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## Vertical Restraints

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# *Vertical Restraints*

G.A. HAY\*

## I. INTRODUCTION

The topic of vertical restraints has generated a good deal of interest, discussion and controversy in recent years. Moreover, the recent publication of the US Justice Department's 'Vertical Restraints Guidelines' ensures that the subject will continue to be discussed, both in the US and in those jurisdictions, like the UK and the EEC, which take competition policy seriously and normally show a keen interest in US developments.

It seems appropriate, therefore, to consider these new Guidelines and to use them as a basis for discussion. At the outset, however, it is important to make a few comments about the structure of the US competition policy enforcement mechanism, lest the precise status of the Guidelines be misunderstood, and their short-run significance as a policy instrument exaggerated.

Competition policy in the US is conducted primarily in the 'judicial' mode. A plaintiff sues a defendant and that lawsuit is adjudicated in a federal court.<sup>1</sup> As in the UK and EEC, defendants are typically business corporations (although trade associations, non-profit organisations and even cities have been defendants in federal cases). However, while in the UK or the EEC a governmental body charged with enforcing competition policy is typically the moving party in a competition action of one kind or another, that is not so in the US. Long before the idea of 'privatisation' became fashionable in the UK, competition policy was effectively privatised in the US, making it possible for private plaintiffs to sue if they have been the victim of an anti-trust injury.

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<sup>1</sup> Many of the fifty states have their own anti-trust statutes for activity that is generally confined within state boundaries. These statutes are typically modelled on the federal laws, and state courts frequently refer to opinions in federal courts.

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## *Fiscal Studies*

This is no mere theoretical possibility. A number of factors, including the generous provision for damages (actual damages as determined by the judge or jury are automatically trebled<sup>2</sup>), relatively efficient mechanisms for organising class actions, the ability of lawyers to represent plaintiffs on a contingent fee basis, and the fact that unsuccessful plaintiffs typically are not required to pay the winning defendant's legal fees<sup>3</sup> all combine to generate substantial incentives for private parties to seek legal remedies for anti-trust-related injuries. The result is that the federal enforcement agencies (the Justice Department and the Federal Trade Commission<sup>4</sup>) are plaintiffs in typically less than 10 per cent of 'federal' anti-trust cases filed in a given year.

The important aspect of this structure, for purposes of the present discussion, is that the Guidelines state merely the enforcement intentions of the Justice Department. They are in no sense binding on private plaintiffs,<sup>5</sup> which have been responsible for virtually all vertical restraint cases filed in the past several years.<sup>6</sup> Nor are the Department's views binding on the courts that adjudicate private cases. Federal judges are appointed for life and thoroughly independent of the Justice Department.

On the surface, then, it might appear that the Guidelines are of little consequence, given the predominance of private action in the area of vertical restraints. But the very paucity of government cases in this area suggests that the purpose of the Guidelines is other than merely a codification of past policy. Indeed, the document acknowledges explicitly that the real purpose of the Guidelines is to contribute to the orderly development of case-law, i.e. to influence judicial opinions in private cases. While the views of Justice are not binding on federal judges, they can be influential. Hence, the document does more than simply state the Department's conclusions; it attempts to argue the case for those conclusions in as clear and convincing a manner as possible. The hope is that the document itself, combined with the weight of authority

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<sup>2</sup> Private plaintiffs may also seek and obtain injunctive relief. There is some controversy at the moment over whether private plaintiffs can obtain divestiture by the defendant or dissolution.

<sup>3</sup> The policy is not symmetrical. Losing defendants pay the successful plaintiffs' fees, further increasing the incentive to sue.

<sup>4</sup> The Federal Trade Commission was established in 1914, and enjoys jurisdiction roughly corresponding to that of the Justice Department. It is perhaps fitting that the same Congress which determined that competition among business entities would be desirable also decreed that there should be competition among federal agencies to enforce the anti-trust laws, notwithstanding the fact that it had already made it possible for private entities to bring anti-trust actions as well.

<sup>5</sup> The FTC is not bound by the Justice Department Guidelines, but its policy is unlikely to differ significantly from that of the Justice Department.

<sup>6</sup> In this respect the previously issued Merger Guidelines are in a different posture, since merger cases brought by private plaintiffs are somewhat rare, and the attitude of the Justice Department is often critical to whether the merger will take place.

behind it, will persuade the judiciary to adopt similar conclusions. For that reason, the Guidelines merit serious discussion.

