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Contracts to Keep Up the Price on Resale and to Buy or Use Other Articles in Connection with Those Sold

By Albert M. Kales[1]

I

Suppose a manufacturer whose goods are neither patented nor subject to any copyright and are in competition with similar goods of other manufacturers and not the subject of any public necessity, and who does not occupy any preponderant position in the business in which he is thus engaged, sells his commodity to retail distributors with the covenant by them not to sell, and that the goods are not to be sold by anyone, for less than certain prices. If such a contract is valid, is it enforcible between the parties by injunction? If so, is it enforcible specifically in equity against third parties who take with notice of the restrictive covenant? These are important questions, but they are subordinate to the settlement of the validity of the contract as between the parties.

Before the decision in the United States Supreme Court of the *Dr. Miles Medical Co.* case[1a] it had been held in England and in several states of the Union—that is to say in a number of common law jurisdictions where the question arose—that such a contract was valid, as between the parties so that damages for the breach might be recovered,[2] or an injunction against the breach obtained.[3] In one case at least the injunction was allowed against third parties who had notice of the contract, and who had procured an original party to the contract to purchase and resell to the defendant so that the defendant might sell for a lower price than that specified.[4] Recently, however, in the *Dr. Miles Medical* case[5] the United States

[1]Of the Chicago Bar.

[1a]Dr. Miles Medical Co. v. Park & Sons Co., 220 U. S. 373 (1911).

[2]Elliman, Sons & Co. v. Carrington & Son, L. R. [1901] 2 Ch. 275; Garst v. Harris, 177 Mass. 72 (1900).

[3]Grogan v. Chaffee, 156 Cal. 611 (1909); Garst v. Charles, 187 Mass. 144 (1905). See also Clark v. Frank, 17 Mo. App. 602 (1885); New York Ice Co. v. Parker, 21 How. Prac. (N. Y.) 302 (1861).

[4]Garst v. Charles, *supra*, note 3.

[5]Dr. Miles Medical Co. v. Park & Sons Co., *supra*, note 1a.

Supreme Court has held that no injunction should issue against the third party who took the commodity with notice of the restrictive agreement. It made no difference that the bill alleged, and the demurrer admitted that the defendant sought to sell the complainant's goods to others who might sell them at cut rates and "thus attract and secure custom and patronage for other merchandise, and not for the purpose of making or receiving a direct money profit," and for this purpose procured the commodities from the complainant's "wholesale and retail agents" by "false and fraudulent representations and statements, and by surreptitious and dishonest methods, and by persuading and inducing directly and indirectly" a violation of their contract. It should also be noted that the decision of the United States Supreme Court did not go on the ground that equity would not give specific performance of a restrictive covenant relating to the disposal of personal property, or that specific performance in general could not be given against a third party who took property with notice of the restriction. The court went solely on the ground that the agreement was illegal between the parties and not enforcible in any kind of an action.

This sharp division of opinion between the United States Supreme Court and the courts of other jurisdictions justifies an examination of the merits of the opposing contentions.

The United States Supreme Court first makes the point that the seller cannot control the passing of title to future purchasers by requiring that title shall pass only at certain prices. Such an attempt, if successful, would, it insists, impose an illegal restraint or forfeiture upon alienation. If this be a sound principle and applicable it would be no answer to it that there is no restriction upon the passing of title, but only a contract as to the price which the purchaser may ask upon a resale. If such an agreement is enforced specifically in equity between the parties and against third parties with notice, there is produced the effect of a restraint on the alienation of the commodity itself. If an attempt to do the latter is illegal, certainly equity would not permit the former. If damages may be collected for the breach of the attempted contract in question there is to a less degree only, a deterrent to alienation. Ignoring, however, the decisive effect of the rule forbidding restraints on alienation, the Supreme Court considers the validity of the arrangement merely as an agreement between the parties. This agreement it finds is illegal because it is one of a scheme of contracts with many retailers which operates as an arrangement between all the retailers to eliminate competition between themselves, and to fix the price at which they will sell a given commodity. This, it is said, is as objectionable

as if the dealers themselves had combined and agreed upon prices generally.

All this is a faithful adherence to the outward form of certain rules without, it is believed, any regard for their actual meaning.

