he followed the path provided by a valid State Fair Trade Act, but this was not terribly helpful. Those laws commonly restricted the application of such contracts to goods bearing a trademark or name; moreover, the laws varied from state to state, some states did not have them, and many states did not have nonsigner provisions, which permit the manufacturer to bind all retailers by signing a contract with one. These and other difficulties prevented many manufacturers from using Fair Trade statutes at all and made them of quite limited usefulness for most manufacturers.

Finally, the Supreme Court has even gone so far as to declare per se illegal a manufacturer's attempt to fix *maximum* resale prices. In *Kiefer-Stewart,*[5] Seagram and Calvert, two commonly owned liquor manufacturers, agreed to sell only to those Indiana wholesalers who would not resell above stipulated maximum prices. The Supreme Court held legally insufficient their defense that they were attempting to counteract a wholesaler price-fixing ring. In *Albrecht* v. *Herald Co.*[6] the Court held that the publisher of a newspaper, the St. Louis *Globe-Democrat,* could not enforce maximum prices at which independent carriers could sell to home subscribers. There could, of course, be no anticonsumer effect from such price fixing, and one suspects that the paper has a legitimate interest in keeping subscriber prices down in order to increase circulation and maximize revenues from advertising. The rule against vertical price fixing is so inflexible, however, that the Court will not pause for such considerations.

As a matter of logic, one would expect the law about vertical market division to be equally harsh. Horizontal price fixing and horizontal market division are the same phenomenon in the contemplation of the law. Both have been illegal per se for decades. Justice Hughes laid down the axiom that since horizontal price fixing is per se unlawful, it follows that vertical price fixing should be unlawful as well, and the law has adhered to that dubious equation. Clearly, then, since horizontal market division is illegal per se, vertical market division should be also. Yet that is not the case.

In *White Motor* [7] the government mounted a Sherman 1 attack on a truck manufacturer's distribution system, which involved closed marketing territories for its retail outlets (no outlet could sell to a customer with an address outside its assigned territory) and reservation of certain types of customers for direct sale by the manufacturer. Relying upon the logic set forth above, the government won a summary judgment in the district court, but the Supreme Court refused to fashion a per se rule for vertical market division, saying it knew too little of the practice's economic impact. Justice Douglas's opinion did suggest that vertical territorial limitations might be "allowable protections against aggressive competitors or the only practicable means a small company has for breaking into or staying in business," and hence within the rule of reason. This seems akin to the suggestion in *Brown Shoe,* which Justice Douglas cited, that any efficiencies which might be created were allowable only in certain classes of cases, and such classes are primarily instances of small firms struggling with giants. The efficiency is apparently not available to large or successful firms. The contours of these suggested defenses were not explored upon remand, however, for the case was settled below and did not clarify the law further.

THE *SCHWINN* CASE

Clarification seemed to be at hand when the *Schwinn* case [8] reached the Supreme Court in 1967, but once more we learned little more than that the Court is uneasy about the conclusion inherent in its prior reasoning, i.e., that vertical market division is illegal per se. Schwinn was a family-owned corporation engaged in the manufacture of bicycles. In 1951 it had 22.5 percent of the United States market and was the largest manufacturer. Ten years later Schwinn's market share had fallen to 12.8 percent, despite a considerable increase in volume. In the ten-year period, in fact, Schwinn had exchanged market positions, almost to the percentage point, with a rival, Murray Ohio Manufacturing Company. Schwinn sold primarily through twenty-two wholesale distributors, sales to the public being made by a large number of retailers. Slightly over a tenth of its output was sold to B. F. Goodrich for resale through Goodrich retail or franchised stores.

The government charged, among other things, that Schwinn had violated Sherman 1 by requiring outlets to adhere to prices it established for Schwinn products and by allocating exclusive marketing territories to its wholesalers. There were thus charges of both vertical retail price fixing and vertical wholesaler market division. The district court found that Schwinn had not set retail prices except where there were valid Fair Trade laws in force. The government did not appeal this finding, but it was clear that the district court and the Supreme Court continued to view resale price maintenance as a per se violation.