This paper has three main sections. After some introductory definitions in Section II, Section III provides a brief history of the American case-law involving vertical restraints. In Section IV, the Guidelines are summarised and explained. Section V raises questions about the Guidelines' treatment of vertical restraints that are suggested by recent developments in the industrial organisation literature. In a brief concluding section, the relevance and likely impact of the Guidelines for UK and EEC policy towards vertical restraints are assessed.

## II. A TAXONOMY OF VERTICAL RESTRAINTS

Vertical restraints, in general, are conditions imposed by a manufacturer on its distributors or retail dealers. Prominent examples include resale price maintenance, where the retail dealer is constrained from selling below the retail price stipulated by the manufacturer; territorial allocation, where the distributor is required to confine its sales efforts to a particular geographic area; and exclusive dealing, where the distributor or retailer is forbidden to carry the products of a competing manufacturer. Occasionally, vertical restraints on the distributor/retailer are combined with self-imposed constraints on the manufacturer; for example, territorial allocation is often accompanied by an agreement that the manufacturer will not appoint competing dealers in the same territory.

There are many possible ways of categorising vertical restraints. For present purposes, a useful taxonomy is according to the nature of the anti-competitive effect that allegedly may arise from vertical restraints. According to this scheme, there are two basic types. In the first, called 'exclusionary vertical restraints', the potential victims are competing manufacturers that are denied access to desirable wholesale or retail outlets. Exclusive dealing is a prototypical example. If a particularly desirable set of distributors or retailers agrees to deal exclusively with a single manufacturer, competing manufacturers are denied access and must seek alternative distributing or retail outlets or must develop their own. This may be a particular problem for smaller manufacturers or potential new entrants by making it difficult to achieve minimum efficient scale or by otherwise increasing their costs.

The second type of vertical restraint has its immediate effect on *intra*brand competition at the distributor or retail level. By one means or another, the manufacturer restricts competition among its own wholesale or retail dealers, e.g. by confining them to operate within their assigned (often exclusively assigned) territories or by directly specifying a minimum retail price. As indicated, the immediate impact is confined to *intra*brand competition. There is no necessary adverse impact on other manufacturers; indeed, if anything, it might appear that competing manufacturers would benefit from the

restriction in competition among a particular rival's dealers.

While the Guidelines refer to both categories of restraint,<sup>7</sup> much of the recent controversy has involved the second, i.e. *intra-brand* restraints, and this will be the primary focus of this paper. To understand the controversy, a small amount of historical background is appropriate.

### III. THE LEGAL STATUS OF VERTICAL RESTRAINTS IN THE US, 1911-85

From at least 1911 up until 1977, the judicial attitude towards most vertical restraints, and especially resale price maintenance, was a hostile one. Indeed, prior to the *Sylvania* decision in 1977, most vertical restraints of the type discussed here (i.e. *intra-brand* restraints) were regarded as illegal *per se*, i.e. if the existence of the restraint was established, there was no further defence argument permitted.<sup>8</sup>

There were two bases for the Courts' hostile attitude towards vertical restraints. The first, based on common-law notion of restraint upon alienation, regarded it as improper for the manufacturer to impose any conditions, once it had passed title to the goods, on the subsequent resale of those goods.<sup>9</sup> The second, and more interesting, basis was by analogy to the legal and economic consequences of horizontal restraints. It was settled doctrine, both in law and in economics, that a horizontal agreement among distributors or retailers not to deviate from a particular price or not to infringe on one another's customers or geographical territories, would be against the public interest and illegal *per se*. It followed, according to the analogy, that if the same restraint occurred as a result of a vertical agreement between manufacturer and dealers, the economic consequences would be the same as for a horizontal agreement and therefore the same legal treatment would be warranted.

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<sup>7</sup> The Guidelines deal also with tie-in sales, which, analytically at least, can be viewed as a form of vertical restraint. But the Guidelines' treatment of tie-ins is both separate from and dissimilar to its treatment of vertical restraints.

<sup>8</sup> This is admittedly a substantial oversimplification of the complex and shifting set of rules that developed during the period. A variety of exceptions and special circumstances were recognised (and often subsequently disallowed) at various times during the 66-year period. The most significant exception, however, was statutory, not judicially-created. During the period 1937-75, many states passed 'fair-trade' laws creating, under certain circumstances, an exemption from federal anti-trust laws for a manufacturer that wished to impose minimum retail prices on its dealers. In 1975, Congress revoked the exemption. For a more complete history of the development of the legal rules, see Hay (1985b).

