Cornell University Law School
Scholarship@Cornell Law: A Digital Repository

Cornell Law Faculty Publications | Faculty Scholarship

1992

Observations: Sylvania in Retrospect

George A. Hay
Cornell Law School, george.hay@cornell.edu

Follow this and additional works at: http://scholarship.law.cornell.edu/facpub

Part of the Antitrust and Trade Regulation Commons

Recommended Citation

Hay, George A., "Observations: Sylvania in Retrospect" (1992). *Cornell Law Faculty Publications.* Paper 1128.
http://scholarship.law.cornell.edu/facpub/1128

This Article is brought to you for free and open access by the Faculty Scholarship at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Faculty Publications by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

OBSERVATIONS: *SYLVANIA* IN RETROSPECT

GEORGE A. HAY*

My remarks consist of a series of observations, followed by several semi-rhetorical questions. These observations and questions are designed to focus attention on what I regard as the key elements in the ongoing debate about vertical restraints.

(1) A manufacturer facing interbrand competition is motivated to take steps to make its product more attractive in the eyes of consumers than other products against which its product competes. These can be referred to generally as "demand-generating activities."

(2) Some demand-generating activities can be adequately handled at the manufacturing level; e.g., altering the manufacturing process to achieve higher quality or engaging in a national advertising campaign. It should be recognized that some of these steps, e.g., increased advertising, will actually raise the dollar price to consumers. It is the manufacturer's hope (and expectation) that the higher quality or increased recognition will, on balance, increase the product's attractiveness to the consumer relative to competing products.

(3) Some demand-generating activities are most efficiently handled at the distribution level (wholesale or retail); e.g., local advertising, maintaining a quality image for the retail outlet, utilizing more or better located shelf space, maintaining adequate stocks, employing well-trained sales personnel, etc. These activities may result in increased distribution costs and higher retail prices. They may nevertheless make the product, on balance, more attractive to consumers. (Put differently, if the manufacturer had to compensate for the lack of demand-generating activity at the dealer level by such steps as increased national advertising, the final retail price would be higher.) The manufacturer has an interest in seeing that its distributors and dealers engage in precisely those activities which, on balance, make the product more attractive in the eyes of the consumer. The manufacturer has no interest in having its distributors and dealers do things that make the product less attractive to consumers.

* Professor of Law and Economics, Cornell Law School.

HeinOnline -- 60 Antitrust L.J. 61 1991-1992

(4) In some cases, the manufacturer can effectively influence its dealers' demand-generating activities by specific contractual provisions in the dealership agreement requiring them to engage in those activities; e.g., "you must maintain adequate inventories"; "you must spend *x* percent of revenues on local advertising"; etc. In other cases, the manufacturer will find it most effective to encourage dealers indirectly, by allowing them to reap the full benefits of whatever demand-generating activities they engage in (sometimes referred to as circumventing the "free rider problem"). Location clauses and exclusive territories are examples of these indirect ways of encouraging dealers to engage in demand-generating activities.

(5) The Supreme Court in *Sylvania*[1] recognized that these indirect measures can, on balance, improve the competitive process and make consumers better off.

(6) In two other respects, however, the Court's analysis left something to be desired. First, the Court seemed to suggest that, in assessing nonprice vertical restraints (under the rule of reason), lower courts should balance the reduction in intrabrand competition against the possible improvement in interbrand competition. At best, this represented semantic confusion. At worst, it was simply wrong. Intrabrand competition is not an independent goal; it is merely a means to be employed under appropriate circumstances. The only thing that is relevant is whether the result of the restraint is likely to make the product more attractive to consumers; i.e., improve interbrand competition. If the restraints accomplish this goal, there is no trade-off to be considered. In other words, consumers are better off if interbrand competition is improved, worse off if it is not. The reduction in intrabrand competition is simply a means to an end and has no independent consequences for the welfare of consumers.

(7) In implementing the Court's instructions to evaluate nonprice restraints under the rule of reason, lower courts have generally tended to avoid the possible confusion about the trade-off between intrabrand and interbrand competition by fashioning a presumption that nonprice restraints are procompetitive where the manufacturer does not have market power.[2] With one or two exceptions,[3] the courts have not indicated whether market power is different from monopoly power. Market share has generally been used as a proxy for market power, although

[1] Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977).

