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THE FREE RIDER RATIONALE AND VERTICAL RESTRAINTS ANALYSIS RECONSIDERED

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My assignment is to discuss some of the recent economic research on vertical restraints and, in particular, to examine what economists have been saying about the free rider rationale for vertical restraints. I will focus my remarks on those vertical restraints that are generally referred to as intrabrand restraints, where the immediate purpose and effect of the restraint is to insulate the dealer or distributor of a particular brand from intrabrand competitition, at least to some degree. Prominent examples include exclusive territories, location and customer clauses, and resale price maintenance.[1]

The degree to which vertical restraints reduce intrabrand competition will vary with the type of restraint and the surrounding conditions. With airtight exclusive territories, for example, intrabrand competition is completely eliminated within any given territory. The effect of location clauses, another kind of nonprice restraint, will differ depending on the nature of the product and the number of dealers that serve the same territory.[2]

Finally, resale price maintenance (RPM), while effectively eliminating price competition, offers no insulation from other, nonprice forms of competition if there are several dealers serving the same territory.

Putting aside these differences in degree, it is still true that the purpose and the effect of the restraints is to reduce intrabrand competition and raise dealers' margins. Hence, one might "naively" conclude that such restraints will necessarily raise retail price and must therefore be anti-

[1] The other category of vertical restraints is labeled interbrand restraints since the effect may be to foreclose manufacturers of other brands from effective access to the market. There can be free rider explanations for interbrand restraints as well. *See* Marvel, *Exclusive Dealing*, 25 J.L. & Econ. 1 (1982).

[2] If, for example, there is no special limit on the number of dealers within a territory, there should be no perceptible diminution of intrabrand competition. Similarly, for items which are expensive enough that a potential customer will drive a few miles to pursue a lower price, the authorized dealers might have to be dispersed widely for any significant degree of insulation to occur.

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competitive in the economic sense, i.e., consumers of the product in question are made worse off.[3] Indeed, this naive economic thinking, together with a long-standing hostility to restraints on alienation, was the basis for the Supreme Court's early condemnation of vertical restraints.[4]

The problem with this "naive" approach is that it fails to provide a plausible motive for the manufacturer to institute the restraints. *Ceteris paribus*, the manufacturer would prefer to minimize the dealers' markup over the wholesale price, since this will result in a lower retail price, greater sales, and consequently higher profits. If the only effect of the vertical restraints is to raise the dealers' margins, less of the manufacturer's product will be sold and the manufacturer's profit will be reduced. Under such circumstances it is hard to see why the manufacturer would wish to "impose" restraints on its dealers.

It follows that, where the manufacturer desires to eliminate intrabrand competition, there must be some special factor operating which provides benefits to the manufacturer that more than offset the usual adverse consequences from higher dealer margins.[5] In attempting to sort out the overall impact of vertical restraints on the consumer, therefore, it is important to try to understand the manufacturer's motive and to account for any additional impact of the restriction on intrabrand competition. Thus reformulated, the question becomes: Are there circumstances in which a vertical restraint that makes the manufacturer better off can cause the consumer to be worse off?[6]

In seeking a motivation for vertical restraints, economists theorized that insulating dealers from intrabrand competition might induce dealers to make greater efforts to promote the manufacturer's product, thereby

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[3] There is a sense in which the meaning of "anticompetitive" can be made coterminous with that of "restraint," and hence no further analysis is needed. A condemnation of restraints on alienation is presumably based on a notion that such a restraint is inherently anticompetitive because it restricts dealers' freedom. In using a definition of "anticompetitive" that focuses on whether consumers are better off, we are not attempting to resolve the issue of whether the antitrust laws are aimed only at consumer welfare.

[4] *See, e.g.*, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

[5] This is not to say that the dealers as a group will be unhappy with the manufacturer-imposed restraints. To the contrary, they may be delighted that the manufacturer has accomplished what they could not achieve on their own because of the almost certain adverse legal consequences. But the fact that the dealers are generally happy with the manufacturer-imposed restraint does not mean that consumers are necessarily disadvantaged.

[6] The article which served to refocus the inquiry in this way is Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. L. & ECON. 86 (1960).