<sup>9</sup> It has been argued that the Courts misinterpreted and exaggerated the sweep of this common-law doctrine. See Hay (1985b).

(At least) by 1960, economists began seriously to question the analogy and the policy conclusions that followed from the analogy. The 'new' analysis took two (interrelated) lines of argument.<sup>10</sup> The first pointed out that, *ceteris paribus*, it would not be rational for a manufacturer to restrict competition among its retail dealers (or distributors), since doing so would serve only to increase the retailers' margins and the retail price, with the result that sales of the manufacturer's product would fall. Hence, such vertical restraints should be expected only when there is some other element in the picture. The higher retail (gross) margins must induce some special behaviour by the retailers which, by stimulating demand, more than compensates for the reduction in sales due to higher retail prices.

The second line of argument identified the nature of this other element. Certain demand-generating activities that retail dealers (or distributors) might usefully perform, such as elaborate showrooms, demonstration facilities and other pre-sale services, are effective in generating demand but costly to undertake. The increased sales would more than compensate for the retailer's greater expenses but for the 'free-rider' effect which permits other retailers to take advantage of the demand-generating activities of industrious retailers by siphoning off the customers that have been induced to buy. This occurs because the free-riders have lower costs (since they do not themselves provide the pre-sale services even though they benefit) and hence can offer lower retail prices.

Over the long run, the bulk of the sales shifts to the free-riders, resulting in losses for the industrious retailers and, eventually, cessation of the demand-generating activity. The manufacturer can prevent this from happening, according to the argument, by insulating the industrious dealers from the price competition of free-riders, either by limiting the number of retailers (or distributors) serving a territory (possibly even creating local monopolies) or by directly preventing price competition, i.e. specifying the minimum retail price.

If the story is as described, the vertical restraints are potentially pro-competitive, since the consumer presumably benefits enough from the extra services that are made possible to more than compensate for the nominally higher retail prices. Indeed, unless the positive impact on sales of the extra services does exceed the negative impact of higher retail prices, the manufacturer would not find it worthwhile to impose the restraints. Hence there ought to be a presumption, according to the argument, that the restraints are pro-competitive.

Two exceptions to this presumption were identified, however. First, the manufacturer may be coerced into 'imposing' the restraints by collective pressure from dealers who in turn desire to be 'restrained' from competing with one another at the wholesale or retail level. This would be in the

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<sup>10</sup> The classic reference is Telser (1960).

manufacturer's interest only because the threatened alternative was a collective refusal by the dealers to handle the manufacturer's products. The second exception was that the restraints might be simultaneously employed by several competing manufacturers. By ensuring the absence of intrabrand competition at the retail level, the restraints might remove a possible source of pressure on a tacit or explicit cartel at the manufacturing level.

In one sense, neither of these scenarios is an exception since, at base, they are primarily horizontal, not vertical, restraints and could be attacked under the normal strict rules governing horizontal agreements. However, such horizontal agreements are typically covert, and difficult to discover. In addition, they may be tacit rather than explicit and less susceptible to legal condemnation even though the economic impact is the same as an explicit cartel. For either reason, it might be good policy to disallow vertical restraints in circumstances where they are likely to facilitate a horizontal impact.

Unfortunately, the economics literature provided little guidance on how courts should decide whether the use of vertical restraints posed a sufficiently large risk of facilitating horizontal collusion, compared to the efficiency-creating effects, that they should be disallowed. It appeared as though, in order to decide the issue, a court would have to undertake fairly detailed and sophisticated analyses of the nature of the product and the structure and behaviour of the industry in question. For reasons discussed in detail elsewhere,<sup>11</sup> American anti-trust courts historically have avoided such complicated inquiries, and have tended to rely on fairly straightforward and simple rules-of-thumb. Faced with the difficulty of incorporating the relevant economics into simple rules, the rule of *per se* illegality for all vertical restraints continued to seem the most attractive alternative in the circumstances.<sup>12</sup>

Eventually, however, the academic literature on vertical restraints had reached such a volume that it was impossible to ignore entirely. Hence, in the *Sylvania* decision in 1977, the Supreme Court, citing much of the relevant literature, abandoned blanket *per se* illegality for all vertical restraints in favour of a new set of rules; henceforth, vertical price restraints would continue to be unlawful *per se*, but non-price restraints would be subject to rule of reason analysis.