The market-division issue was more complex. Schwinn had three principal marketing techniques: (1) sales to wholesalers, B. F. Goodrich, and hardware jobbers for resale to cycle retailers; (2) sales to retailers by consignment or agency arrangements with wholesalers; and (3) sales to retailers under the "Schwinn Plan," by which Schwinn shipped direct to the retailer and paid a commission to the wholesaler taking the order. Whichever way the defendant sold, it was clear, the Supreme Court said, that Schwinn had been "firm and resolute" in requiring that the wholesalers sell only within their assigned territories and only to retailers franchised by Schwinn, and that the retailers sell only to consumers. This "firmness" was "grounded upon the communicated danger of termination."

The Court recognized that Schwinn's purpose was to improve the efficacy of its distribution system, but thought that was not enough in itself to save the whole arrangement. Justice Fortas's opinion made no effort to explain why efficiency in distribution should be regarded as less worthy than efficiency in manufacturing. Yet, once more, the Court was unwilling to opt for per se illegality, and instead chose a curious method of sawing the baby in half:

> We conclude that the proper application of § 1 of the Sherman Act to this problem requires differentiation between the situation where the manufac-

turer parts with title, dominion, or risk with respect to the article, and where he completely retains ownership and risk of loss. . . . Where a manufacturer *sells* products to his distributor subject to territorial restrictions upon resale, a *per se* violation of the Sherman Act results. And, as we have held, the same principle applies to restrictions of outlets with which the distributors may deal and to restraints upon retailers to whom goods are sold. Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it. [Citing *White Motor* and *Dr. Miles.*] Such restraints are so obviously destructive of competition that their mere existence is enough.

Neither here nor in any other vertical restraint case did the Court ever explain why such restraints are destructive of competition. They are only "obviously" so if the Court is defining competition as the complete freedom of the outlet. But that is a definition of competition not keyed to consumer welfare. Indeed, the definition's only criterion—the freedom of the dealer—seems designed simply to destroy contractual obligations. The Court's reasoning is unsatisfactory because the meaning of "competition" has not been thought through. Justice Fortas continued:

On the other hand, . . . we are not prepared to introduce the inflexibility which a *per se* rule might bring if it were applied to prohibit all vertical restrictions on territory and all franchising, in the sense of designating specified distributors and retailers as the chosen instruments through which the manufacturer, retaining ownership of the goods, will distribute them to the public. Such a rule might severely hamper smaller enterprises resorting to reasonable methods of meeting the competition of giants and of merchandising through independent dealers, and it might sharply accelerate the trend towards vertical integration of the distribution process.

Once more the Court displayed concern for efficiency only when a small firm acquires it in order to do battle with the "giants," and the Court assumed that vertical integration was a condition to be avoided. And if there are benefits to be gained by permitting vertical restraints, why should it make any difference whether the manufacturer or the retailer has title to the goods at the time they are sold to the consumer?

But to allow this freedom where the manufacturer has parted with dominion over goods—the usual marketing situation—would violate the ancient rule against restraints on alienation and open the door to exclusivity of outlets and limitation of territory further than prudence permits.

That is all too typical of the antitrust analysis offered by the Supreme Court during the late 1950's and the 1960's. We are not told why prudence does not permit complete freedom to choose exclusivity of outlets and limitation of territory. Indeed, the only "reason" offered is the "ancient rule against restraints or alienation." After years of unexplained antitrust policy, we are at last offered this distillation of the subtle interactions between law and economics: equitable servitudes do not run with chattels personal. It is hardly reassuring to learn that the sole basis for antitrust's answer to a modern business problem is the solution given three or four hundred years ago by an English judge who was talking about something else.

But *Schwinn* maintained even more profound distinctions—that, for example, between vertical price fixing and vertical market division. The reason this distinction is so profound is that it does not exist. Each is a method by which a manufacturer limits rivalry among his resellers. Why is vertical price fixing uniformly held per se illegal? Because, though it may benefit the manufacturer, it eliminates rivalry among resellers. Why is vertical market division sometimes lawful? Because, though it eliminates rivalry among resellers, it may benefit the manufacturer.

Antitrust is capable of sustaining meaningless distinctions and sterile paradoxes, but those of *Schwinn* were too many and too obvious to persist for long. The precedent suffered a timely and a deserved demise shortly after its tenth anniversary.