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increasing overall demand for the product.[7] Insulating dealers from intrabrand competition is necessary, according to the theory, because dealers' efforts are subject to "free riding" by other dealers. That is, one dealer might spend time and money to promote the product only to lose sales to a second dealer who can offer the same product at a lower price by virtue of not having incurred any promotional expenses.[8] With these incentives, no dealer has an incentive to incur the promotional expenses and the manufacturer must turn to other, presumably less efficient, means of product promotion.[9]

Now, the general logic of this analysis is well known and need not be elaborated further. It is important to emphasize, however, that this represents not merely a footnote or a qualification to the early judicial theories about vertical restraints. If the free rider problem is the explanation for the existence of manufacturer-imposed vertical restraints, the basic economic intuition about vertical restraints appears to lead to policy conclusions which are the reverse of the "naive" view. The manufacturer benefits from vertical restraints only to the extent that the demand-generating consequences of the dealers' promotion activities outweigh the demand-reducing consequences of higher dealer margins. Put simply, the net effect of the vertical restraints must be that consumers regard the product as a "better deal" and there is no economic basis for seeking to discourage the manufacturer from imposing them.[10]

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[7] In the jargon of economists, the dealers' efforts would "shift out the demand curve" for the product, increasing the quantity that consumers would be willing to buy at any given retail price.

[8] A typical example involves a dealer in high quality stereo equipment who generates demand by maintaining an expensive "listening room" and employing highly trained sales personnel to answer questions. The consumer could take advantage of these services to determine whether to purchase the particular brand of equipment, but could make the actual purchase at a retail outlet that provided no services and lower prices. But for the promotional efforts of the first dealer, according to the theory, there would be fewer total sales of that particular brand.

Not all promotional expenses are subject to free riding. When a dealer establishes a reputation for fair dealing and good service, this will likely increase the demand for the particular brand that dealer carries, but most of the increased demand will be aimed at the dealer in question. In such cases, the dealer does not need to be insulated from intrabrand competition to provide the appropriate incentives. Proponents of the "free rider" rationale do not dispute that some promotional activity will occur in the absence of vertical restraints. But they would argue that, in those cases where the manufacturer opts for vertical restraints, it is precisely because the kinds of promotional activities the manufacturer deems most effective are subject to free riding.

[9] The alternative means are less efficient because, if they were not, the manufacturer would have chosen them in the first place.

[10] This point is pressed in two papers by former Professor (now Judge) Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J. 135 (1984), and *The Limits of Antitrust*, 63 TEXAS L. REV. 1 (1984).

Moreover, this basic intuition about the consequences of vertical restraints does not depend on any assumptions about the intensity of *interbrand* competition; it applies to a manufacturing monopolist as well as a firm facing intense interbrand competition.[11] Nor does the intuition depend on the nature of the restraint, i.e., whether it is a price restraint or a nonprice restraint. In each case, the object of the manufacturer is to insulate the dealer from intrabrand competition at least to some degree, in order to protect dealer margins from the efforts of free riders.

While the basic economic intuition about vertical restraints is appealing, few economists have accepted it completely. Indeed, much of the modern economic literature about vertical restraints involves efforts to find conditions under which the imposition of vertical restraints can hurt consumers. Some of the literature rejects the traditional free rider explanation; other contributions accept the basic logic of the free rider explanation, but question the conclusion that what benefits the manufacturer necessarily makes consumers better off.

One circumstance in which vertical restraints can hurt consumers (which has been recognized from the beginning) is where the restraint is not in fact desired by the manufacturer, but is imposed upon the manufacturer by the combined monopsony power of the dealers acting as a group, and the presumption that the restraint serves on balance to expand output is rejected. This is not really in conflict with the basic economic intuition since, by assumption, the manufacturer does not benefit from the implementation of vertical restraints. Moreover, it is not clear that any new legal issues are raised, since the vertical restraints presumably could be attacked as resulting from a horizontal agreement among dealers.[12]

[11] Recent policy proposals do attempt to distinguish among vertical restraints based on the degree of interbrand competition. Easterbrook argues that market power should be used as a filter in examining vertical restraint claims. If the firm has no market power, Easterbrook argues that interbrand competition protects consumers from any potential anticompetitive effects. Hence vertical restraints employed by firms without market power should be presumed lawful. The Department of Justice Vertical Restraints Guidelines would presume restraints lawful unless a market is highly concentrated and the restraint is employed by most firms in the market.