While the authors cited in the *Sylvania* opinion might have taken pride in the fact of their being cited and pleasure at the Court's acknowledgement of the importance of economic analysis, they would not have awarded uncritical acclaim to the new set of rules, since there is little in the literature to suggest the wisdom of fundamentally different treatment of price and non-price

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<sup>11</sup> See Hay (1984, 1985a).

<sup>12</sup> This is only one of several possible explanations for the reluctance of the courts to be guided by the economics literature.

restraints. Indeed, most economists would have regarded them as analytically more or less equivalent, each designed to protect the industrious dealer from free-riders, by limiting the opportunities for price competition.

Two other problems were quickly discovered with the *Sylvania* result. First, there was nothing to tell subsequent courts how precisely to distinguish price and non-price restraints. While a formal agreement by the dealer to adhere to suggested prices is clear enough to interpret, many other nominally non-price conditions are intended to achieve the same impact, i.e. insulation of the dealer from price competition. Are they to be classified by the words actually used in the agreement or by the intended and actual impact? The problem is made even more acute as a result of the sharply different legal treatment accorded price and non-price restraints, since plaintiffs have an incentive to characterise every restraint as a price restraint.<sup>13</sup>

The second problem is that, for non-price restrictions, the *Sylvania* Court gave no instructions as to how to conduct a rule of reason analysis. The Court mentioned something about balancing the loss in intrabrand competition against the improvement in interbrand competition without explaining either why such a trade-off makes sense<sup>14</sup> or how it is to be assessed.

#### IV. THE GUIDELINES' APPROACH TO VERTICAL RESTRAINTS

Had the Justice Department been entirely free to say what its officials believed, it is likely that the Vertical Restraints Guidelines would have attempted to deal both with the dubious value of the price/non-price distinction and the issue of how to evaluate the overall competitive impact of individual non-price restraints. But, for political reasons too complex to explain here, the Department elected not to take issue with the wisdom of the *per se* rule for price restraints.<sup>15</sup> Hence, save for one brief section indicating the difficulty of distinguishing between price and non-price

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<sup>13</sup> In a quite remarkable passage in a recent opinion, the Supreme Court acknowledged the possible artificiality of the distinction while maintaining its importance:

but the economic effect of ... agreements on price and non-price restrictions — is in many, but not all, cases similar or identical. ... And judged from a distance, the conduct of the parties in the various situations can be indistinguishable. ... Nevertheless, it is of considerable importance that ... concerted action on non-price restrictions, be distinguished from price-fixing agreements, since under present law the latter are subject to *per se* treatment and treble damages.

(*Monsanto Co. v Spray-Rite Serv. Corp.*, 104 S.Ct. 1464, 1470, 1984)

<sup>14</sup> For an argument that the trade-off does not make sense, see Easterbrook (1984), pp.13-14.

<sup>15</sup> Two years earlier, the Department made clear that it regarded the *per se* rule as unwarranted but was threatened by Congress with severe political and financial consequences if it continued to express the view as an official opinion.

restraints, the Guidelines are limited to the question of how to assess the legality of non-price restraints, i.e. how to interpret the court's mandate to perform a rule of reason analysis.

What distinguishes the Guidelines, and what increases the likelihood of their being influential on courts that are disinclined to get involved in any complex economic analysis, is that they go beyond merely identifying and describing the possibilities for pro-competitive and anti-competitive effects. Instead, they are intended to offer relatively simple and easily applied rules-of-thumb, based on data presumed to be available to courts, to screen out without elaborate economic analysis those situations in which vertical restraints are likely to be primarily efficiency-creating. Detailed analysis is left only for those restraints that fail to pass this initial screen, and even that analysis is largely confined to examining various observable structural characteristics of the industry.

To perform the screen, the Guidelines define two concepts. The first, called the Vertical Restraints Index (VRI) is analogous to the Herfindahl-Hirschman Index (HHI) used in the Merger Guidelines. It is calculated by squaring the market share of each firm in the market that is a party to a contract or other arrangement that contains the vertical restraint and then summing the values obtained for firms at the same level of operations (i.e. supplier or dealer);<sup>16</sup> the maximum value that the VRI can take is therefore  $100^2 = 10,000$ .