THE *SYLVANIA* CASE

The litigation in *Continental T.V., Inc. v. GTE Sylvania Inc.*[9] brought the Supreme Court face to face with yet another luminous inconsistency in the law of vertical restraints. Though a manufacturer was only sometimes allowed to divide the territories of his outlets in the sense of dictating that they not sell to customers outside a defined region, he had always been able without interference from the law to follow an announced policy of having only one dealer in any particular area. Franchise agreements often specify the business address of the franchisee, and though it may not be a formal promise, each franchisee usually understands that if all goes well the manufacturer will not locate a second franchisee in the first one's market area. This is, of course, a form of vertical market division. It relies on the costs of doing business at a distance rather than on an agreement to keep the dealers from competing with each other. The only difference between such a franchise policy and closed dealer territories, as exemplified by the arrangements in *Schwinn*, is the sharpness with which the edges of the territories are defined. It was inconsistent of the law to allow one and disallow the other. The inconsistency could not easily be cured by disallowing franchise systems, for this would mean that manufacturers must either accept as outlets any "qualified" retailers who apply or permit dealers to choose their own locations (results which would wreak havoc with many distribution systems); alternatively, the law must specify the minimum number of outlets every manufacturer must have in every territory (an enormous task for which the litigation process is unsuited). The remaining course—freely allowing all vertical market division—would bring consistency to the law and would also be the proper decision for consumers. This, to the delight and astonishment of much of the business world, was the result the Supreme Court seems to have approximated in its 1977 *Sylvania* decision. Moreover, *Sylvania* accomplished these improvements by adopting a mode of reasoning that will prove enormously beneficial if employed throughout antitrust.

Before 1962, Sylvania, a manufacturer of color television sets, sold to wholesalers who resold to a large and diverse group of retailers. In an effort to reverse a decline in its market share to 1 or 2 percent, Sylvania then adopted a franchise system under which it sold directly to a smaller number of selected retailers. The number of franchises in each area was limited, and each agreement specified one or more locations from which sales could be made. Although Sylvania retained discretion to add franchisees in any market, the intent and effect of the system clearly were to decrease rivalry among resellers of Sylvania products. Whether because the system induced greater dealer effort or for other reasons, Sylvania's share of the national market rose to 5 percent by 1965.

The dispute with Continental, a franchised San Francisco television retailer, had complex origins, but centered in its Supreme Court phase on Sylvania's refusal under the location clause to permit Continental to sell Sylvania sets from a new location in Sacramento. Proceeding on the not unreasonable theory that the location clause was invalidated by *Schwinn*, Continental won a judgment in the district court, lost in the en banc court of appeals, and brought the case to the Supreme Court.

The Supreme Court majority, in an opinion by Mr. Justice Powell, overruled *Schwinn*, held vertical market division not properly subject to a per se rule, and upheld Sylvania's location clause. *Schwinn*, Justice

Powell said, was impossible to distinguish. (The court of appeals, unhappy with the precedent but lacking the authority to overrule it, had purported to distinguish the case.) Title to the television sets passed upon sale from Sylvania to the retailer, and in both cases the retailer's freedom to sell as he might wish was limited. Rather than apply the much-criticized *Schwinn* per se rule, the Court reexamined it and found it unjustified.

Justice Powell began the reexamination with the observation that "the market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition [rivalry between sellers of the same brand] and stimulation of interbrand competition [rivalry with sellers of other brands]." He went on to cite ways in which "vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products." A variety of likely efficiencies were mentioned. Since there had been no showing that vertical restrictions have a pernicious effect on competition, a rule of per se illegality was inappropriate, *Schwinn* was overruled, and Sylvania's location clause upheld.

The opinion carefully reserved the possibility that some (unspecified) applications of vertical restrictions might justify per se prohibition and that others (also unspecified) might fall under a case-by-case examination of competitive effects. These reservations may be viewed either as unfortunate wafflings or as judicious concessions necessary either to put together a majority or to guard against unforeseen situations. Whichever, we must be grateful for the main thrust of the opinion, which is surely one of the best in the modern career of antitrust.