[12] The fact that dealers benefit from the vertical restraints is insufficient basis to infer that the restraints have been imposed on the manufacturer by the dealers. The basic economic analysis of vertical restraints suggests that it may be in the interests of both the manufacturer and the dealers collectively to solve the free rider problem. Thus the fact that dealers initiated the discussions, urged the adoption of the restraints, or pressed for enforcement of the restraints against non-complying dealers does not establish that the restraints are not in the best interests of the manufacturer and, according to the theory, the consumer. It is only when the manufacturer genuinely prefers not to have the restraints that the presumption they are procompetitive is rejected. One would expect such cases to occur infrequently.

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A somewhat different circumstance is where all or most manufacturers impose similar restrictions on their dealers. In such cases, the effect (and indeed the purpose) may be to eliminate or reduce competition at the manufacturing level. The classic example given involves RPM. If manufacturers have agreed among themselves not to engage in price competition, RPM arguably reduces the incentive of an individual manufacturer to give secret discounts to dealers since, if the dealer cannot pass on the discount in the form of lower retail prices, there will not be any significant increase in the sales of the discounting manufacturer's product.[13] The vertical agreement, therefore, serves to facilitate the horizontal agreement among the manufacturers and is anticompetitive precisely because the horizontal agreement is anticompetitive.

Once again it could be maintained that no new legal issue is raised by this analysis since the horizontal agreement could be attacked directly under the Sherman Act. But if the horizontal agreement is tacit rather than explicit, or if there are problems in establishing the existence of a horizontal agreement, arguably it could be more efficient to attack the facilitating practice.[14]

Other questions about the impact of vertical restraints do not rely on the existence of a horizontal agreement. Several economists have argued that vertical restraints may not impact individual consumers in the same way.[15] For example, some particularly knowledgeable shoppers for stereo equipment may get no benefit from the extra services provided by the dealer and would buy the product without them. They are clearly harmed by having to pay the higher prices that result from the reduction in intrabrand competition and the consequent higher retail prices. While a sufficiently large number of consumers may be attracted to the product because of the additional services to make the manufacturer better off for having implemented the vertical restraints, the extra costs imposed on those who were prepared to buy the product anyway (the so-called

[13] For qualifications to this scenario, *see* T. Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence*, Bureau of Economics Report to the FTC, 19–23 (Nov. 1983).

[14] A necessary condition for the vertical restraints to be anticompetitive according to this theory is that they be adopted by most of the competitors at the manufacturing level. This is hardly a sufficient condition, however, and in those circumstances where the vertical restraints are truly essential to generating demand, one would expect their widespread adoption. Hence, a presumption of anticompetitive effect based on widespread use is unwarranted.

[15] Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARVARD L. REV. 983 (1985); Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L. J. 687 (1983). *See also* Comanor & Kirkwood, *Resale Price Maintenance and Antitrust Policy*, 3 CONTEMP. POL'Y ISSUES 9 (Spring 1985); White, *Resale Price Maintenance and the Problem of Marginal and Inframarginal Customers*, 3 CONTEMP. POL'Y ISSUES 17 (Spring 1985).

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inframarginal consumers) may be high enough that overall consumer welfare is reduced. No one argues that this result will necessarily occur, but the example is used to disprove the proposition that a unilaterally imposed vertical restraint that benefits the manufacturer must necessarily benefit consumers.

Other questions about the impact of vertical restraints arise out of empirical efforts to document the dealer services/free rider rationale.[16] In a number of instances where manufacturers have desired to use vertical restraints, the product is not something like high quality stereo equipment or personal computers requiring extensive presale demonstration and explanation but products as simple and basic as denim blue jeans.[17] Recent research helps to shed some light on this apparent puzzle.[18] The proposed explanation is that, when a dealer with a reputation for carrying quality or fashionable merchandise agrees to carry the product of a particular manufacturer, the demand for that manufacturer's product is increased by virtue of its association with the dealer. However, the demand generating activities of the dealer are subject to free riding by other dealers who can offer the same merchandise at a lower price beacuse the dealer with the reputation for carrying quality merchandise will have incurred costs to establish and maintain that reputation.[19] Hence a manufacturer may wish to insulate such a dealer from intrabrand competition by instituting some kind of vertical restraint.[20]

Such results need not pose any challenge to the permissive policy stance suggested by the basic economic intuition about vertical restraints if quality certification which raises demand for the product is regarded as a genuine consumer benefit. Some certification activities can undoubtedly be viewed as providing valuable information to consumers about the

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[16] For a thorough survey of the empirical literature on RPM, *see* Overstreet, *supra* note 13. *See also* Lafferty, Lande & Kirkwood, *Impact Evaluations of Federal Trade Commission Vertical Restraints Cases*, Bureau of Competition and Bureau of Economics Report to the FTC (Aug. 1984).