The second concept, called the coverage ratio, is the percentage of each market involved in a restraint. For example, if ten suppliers, each with 5 per cent market shares, employ a restraint, the coverage ratio is 50 per cent. Hence the VRI could be low (because the industry is not highly concentrated) while, at the same time, the coverage ratio is high (since virtually all firms employ the restraint).

Using these two concepts, the screen operates as follows. The use of a vertical restraint will not be challenged if (i) the firm employing the restraint has a market share of 10 per cent or less; or (ii) the VRI is under 1200 and the coverage ratio is below 60 per cent in the same market (which can be either the supplier or dealer market); or (iii) the VRI is under 1200 in both relevant markets; or (iv) the coverage ratio is less than 60 per cent in both markets.

The first test simply provides a safe harbour for small firms on the theory that they are unlikely to be prominent in any cartel or in any effort to facilitate a cartel. The remaining tests are based on the assumption that the restraints are unlikely to facilitate collusion (or to have an exclusionary impact) unless the relevant markets are highly concentrated and the practice is widely used. For situations where the restraints are not immunised with this

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<sup>16</sup> For example, if three of four manufacturers, each with a 25 per cent market share, employ a restraint, the  $VRI = 25^2 + 25^2 + 25^2 = 1875$ .

structural screen, the Guidelines suggest a further examination, focusing primarily on ease of entry and other factors that would render collusion more or less likely, but including other evidence that may shed light on the likely net competitive impact of the restraints.<sup>17</sup>

#### V. THE GUIDELINES AND RECENT ECONOMIC THEORY

There are a number of mechanical ambiguities about the Guidelines' analysis,<sup>18</sup> but these are likely to be resolved in subsequent clarifications by the Department. In addition, there will be reservations about whether the data to perform the calculations are likely to be available in litigation involving only a single manufacturer. Finally, the overall level of the numerical criteria may be questioned, i.e. perhaps all the numbers should be lower (it is hard to see how they could possibly be higher).

The most interesting questions, however, relate to whether the Guidelines, in isolating the risk of collusion at the manufacturing or dealer level, have properly accounted for all the important kinds of adverse impacts that may flow from the use of vertical restraints. This possibility is suggested by several factors. First, casual empirical observation (based partly on periods in various countries when legal prohibitions on vertical restraints, especially resale price maintenance, were not in force) suggests that for many of the products for which manufacturers have desired to isolate retailers from price competition, the pre-sale service, free-rider explanation seems not to fit easily. The most frequently commented-upon example (from the US) is blue jeans, where the principal manufacturer was a staunch defender of resale price maintenance and other ways of minimising dealer price competition. It is difficult to see precisely what kind of elaborate pre-sale service might be provided for blue jeans that is seriously threatened by free-riders.

Recent research by Marvel and McCafferty (1984) sheds some light on this puzzle. They argue that when a particular dealer, with a reputation for quality (or perhaps for being a trendsetter in fashion), carries a manufacturer's product, the demand for that product is increased as a result of the retailer's implicit stamp of approval. Once the demand has been generated, other retailers benefit, since by offering the product at a reduced

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<sup>17</sup> For example, if the restraints have been in existence for some time, the Guidelines suggest an effort to evaluate the actual impact. Other evidence may come from documents indicating the intent of the parties or other evidence suggesting the plausibility of a pro-competitive impact. Finally, the Guidelines suggest that if many of the firms using restraints have small shares or are recent entrants, the restraints are most likely to have an efficiency explanation.

<sup>18</sup> For example, it may be asked how it is possible for the coverage ratio to be high in the supplier market but low in the retail market (and vice versa), since each restraint involves both a supplier and a retailer. Conceivably, it applies to a situation where a supplier imposes restraints on some, but not all, of its retailers, but this is not made clear.

price, they can free-ride on the quality certification activities of the industrious retailer. To the extent that the original retailer, to perform this quality certification function, must incur higher costs (say, by testing or expensive market research), the viability of the activity is threatened. Hence a manufacturer may wish to insulate such a dealer from free-riders, by either some form of territorial protection (unlikely for items such as blue jeans), resale price maintenance, or simply refusing to supply the kind of discount stores that are most likely to pose a serious free-rider problem.<sup>19</sup>

To the extent that what is occurring is genuine quality certification, most economists would regard the activity as desirable and worthy of protection. Where the activity is more accurately described as fashion-setting, arguments about changing tastes and artificial differentiation are involved, and economists may feel that less can be said in defence of restraints on economic grounds. However, the Guidelines are not at all hostile to this type of reason for vertical restraints, at least on the initial screen. For those situations which fail to gain clearance at the initial screen, the only way the issue might arise is whether, in considering the manufacturer's explanation of the need for such restraints, the quality certification argument is afforded parity with the more traditional reasons.