The great virtue of *Sylvania* is not so much that it preserves a method of distribution valuable to consumers, though that is certainly a welcome development, but that it displays a far higher degree of economic sophistication than we have become accustomed to, and introduces an approach that, generally applied, is capable of making antitrust a rational, proconsumer policy once more. Both Justice Powell for the majority and Justice White in concurrence gave weight to business efficiency in framing their respective rules. The majority opinion specified some of the efficiencies involved, including the "free ride" effect, which will be discussed subsequently. For years the Court has denigrated business efficiency either as irrelevant to antitrust analysis or as a factor weighing on the side of illegality. I have argued in this book—to the verge of harping on the subject, and perhaps beyond—that this has been the cardinal sin of the policy as the modern Court has elaborated it. *Sylvania* may presage a general reformation of a policy gone astray. I will indicate next the full implications of this approach for the law of vertical restraints.

THE POLICY

Analysis shows that every vertical restraint should be completely lawful. The majority opinion in *Sylvania* was careful in a footnote to state that its reasoning did not apply to the rule of per se illegality for vertical price fixing. The supporting argument consisted of Justice Brennan's observation in a concurring opinion in *White Motor* that resale price maintenance is not designed to, but in fact almost invariably does, reduce price competition not only among sellers of the product directly affected but also between that product and competing brands; the claim that "industry-wide resale price maintenance might facilitate cartelizing"; and the suggestion that Congress approved of the per se illegality of vertical price restrictions by repealing those provisions of the Miller-Tydings and McGuire acts that permitted resale price maintenance pursuant to state Fair Trade statutes.

These considerations are not adequate to support different rules for vertical price and territorial restraints. Justice Brennan's observation runs counter to theory and experience. The cartelization objection is insubstantial, as we shall see. The repeal of Miller-Tydings and McGuire leaves Section 1 of the Sherman Act in place as a delegation to the courts of the power to create rules forwarding consumer welfare. There is no reason for the Court to interpret the repeal as freezing in place forever the mistaken economics of Justice Hughes in the *Dr. Miles* case. As Chief Justice White said in *Standard Oil*, the Court should continue to reinterpret the Sherman Act under the rule of reason as its economic understanding evolves.

A restraint—whether on price, territory, or any other term—is vertical, according to the usage employed here, when a firm operating at one level of an industry places restraints upon rivalry at another level for its own benefit. (This definition excludes restraints, vertical in form only, that are actually imposed by horizontal cartels at any level of the industry, e.g., resale price maintenance that is compelled not by the manufacturer but by the pressure of organized retailers.)

Vertical restraint law has reached its present unhappy state because the Supreme Court is struggling with the logical results of an incorrect premise laid down sixty years ago by Justice Hughes in the *Dr. Miles* opinion. That premise, as we have seen, holds that there is no more reason to permit a manufacturer to eliminate rivalry among his retailers than there is to permit the retailers to eliminate rivalry by agreement among themselves. The premise is wrong. Retailers who agree to a horizontal restraint that the manufacturer does not desire are almost certainly attempting to restrict output for the sake of monopoly gains. If such a restraint would increase efficiency, the manufacturer would not only favor it but would impose it himself. When a manufacturer wishes to impose resale price maintenance or vertical division of reseller markets, or any other restraint upon the rivalry of resellers, his motive cannot be the restriction of output and, therefore, can only be the creation of distributive efficiency. That motive should be respected by the law.

Judge Taft saw this in *Addyston Pipe & Steel*[10] when he justified "a case in which a railroad company made a contract with a sleeping-car company by which the latter agreed to do the sleeping-car business of the railway company on a number of conditions, one of which was that no other company should be allowed to engage in the sleeping-car business on the same line." This is a vertical elimination of rivalry. Taft argued:

> The railroad company may discharge this duty [of furnishing sleeping-car facilities] itself to the public, and allow no one else to do it, or it may hire someone to do it, and, to secure the necessary investment of capital in the discharge of the duty, may secure to the sleeping-car company the same freedom from competition that it would have itself in discharging the duty.

Taft saw that since the railroad company could furnish the sleeping-car facilities itself without competition, nothing is lost if it grants to its hired sleeping-car company the same freedom from competition. In fact, something must be gained. The railroad company will choose between offering the services itself and getting some other firm to offer them on the basis of comparative cost. The decisions to bring in a sleeping-car company means a judgment that that is the less costly method. The vertical restraint results in no increase in output restriction but effects some decrease in costs, a net benefit to consumers. And this is true regardless of the market share of the railroad company.