[17] *See* Oster, *The FTC v. Levi Strauss: An Analysis of the Economic Issues*, in Lafferty, Lande & Kirkwood, *supra* note 16.

[18] Marvel and McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346 (1984).

[19] Clearly, a high quality dealer does benefit from its superior reputation to a very great extent. Despite higher prices, people will patronize a store with a pleasant ambience, a friendly and helpful sales staff, and a reputation for dealing fairly with problems that may arise subsequent to purchases. The new research does not dispute that such benefits are internalized but argues that vertical restraints are employed precisely where some important benefits are appropriated by free riders.

[20] This point has been expanded on by Victor Goldberg, who provides a variety of explanations for why a manufacturer may wish to insulate dealers from intrabrand competition. Goldberg, *The Free Rider Problem, Imperfect Pricing, and the Economics of Retailing Services,* 79 NW. U.L. REV. 736 (1984).

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underlying quality of a product. In other cases, however, it is argued that what is occurring is an effort to create in the minds of consumers "artificial" distinctions among otherwise identical products. Moreover, efforts along such lines by competing manufacturers are mutually canceling and collectively wasteful.[21] When this issue has arisen in other contexts (for example, in discussing the economic impact of advertising) economists have sometimes been wary of attempting to evaluate activities which in essence act to change consumers' tastes. If this wariness is carried over to the evaluation of vertical restraints, it does not establish a presumption that such restraints are anticompetitive, but may be viewed by some as undercutting the claim that they are necessarily procompetitive.

The precise merits of these or any other specific criticisms of the basic economic intuition favoring vertical restraints are open to further analysis and debate. Nevertheless, it is unrealistic to believe that a consensus will soon emerge among economists to the effect that there are no circumstances in which individually imposed vertical restraints can be anticompetitive. Indeed, the nature of research patterns in economics is that as a consensus begins to emerge on any issue the next wave of research will be designed to demonstrate exceptions. At present, technically skilled economists are at work creating models containing ever more complex assumptions to be solved with ever more complex techniques. At least some of those will generate scenarios under which vertical restraints can diminish consumer welfare (or some other measure of goodness).[22]

This suggests that antitrust policy towards vertical restraints will have to be formulated in the absence of any consensus to the effect that vertical restraints are always procompetitive. This lack of consensus remains even if we put to one side the set of cases where the vertical restraints are imposed on the unwilling manufacturer by the monopsony power of dealers or where the restraints are used to facilitate a horizontal cartel among manufacturers.[23]

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[21] *See, e.g.*, Scherer, *supra* note 15, at 696.

[22] By way of example, *see* Rey & Tirole, *The Logic of Vertical Restraints*, 76 AM. ECON. REV. 921 (1986). The abstract of the paper reads as follows:

> This paper shows that direct (product) competition acts as a tournament between retailers when informational problems (or transactions costs) prevent the manufacturer from using contracts based on their relative performance. Anticompetitive restraints such as exclusive territories and resale price maintenance (which, we show, are not necessarily good substitutes) may or may not be privately desirable. It also shows that privately desirable anticompetitive restraints may not be socially desirable.

[23] There is considerable dispute about the extent to which vertical restraints fall into these categories. *Compare* Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing*, 71 GEO. L.J. 1487 (1983) and Carstensen & Dahlson, *Vertical Restraints in Beer Distribution: A Study of the Business Justifications for and Legal Analysis*

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Nevertheless, several themes do emerge from the literature that are worth taking into account in the formation of antitrust policy toward vertical restraints. First, while the literature indicates that RPM and non-price restraints do not always operate in precisely the same way, there is no general support for the proposition that RPM is systematically more suspect than nonprice restraints. Indeed, one of those economists who has most vigorously opposed the current permissive policy toward non-price restraints has recently argued that "non-price restraints are more likely to impose greater costs on consumers than price restraints, and therefore antitrust prohibitions are more warranted."[24] Moreover, as I have argued elsewhere,[25] there are severe evidentiary burdens imposed on a court attempting to categorize a particular restraint as a price or a nonprice restraint, since the purpose and effect of each is to insulate the dealer from intrabrand price competition and to raise the dealer's gross margin.