[2] *See, e.g.*, Assam Drug Co. v. Miller Brewing Co., 624 F. Supp. 411 (D.S.D. 1985), *aff'd*, 798 F.2d 311 (8th Cir. 1986).

[3] *See, e.g.*, Shoppin' Bag of Pueblo, Inc. v. Dillon Cos., 783 F.2d 159 (10th Cir. 1896).

HeinOnline -- 60 Antitrust L.J. 62 1991-1992

with no precise cutoff point, i.e., no specific percentage below which the absence of market power can safely be presumed.

(8) The second problem with the Court's analysis in *Sylvania* was the sharp distinction drawn between price and nonprice restraints, the former remaining illegal per se. The Court provided no analytical basis for such sharp line-drawing, and it is at least questionable whether there is such a basis. Vertical price restraints are like location clauses and exclusive territories in that they are indirect ways of encouraging the dealer to engage in certain demand-generating activities. (Vertical price restraints may be less effective than exclusive territories in addressing the free rider problem, but granting an exclusive territory is probably not a viable option for many kinds of products.) The Court apparently felt, as certain commentators have suggested, that price restraints are more likely to facilitate horizontal collusion among manufacturers than nonprice restraints, and hence, on balance, were too dangerous to be tolerated.[4]

(9) *Monsanto*,[5] in a remarkably forthright way, acknowledged that price and nonprice restraints can each be methods of promoting interbrand competition, that they can have similar, even identical, economic effects, and that, as an evidentiary matter, they can be very difficult to tell apart. However, in a bizarre exaltation of form over substance, the Court told lower courts they would have to do their best to distinguish price and nonprice restraints, since the former continue to be unlawful per se.

(10) To compound the evidentiary problems facing the lower courts, the Court in *Monsanto* resuscitated the *Colgate*[6] doctrine in suggesting that it was all right for manufacturers to induce dealers not to be price cutters by threatening to terminate price cutters so long as dealers did not actually "agree" to comply. And in distinguishing between these two concepts, evidence of complaints from dealers about other dealers' price cutting, and evidence that the manufacturer terminated a noncompliant dealer in response to such complaints could not serve as the basis of an inference that there was an agreement between the manufacturer and the complaining (or complying) dealers.

(11) Finally, in *Sharp*, the Court again acknowledged the similar economic consequences of price and nonprice restraints in terms of their serving to induce dealers to undertake demand-generating activities. Moreover, while an agreement between a manufacturer and a dealer to

---

[4] This is also the thrust of Justice Scalia's argument in Business Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717 (1988).

[5] Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752 (1984).

[6] United States v. Colgate & Co., 250 U.S. 300 (1919).

terminate a price cutter could possibly be labeled a price restraint, such an agreement would not deserve to be labeled unlawful per se, since it might be an integral aspect of inducing those dealers to undertake costly, but valuable, nonprice restraints. Only an agreement by dealers to set prices at some level (even if the precise level is not specified) deserves unequivocal condemnation. By this further narrowing of the scope of the per se rule, the Court was trying to isolate only those forms of price-related vertical restraints that would likely facilitate horizontal collusion and leave all others to be treated under the rule of reason on the same footing as nonprice restraints.

(12) Congress has reacted by attempting to craft legislation that would overturn portions of both *Monsanto* and *Sharp* so that termination of price cutters in response to complaints from other dealers could be the basis for an inference of a per se illegal price restraint.

(13) Meanwhile, some economists have argued that the de facto presumption in favor of nonprice restraints that has emerged as the legacy of *Sylvania* is misguided, since such restraints could increase sales of the manufacturer's product while simultaneously reducing overall consumer welfare.[7] This apparent paradox is explained by focusing on the "inframarginal" consumer who does not need any additional demand-generating activities to induce him or her to purchase the product, and who would prefer not to pay the higher prices that result from such activities. The policy implications of such a finding, I presume, is that increased output should not be a presumptive test for whether a restraint is lawful under the rule of reason. However, as I have indicated, courts have rarely attempted to assess the impact of a restraint on output directly, but have presumed the absence of a negative effect from the market share of the manufacturer (or other evidence indicating the lack of market power).