Precisely the same analysis may be applied to all vertical restraints. The *Schwinn* case may be used for illustration. Schwinn's vertical price fixing (in states that permitted Fair Trade contracts) and vertical market division did not eliminate the rivalry of any other bicycle manufacturer with itself. These vertical restraints could not, therefore, create any additional power in Schwinn to restrict output. This would be true whether Schwinn had 1 or 100 percent of the bicycle market. If it had any power to restrict output, it would exercise that power directly and take the monopoly profits itself. There is no need for vertical restraints on retailers or wholesalers. The vertical restraints could not be anticompetitive for any effect they might have on the manufacturer's level of the industry.

But by maintaining its retailers' prices and dividing its wholesalers' markets, did Schwinn simply give retailers and wholesalers the power to restrict output? That is so unlikely as not to be worth consideration. No manufacturer or supplier will ever use either resale price maintenance or reseller market division for the purpose of giving the resellers a greater-than-competitive return. The extra return would be money out of his pocket for no good reason, and we may safely assume that manufacturers are not moved to engage in that peculiar form of philanthropy. The manufacturer shares with the consumer the desire to have distribution done at the lowest possible cost consistent with effectiveness. That is why courts need never weigh the opposing forces of lessened intrabrand and heightened interbrand competition. When the manufacturer chooses, he chooses on critieria that also control consumer welfare. No court is likely to make a more accurate assessment than does a businessman with both superior information and the depth of insight that only self-interest can supply.

Since vertical restraints are not means of creating restriction of output, we must assume that they are means of creating efficiencies, and it is perfectly clear that they are. The Court in *Schwinn* admitted as much. The most obvious efficiency is the purchase of increased sales and service efforts by the reseller. A retailer whose price is controlled will have to vie for business by sales and service effort. In the absence of resale price maintenance, the problem of the free ride may arise, just as it does in horizontal systems like that displayed in *Sealy*. Customers will be able to go to the retailer who offers a display of the full line, explanation of the product, and so forth, and then purchase from the retailer who offers none of these things but gives a lower price. The result will be a diminution in the amount of sales and service effort by all retailers. When this is to the manufacturer's disadvantage, he may wish to employ either resale price maintenance or vertical division of territories to get the performance he wants. This technique is preferable to direct payment for such effort. Direct payments may be accepted and competed away in lower prices, again destroying the incentive of other outlets to provide the desired efforts. The manufacturer would have to engage in extensive policing activities to catch such actions, and would have to argue the question of whether the efforts being made were the correct amount. A vertical restraint, however, will be policed for the manufacturer in large measure by other outlets, which will quickly feel and report any price cutting or crossing of territorial lines. When the restraints are complied with, arguments about the amount of effort being made are minimized, since each outlet has the same incentive as the manufacturer to provide such efforts at the proper level. (Other efficiencies attainable by vertical restraints are discussed in the Appendix to Chapters 13 and 14.)

OBJECTIONS TO VERTICAL RESTRAINT

The argument thus far has attempted to show that a manufacturer imposing a vertical restraint, such as resale price maintenance or closed dealer territories, will be attempting to create distributive efficiency and not to restrict output. To this thesis and to the policy conclusion that vertical restraints should always be lawful a variety of objections may be raised, and we shall attempt to deal briefly with them.

William Comanor has objected to my conclusion on the ground that the efficiencies cited are largely in sales and promotion and that these create product differentiation, which enhances market power.[11] He opts for a rule of per se illegality. This is a thoroughly inadequate argument, for it implies that all sales effort, including promotion and advertising, should be illegal per se—an impossible position. That being so, it seems curiously inconsistent to pick out for prohibition only that sales effort which is enhanced by vertical restrictions. In any case, we shall see in Chapter 16 that the objection is meaningless, since it says no more than that success in selling products makes a firm successful, and a successful firm may achieve market power. Comanor's objection reduces to an attack upon efficiency that leads to growth.

Here I shall deal with four objections, which may be characterized as (1) the dealer cartel objection, (2) the manufacturer cartel objection, (3) the price discrimination objection, (4) the restriction of output objection.

THE DEALER CARTEL OBJECTION

The dealer cartel objection arises from the observation that some seemingly vertical restraints may actually have been forced upon manufacturers by a reseller cartel. This constitutes a serious objection to the proposed legality of all vertical restraints only if (1) reseller coercion or inducement is more common than manufacturer origination of vertical restraints, *and* (2) there is little likelihood that the antitrust enforcement agencies can tell the two apart. It seems highly doubtful that the first condition obtains, and the second certainly would not.