Second, there is some ground for agreement on the proposition that unilaterally imposed vertical restraints are unlikely to have any significant anticompetitive impact unless the manufacturer imposing the restraint enjoys some degree of insulation from interbrand competition. In effect, the opportunity to buy a different brand is a satisfactory alternative to the foreclosed option of benefiting from competition among several dealers of the same brand. This suggests that using market power as a filter, as Frank Easterbrook has suggested,[26] would be consistent with the views of most economists about the likelihood of an anticompetitive impact from vertical restraints. This would leave open the question of how to handle cases where some market power exists,[27] but might simplify

of Restricting Competition, 1986 WIS. L. REV. 1 (1986) *with* Easterbrook, *Vertical Arrangements and the Rule of Reason*, *supra* note 10, at 161, and Overstreet, *supra* note 13, at 13–24. Beliefs about the frequency of the cartel hypotheses are important given that the existence of a horizontal agreement may be hard to establish. Those who believe that the bulk of vertical restraints have horizontal causes or effects may wish to bias the judicial treatment of vertical restraints toward their being regarded as unlawful. Those who think that the cartel explanation is only rarely applicable may wish to bias the outcome in the opposite direction.

[24] Comanor, *Vertical Arrangments and Antitrust Analysis* 18, Conference on the Antitrust Alternative, Airlie House, Virginia (March 1987). Comanor's argument is that when manufacturers impose explicit price restraints on their distributors through RPM, nonprice competition among distributors continues so that the higher revenues that result from the restraints go to support greater distribution services or other distributor activities that are designed to capture a greater share of the overall demand for the specific product. Exclusive territories, on the other hand, obviate the need for dealers to compete against one another through nonprice means.

[25] Hay, *Vertical Restraints after* Monsanto, 70 CORNELL L. REV. 418 (1985).

[26] Easterbrook, *Vertical Arrangements and the Rule of Reason*, *supra* note 10, at 159.

[27] Scherer, for example, makes the following concession:

My tentative conclusion is that most vertical restraints should be presumed legal

litigation in circumstances where there is not realistic economic foundation for arguing that consumers have been hurt by the vertical arrangements certain manufacturers choose to employ.[28]

In summary, there has been extensive economic research on vertical restraints since the early articles which suggested a possible free rider rationale for those restraints. Because of that research, our understanding of the causes and consequences of vertical restraints is considerably more advanced than it was twenty-five years ago. In some respects, the recent research has confirmed the free rider explanation, although it has embellished the explanation to include concepts such as quality certification. In other respects, the research has undercut the free rider justification, by showing that the fact of a free rider effect does not necessarily mean that consumers are better off when the free rider is thwarted. It is reasonable to expect additional contributions from economists on the subject, but unrealistic to expect that future research will point to a simple, easily administered antitrust policy that always reaches the economically correct result. Policymakers must recognize the tradeoff between accuracy and simplicity and design rules that make the best out of a less than ideal situation.[29]

> on efficiency grounds, except in the case of leading firms in concentrated markets, or in those situations where the restraints are applied very widely. However, because it is such a blunt instrument and because it seems to have so few other redeeming merits, I would argue that resale price maintenance ought to be presumed legal only for relatively small upstream firms and in situations where its use is not ubiquitous. Where those conditions are not satisfied, I would require those who want to use resale price maintenance to bear the burden of proving why it should be used.

Scherer, *supra* note 15, at 707.

[28] While in principle the idea of using market power as a screen would be acceptable to most economists, however, the apparent consensus might crumble when it came to the standards for determining market power. Some would undoubtedly opt for criteria that would label the manufacturer of virtually any differentiated product as enjoying market power, while others would see market power as not that dissimilar to monopoly power as that term is used in a Section 2 context. Two recent cases in the Tenth Circuit illustrate the difficulties in attempting to define market power and to distinguish it from monopoly power. Shoppin' Bag of Pueblo, Inc. v. Dillon Cos., 783 F.2d 159 (10th Cir. 1986); Westman Comm'n Co. v. Hobart Int'l Co., 796 F.2d 1216 (10th Cir 1986), *petition for cert. filed*, 55 U.S.L.W. 3259 (No. 86–484) (U.S. Sept. 22, 1986).

[29] For an effort to take administrative costs explicitly into account, *See* Fisher, Johnson & Lande, *Bright Lines and Unstructured Discretion in the Vertical Restraints Guidelines*, ANTITRUST BULL. (forthcoming 1987).