A second area of concern about the economic consequences of vertical restraints is suggested by Scherer (1983) who argues that while, for any one manufacturer, vertical restraints may increase demand, a large chunk of the increase may not represent a net expansion in the industry's output, but merely a shift from one manufacturer to another. Moreover, he argues, if other manufacturers react by instituting similar restraints to stem the loss of business, the net result may resemble the original equilibrium in terms of market shares, i.e. no significant increase in overall demand, yet with the product being sold at higher prices (to cover the increased costs of the additional dealer services that are generated).

What is not explained is whether, if the added value to the consumer is less than the added costs, the high-price, high-service outcome is a true equilibrium. Put differently, it appears that a firm which deviated from the pattern and offered a low-service, low-price version of the product would attract those consumers for whom the retail services are not worth the higher price. New entry could, of course, accomplish the same result. Notwithstanding, if one accepts Scherer's view of the potential disutility of such activities, a circumstance which might generate an undesirable result but would not be picked up by the Guidelines would be one in which concentration is low, but the coverage ratio nonetheless quite high.<sup>20</sup> (If the

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<sup>19</sup> Obviously, there may be circumstances in which the quality retailer does not incur additional product-related expenses, or is not seriously threatened by free-riders since shoppers will patronise the store anyway.

<sup>20</sup> One could still argue that the overall levels of the coverage ratio and the VRI criteria are too high, but that argument seems insensitive to whether the concern is collusion or excessive differentiation.

VRI is below the critical level in both supplier and dealer markets, firms using restraints escape further scrutiny even where all suppliers or all dealers are governed by the restraints. Moreover, any firm with less than 10 per cent is automatically exempt.) However, it could be argued that, whatever the overall merits of Scherer's hypothesis, the likelihood of a destructive equilibrium of the type envisaged by Scherer is especially remote when concentration is low.

A different, but related, argument comes out of recent literature on product differentiation,<sup>21</sup> since one can view vertical restraints as facilitating product differentiation. It has been established that, under a given set of assumptions, firms can reach an equilibrium in which there is excessive differentiation relative to some social optimum.<sup>22</sup> The relevance of this dilemma to the vertical restraints issue is unclear, partly because theory does not predict excessive differentiation as a universal outcome and partly because the theoretical comparison is to the social optimum. For vertical restraints, the appropriate bench-mark is the situation that would exist under a stricter policy towards such restraints, which does not necessarily mean the first-best equilibrium.

As in the previous discussion, the problem, to the extent that there is one, is most likely to be serious when most firms employ the restraint to accomplish differentiation. Where a significant percentage of producers offer the 'undifferentiated' model, the risk of an unfavourable equilibrium seems more remote.<sup>23</sup> The Guidelines fail to isolate potentially troublesome situations in circumstances where the coverage is complete but industry concentration modest. This of course stems from the Guidelines' emphasis on the risk of collusion. The problem would be cured if a low coverage ratio were necessary, not merely sufficient, to immunise the industry from the second level scrutiny, i.e. if all situations with very high coverage ratios were subject to further examination.<sup>24</sup>

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<sup>21</sup> See, e.g., Spence (1976) and Dixit and Stiglitz (1977).

<sup>22</sup> It is important to stress that this is not a general result but highly conditional on the assumptions. Under a different set of assumptions, the equilibrium has insufficient differentiation.

<sup>23</sup> Although this will depend on the degree of substitution between the high-priced products and the homogeneous substitute. For a model which allows for a portion of the industry to produce the homogeneous good, see Salop (1979).

<sup>24</sup> This is not intended to imply that situations where the coverage ratio is quite high are necessarily inefficient. Indeed, when most or all firms are following the same business practice, it is likely to be the case that this is an efficient way of doing business.