Market division seemingly imposed by the manufacturer would be a poor instrument for reseller cartels, since it would not eliminate the rivalry of resellers of other manufacturers' products. Where the outlets are exclusive and the products somewhat different, resale price maintenance would be relatively ineffective as the instrument of a dealer cartel because of the difficulty of negotiating agreeable price differentials among all the retailers and manufacturers. The problem is complicated for all dealer cartels by the modern development of new high-volume, low-price methods of retailing, which create so much diversity among retailers that cartelization is more difficult than ever. It seems unlikely, therefore, that vertical restraints are usually disguised horizontal restraints imposed by a reseller conspiracies.

Moreover, the enforcement authorities should have no difficulty in detecting those restraints that are really horizontal. First, if manufacturer-imposed restraints were lawful, any disguised agreement could be presumed horizontal and unlawful. Second, attention could be directed to those industries in which almost all of the output was subject to seemingly vertical restraints. A manufacturer-imposed restraint would make economic sense even if no other manufacturer employed the same method, but a reseller cartel must control at least a large majority of industry sales in order to restrict output. This fact would considerably narrow the range of restraints the enforcement agencies must scrutinize. Third, coerced manufacturers will often complain to the enforcement agencies. Fourth, reseller cartels are very easy to detect because the large numbers and disparate interests involved make such cartels notoriously difficult to organize, administer, and police. Observation of some such cartels shows the necessity for open meetings, fight talks, advertisements and stories in trade papers, complaints by dissident resellers, and so forth. Reseller cartels tend to be so visible that they are hard for an enforcement agency to miss. The large numbers involved also mean that an investigation will usually turn up a paper record of the conspiracy and will always locate some persons willing to describe it. Conspiracies are very difficult to run and impossible to administer without leaving a trail. Once an investigation begins, fear of the law ensures cooperative witnesses.

The proposed legality of vertical restraints need not be questioned on the theory that it would enable successful and undetectable horizontal reseller cartels.

THE MANUFACTURER CARTEL OBJECTION

It has been suggested that manufacturers may agree to use resale price maintenance as a means of discovering defections from their own horizontal cartel.[12] Where the manufacturers' prices to their retailers are not visible, the theory runs, price cutting by a manufacturer may be hard for other cartel members to detect; but if the manufacturers agree to use resale price maintenance, any defection could be seen at the retail level. There would, moreover, be no incentive to cheat on the cartel price if a manufacturer's price cut could not be passed on to consumers. Of course, this theory does not apply to vertical market division, which would not provide any means of policing a manufacturer cartel.

But even the theory that a manufacturer cartel might use resale price maintenance to police compliance with the agreement does not seem a substantial one. Resale price maintenance is totally unnecessary to enforcement of a manufacturer's cartel where the manufacturers sell through common outlets, because the outlets themselves would instantly report any price cut by one to the others in an effort to get matching price reductions. Resellers continually play one supplier off against another in an attempt to get better terms. The device would be of limited utility even where outlets were specialized by brand, for price cheating on the agreement would show up in manufacturer rivalry for new or better outlets. Again the outlets would report to other manufacturers the bids made.

When outlets are specialized by brand, moreover, there exists a good deal of product differentiation. Two things are true of such cases. First, cartelization is more difficult because the products are not easily compared, resulting in difficulties in agreeing on price and other terms. Second, resale price maintenance would not completely eliminate the incentive for a manufacturer to offer a price cut as a means of cheating on the cartel. The price cut would be used by the outlets to offer consumers other terms, services, and sales and promotional effort. The diversion of competition to these forms may reduce the incentive for a manufacturer price cut, but a substantial incentive will still exist. Policing the agreement will actually be made more difficult, since the signs of cheating will not be lowered retail prices, which are easy to detect, but heightened retail sales effort, which is far more difficult to prove and trace to a lowered manufacturer's price.

These considerations suggest that it will be unusual for resale price maintenance to give the manufacturer cartel a means of internal policing it would not otherwise possess, and that the imposition of resale price maintenance will still leave intact a major portion of the incentive to cheat through price cuts to retailers.