In light of all of the above, I suggest that the following questions are worth thinking about:

(1) Putting aside for the moment the possibility that vertical restraints may facilitate horizontal collusion among manufacturers (or may be the result of horizontal collusion from retailers imposing their collective will on manufacturers), why should the antitrust laws be concerned with how an individual manufacturer chooses to arrange for the distribution of its product? We do not have laws prohibiting "excess" advertising (so long as it is truthful), even though it is clear that advertising often raises the

[7] *See, e.g.*, Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983 (1985); Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983).

HeinOnline -- 60 Antitrust L.J. 64 1991-1992

retail price and reduces the welfare of individuals who do not need the advertising to inform them or persuade them about the merits of the product. Similarly we do not have laws prohibiting "excess" quality (with its attendant higher retail prices) or requiring manufacturers to offer a "stripped down" model of its product for those consumers who do not really desire the high quality version. Why then should we intervene when the manufacturer, perhaps in lieu of a national ad campaign, seeks to have its product carried only by certain kinds of dealers as a way of competing against the products of other manufacturers. The manufacturer may have been mistaken in its optimism about the wisdom of such a marketing strategy, but can't the market be left to regulate such mistakes just as it regulates mistakes by manufacturers who invest in "too much" advertising or "too much" quality?

(2) If the only real concern is that vertical restraints will facilitate horizontal agreements, can't these be dealt with when they occur under Section 1 of the Sherman Act (or Section 5 of the FTC Act) rather than attempting to treat Section 1 as an incipiency statute? Under this approach, vertical restraints would be handled like the old basing-point pricing cases.[8] Alternatively, shouldn't a necessary condition for vertical restraints to be unlawful be that most manufacturers are employing them (as suggested by the notorious DOJ Vertical Restraint Guidelines)?

(3) If courts insist on examining (at least some) vertical restraints under the rule of reason, how precisely should courts determine whether they ought to be permitted in a particular case? If the test is to be whether the manufacturer has market power, what is the operative test for market power and how does market power differ from monopoly power? Is there any significance to the fact that in *Jefferson Parish*,[9] a tying case, the Court found a firm with 30 percent of the market not to have market power? Does this suggest a fairly large "safe harbor" for firms that wish to implement nonprice vertical restraints?

(4) As for price restraints, does it really make sense to continue to maintain that nonprice restraints can be, and, in the absence of market power are, procompetitive, while at the same time to seek to condemn price restraints regardless of whether the manufacturer has market power, even though the Court has acknowledged on at least two occasions that the two are often indistinguishable in purpose and effect? At least prior to *Sharp*, this radically different treatment created an incentive for the plaintiff to label any vertical restraint as a price restraint to take advantage of the per se rule. *Sharp* has served to make this much more

---

[8] *See, e.g.*, FTC v. Cement Institute, 333 U.S. 683 (1948).

[9] Jefferson Parish Hospital Dist. No. 2 v. Hyde, 466 U.S. 2 (1984).

difficult, since apparently only a fairly specific price-related agreement will be eligible for per se treatment.

(5) Assuming the outright prohibition of clear-cut vertical price agreements is to be maintained, is there a meaningful distinction between an agreement between the manufacturer and its dealers for the manufacturer to terminate price cutters and an agreement by dealers "to set prices at some level, though not a specific one" as *Sharp* seemed to indicate? What does it mean to be a price cutter except to fail to adhere to some level of retail price?

(6) Is it rational for Congress to deplore vertical price-fixing yet still honor the *Colgate* doctrine? Put differently, if Congress really wants manufacturers not to be able to terminate a firm for being a discounter, why fuss around with the inferences to be drawn from dealer complaints about other dealers' price cutting? Wouldn't it be a lot easier simply to decree that an agreement can be inferred from the fact that a manufacturer expresses a policy of not dealing with discounters or otherwise threatens price cutters with termination and some dealers comply with the manufacturer's policy to avoid being terminated (in effect overturning *Colgate*)?

HeinOnline -- 60 Antitrust L.J. 66 1991-1992