VI. IMPLICATIONS FOR THE UK AND THE EEC

The issue that remains is the relevance of the Guidelines for competition policy outside the US, especially in the UK and the EEC. As far as the EEC is concerned, it seems fair to say that the Guidelines would be totally unacceptable at the present time. Because the EEC is equally concerned about market integration and about manufacturer or dealer collusion, it is unlikely to sanction any kind of intrabrand restraints used to achieve (or perpetuate) different prices in different member states.

This policy seems not dependent on the manufacturer being in any sense dominant, or on concentration being high enough to make manufacturer collusion a serious risk. In the US, absent market power at the manufacturing level, it is highly unlikely that even airtight exclusive distributorships will lead to significant differences in price across states, since interbrand competition will force prices to the common competitive level.<sup>25</sup> For the EEC, in contrast, various countries' specific regulations (e.g. price controls) may generate significant country price differences that will not be eroded by interbrand competition (if all manufacturers in a country are governed by the same rules) but may be undermined by parallel intrabrand imports. Hence, while the Guidelines provide a safe harbour for a small manufacturer (10 per cent or less market share) or a manufacturer in a relatively unconcentrated industry to impose airtight territorial allocations on its dealers, such behaviour would run afoul of Article 85(1) and would almost certainly not be exempted under 85(3); nor would it come under the block exemption for exclusive distribution since the latter cannot be used to prevent or discourage parallel imports.

In addition, to the extent that the Justice Department's 'hidden agenda' is to have similar rules apply to resale price maintenance, the policy is likely to be unacceptable in the EEC.<sup>26</sup> This is partly due to the market integration factor just mentioned. While in the US resale price maintenance is likely to be employed to produce uniform retail prices nation-wide, in the Community resale price maintenance may be simply another tool for price discrimination across member states.

However, an additional factor that appears to motivate EEC policy is the relative infancy, and possible fragility, of the discount store phenomenon. That is, it may be perceived that there is a genuine risk that in an environment permissive of retail price maintenance, the power of the traditional dealer network is such that, even without collusion on the part of dealers, manufacturers would feel pressured to avoid selling to discounters. In the US, discount stores are so well established, and account for such a large

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<sup>25</sup> Some differences might persist, related perhaps to transportation costs or state-specific regulatory requirements (e.g. stricter emissions standards for cars in California), but these are not likely to be overcome by parallel intrabrand imports in any event.

<sup>26</sup> On this subject see Waelbroeck (1984).

portion of many manufacturers' sales, that a full-scale return to retail price maintenance is unlikely even if it were expressly permitted.

As for the UK, it is possible to argue that the UK has already gone well beyond the Guidelines in immunising non-price vertical restraints. Properly drafted agreements awarding exclusive distributorships or assigning exclusive geographic territories are not registrable under the Restrictive Trade Practices Act. In addition, while vertical practices may be picked up under the Fair Trading Act or the more recent Competition Act, this should happen only for dominant firms, almost certainly requiring more than the 10 per cent safe harbour allowed under the Guidelines.

There are two important caveats to this picture of apparently quite lenient treatment. First, the market definition standards employed in the Vertical Restraints Guidelines are the same as those contained in the 1984 Merger Guidelines. It has been clearly demonstrated that these produce markets that, in general, are much broader than those implicit in traditional product and geographical market definitions based on existing patterns of consumer substitution, imports, and supply cross-elasticities,<sup>27</sup> which are the ones likely to be used by the OFT or MMC.

Second, dominance has been defined to include market shares as low as 30 per cent. Under the Guidelines, a firm with 30 per cent market share would be protected if the overall coverage ratio for firms using such vertical restraints were less than 60 per cent. This occurs because, under the Guidelines, eliminating intrabrand competition is not offensive in and of itself, but only where it is the result of dealer collusion or serves to facilitate manufacturer or dealer collusion. Since the UK need not be individually concerned about market integration, it might be influenced to move closer to the Guidelines' approach on this issue.

Finally, with respect to resale price maintenance, the present rules seem roughly comparable to the *per se* treatment under US case-law. It is unlikely that the UK would be receptive to any suggestion that the rules on resale price maintenance be relaxed, for some of the same reasons given for the EEC, namely the perceived fragility of the discount store revolution and the fear that, freed from legal prohibition, manufacturers would bow to the implicit pressure for traditional retailers to insulate them from the price competition of discount stores.

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<sup>27</sup> See Hay and Reynolds (1985).

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