But there is still another disadvantage to resale price maintenance as a tool of a manufacturer cartel—its cost. Since the outlets will have differing costs of operation, resale price maintenance will present serious inefficiencies. The agreement on resale prices will have to take account of the differing efficiencies of the various outlets, the differences in products, and constantly changing marketing conditions. The costs to the manufacturers will arise not only from the time and effort devoted to the constant operation of the machinery of this detecting device but also from the loss of reseller efficiency, since the outlets are, by hypothesis, subjected to artificial price constraints that the manufacturers would not individually have chosen as means to distributive efficiency.

Finally, if some cases of manufacturer agreement to use resale price maintenance as a policing device for a manufacturer cartel do arise, they should not be difficult for antitrust enforcement agencies to detect. In fact, the presence of an industry-wide pattern of resale price maintenance should, as in the case of the dealer cartel, attract government attention and make easier the discovery of the basic manufacturer cartel. The need to coordinate the various manufacturers' policies with respect to resale prices will produce additional evidence of cartelization. Another telltale sign would be any manufacturer's attempt to discourage competition on terms other than price, since the legitimate use of resale price maintenance is to obtain just such reseller efforts.

In sum, the manufacturer cartel objection to the legality of vertical restraints appears insubstantial. It applies only to resale price maintenance, would at best provide only a marginal advantage as a means of detecting defections, would encourage other forms of retail competition, would not remove most of the incentive to cheat on the agreement, would incur substantial costs, and would increase the likelihood of detection by the antitrust enforcement agencies. It is not certain that resale price maintenance is never actually used for the purpose of policing a manufacturer cartel, but it appears reasonably certain that such use will be so rare and the ease of detection so great that this objection should not stand in the way of the legality of truly vertical restraints.

THE PRICE DISCRIMINATION OBJECTION

Some vertical restraints can be used to separate markets in order to make price discrimination possible. Resale price maintenance cannot be used in this fashion, since reselling among customers would destroy the market separation. Vertical geographic market division will not be employed when the presence of rivals in one market but not another indicates different revenue-maximizing prices. The restriction on dealers is unnecessary if the markets are separated by transportation costs. If they are not, the restriction is pointless, since rival sellers in the lower-price market, not being bound by the restraint, can sell in the higher-price market. But vertical customer allocation might be used to separate purchasers with different elasticities of demand if rival sellers did not have a product appropriate to the low-elasticity, high-price market.

Such cases are probably not very common, but the conclusion that the law should not worry about them rests on three other grounds. First, the identification of discrimination, particularly in a litigation context, is probably impossible, so that a law against discrimination might easily compel more discrimination than it stopped. Second, any attempt to enforce a law against discrimination imposes costs which, if fully measurable, might be considered prohibitive. Third, even if price discrimination could be readily identified and costlessly prohibited, it is unclear whether, on balance, discrimination benefits or injures consumers, and there is some indication that its net effect is beneficial. These considerations, which are taken up at greater length in Chapter 20, seem overwhelmingly to support the conclusion that the law simply should not concern itself with price discrimination in any context.

THE RESTRICTION OF OUTPUT OBJECTION

This chapter has argued that a manufacturer will never institute resale price maintenance or closed dealer territories for the purpose of restricting output: the practice does not eliminate any rivalry he faces, and he has no reason to restrict the output of his resellers—quite the contrary. A more sophisticated version of the restriction of output objection has been advanced by J. R. Gould and B. S. Yamey.[13] They have suggested that resale price maintenance, by obtaining successful promotional efforts from dealers, would shift the final demand curve and the marginal revenue curve upward and to the right while adding to dealer costs, thus shifting the marginal cost curve upward and to the left. This raises the possibility that the new intersection of the marginal revenue and marginal cost curves will be to the left of the old, signifying a higher price and a reduced output.

I think this suggestion incorrect for two reasons. First, and perhaps less fundamental, the general effect of promotional activity, as of advertising, is to increase the sales of the product promoted. This is a widely known result of advertising and promotion. The mere possibility of drawing curves that give a different result should not overcome the almost universal testimony of business experience. The new intersection of the cost and revenue curves will almost surely lie to the right of the old.

The second and more basic objection to the observation advanced by Gould and Yamey takes account of even the theoretical possibility that the new intersection lies to the left of the old. Their argument leaves out of account a fundamental change that resale price maintenance has introduced into the situation: a change in the composition of the product offered. Thus, even though it is theoretically conceivable that, in some rare case, resale price maintenance, like advertising, would lead to fewer sales of the physical product and to increased expenditures by consumers, it does *not* follow that output is lower or price higher. The error consists in failing to count the efforts of the reseller, purchased through resale price maintenance, as an economic output. The consumer is no longer offered merely a physical product but a composite product, part of which is the same physical product and part of which consists of the information, display, services, conveniences, etc., that the reseller now provides. These things must be counted as part of the product, as economic outputs, for we know that consumers willingly pay for them even when they are offered the alternative of the physical product without them. Stores charge for décor in the price of the clothing, restaurants charge for atmosphere and service in the price of the food, gasoline stations charge for rest rooms, window washing, and air pumps in the price of the gasoline. It would be completely wrong to say that these additions are not part of the product, or that consumers are paying more for less when they patronize such establishments instead of those that offer merely the physical product.

Such changes in product composition are a general means of economic progress. When a truck manufacturer, such as White Motor, switches from selling trucks to selling trucks plus reseller-provided information and service, it is changing product composition just as certainly as if it had switched from offering a stripped-down model to a model with a variety of extra features. This, in turn, is no different from the changeover in the razor blade industry from carbon steel to stainless steel blades. Perhaps these changes might conceivably have led to the sale of fewer trucks and fewer razor blades, but it would be fallacious to contend that output had been restricted. The measure of output is really the utility offered, and the mere number of physical items sold, considered by itself, tells one nothing about that. The only safe guide is whether consumers respond to the change in product composition, and we measure that by whether the manufacturer finds it profitable to continue offering the new product. That analysis holds true for the addition of dealer services through resale price maintenance just as for the change in truck models or razor blade types. And it is as improper for the law to forbid the addition of those services and efforts by banning vertical price fixing and market division as it would be for the law to require the truck manufacturer to switch back to the stripped-down model or the razor blade maker to return to carbon steel.

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We have seen that vertical price fixing (resale price maintenance), vertical market division (closed dealer territories), and, indeed, all vertical restraints are beneficial to consumers and should for that reason be completely lawful. Basic economic theory tells us that the manufacturer who imposes such restraints cannot intend to restrict output and must (except in the rare case of price discimination, which the law should regard as neutral) intend to create efficiency. The most common efficiency is the inducement or purchase by the manufacturer of extra reseller sales, service, or promotional effort.

The proposal to legalize all truly vertical restraints is so much at variance with conventional thought on the topic that it will doubtless strike many readers as troublesome, if not bizarre. But I have never seen any economic analysis that shows how manufacturer-imposed resale price maintenance, closed dealer territories, customer allocation clauses, or the like can have the net effect of restricting output. We have too quickly assumed something that appears untrue.

Perhaps the ambiguity of the word "restraint" accounts for some of our confusion on this topic. When the Supreme Court speaks of a restraint it often, or even usually, refers merely to the manufacturer's control of certain activities of his resellers or to the elimination by the manufacturer of some forms of rivalry among his resellers. There is, of course, nothing sinister or unusual about "restraint" in that sense. It is merely a form of vertical integration by contract, a less complete integration than that which would obtain if the manufacturer owned his outlets and directed their activities. It is merely one instance of the coordination of economic activities which is ubiquitous in the economic world and upon which our wealth depends. The important point is that such vertical control never creates "restraint" in that other common meaning, restriction of output. Perhaps, if we are more careful about the ambiguity of the word and make clear in which sense we use it, our reasoning about antitrust problems, including the problem of vertical restraints, will improve.

The perception that the vertical elimination of rivalry does not always injure competition has long troubled the courts, producing the tortured reasoning of cases like *Schwinn*. Even that is infinitely preferable to the dogmatic error of cases like *Kiefer-Stewart*. *Sylvania* represents at last a long stride in the right direction. This field of law can be made clear, internally consistent, and congruent with reality only when we face the fact that the premise laid down in *Dr. Miles*—that the vertical elimination of dealer rivalry has the same effect as a horizontal cartel—is incorrect and must be rejected. That premise was adopted by the Supreme Court, and it may properly be abandoned by the Court.