We have, for instance, a faithful adherence to the form of the rule that restraints and forfeitures upon alienation of absolute interests in personal property are illegal. It is entirely overlooked that this expressed a rule of public policy, and is properly qualified whenever the courts have to deal with a distinctive transaction which does not infringe the policy which the rule carries out. Thus one may provide for forfeiture upon alienation to a particular person or group of persons.[6] Some cases have even gone so far as to permit a forfeiture on alienation to any one except a certain group of persons.[7] The question always is, has the restraint or forfeiture on alienation been restricted in so distinctive a way that the public policy behind the rule has not been infringed? Perhaps it would be better to say that upon a balance of all considerations the freedom of action of the party restricting alienation to some extent outweighed the dangers to the public from the limitation on alienation. The moment the case in question is approached in this way, what do we find? The manufacturer is in the business of selling products to the public. He cannot prosper unless sales are made. His goods are in competition with goods of other manufacturers who are as strong commercially as he is. These are distinctive features which the courts can lay hold of. They automatically require a price at which the manufacturer's goods will sell. This means that any restraint or forfeiture on alienation is reduced to the minimum. It means that there is a restraint or forfeiture on alienation to the class of people who will buy only at the reduced price which dealers not subject to the contract might make. The distinctive feature of the transaction makes it clear that this will be a small group in comparison with those who are ready to buy at the established price. Properly analyzed the restraint or forfeiture on alienation whether it proceeds from an expressed forfeiture of the title on alienation or a restraint on its alienation below a certain price, or from the specific enforcement of the contract in equity, is reduced to such a point as to exclude it from the infringement of any public policy against general provisions of forfeiture or restraints on alienation of personal property. When we add the special grounds for freedom of economic action

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[6]Littleton, 361.

[7]Doe v. Pearson, 6 East (Eng.) 173 (1805); *In re* Macleay, L. R. 20 Eq. 186 (1875). *Contra*, Attwater v. Attwater, 18 Beav. (Eng.) 330 (1853). And see *In re* Rosher, 26 Ch. Div. 801 (1884).

in transactions having the distinctive features of this one, the validity of the arrangement in question should not be in doubt.

The manufacturer of a "specialty" or of "branded goods" succeeds commercially by doing a large part of the selling himself. He packs his own goods. He standardizes them. He advertises them in competition with similar goods of other equally strong manufacturers. The only thing he does not do is to distribute them. He cannot succeed if he attempts to do that. These goods are of the sort that the purchaser comes to know and to call for wherever he is, and he pays for them, very largely, over the counter of the distributor. The manufacturer, therefore, needs a large number of convenient distributing points. He needs all the groceries in the United States or all the pharmacies. These are not really purchasers of goods for sale. They are distributors of goods for the manufacturer— the manufacturer having by his advertising, standardizing and packing, done a large part of the business of selling. Now comes the prime difficulty with this system of selling. Grocers in small groups all over the United States compete with each other. So do the owners of pharmacies in small groups. The smaller retailer is in competition with the better organized department store. The moment that the retailers are permitted to compete with each other as to the price of "specially" or "branded" goods, the manufacturer's distributing plan, which is vital to his success is impaired. If his goods are very popular some retailer or department store will advertise a cut rate below cost in order to attract customers to whom other goods will be sold at a compensatory profit. Such a course disrupts the manufacturer's distributing units. Others who cannot or will not meet the cut cease to be interested in carrying or pushing the manufacturer's goods. This arrangement tends to exist everywhere because some unit will always be in a state of cutting prices on a popular branded article in order to stimulate general trade for the unit.

This is the condition which the manufacturer seeks to meet by his contract to stabilize prices upon resale. That such contracts are necessary to this method of doing business is plain; that the method of doing business itself has some advantages to the public is equally clear. It centralizes advertising, and, therefore, saves greatly on this item. It centralizes the labor of packing, which saves also on the cost of the article. It standardizes articles so that the time spent at the counter in determining what to buy is cut down, and in this way the selling cost is reduced. It is efficient in service because of the large number of convenient distributing points which are used. To tell the manufacturer that he cannot

work out the marketing end of his business by the method in question is to tell him that he cannot distribute most efficiently through a large number of retailers without suffering the consequences of their tendency to compete with each other. This is to condemn a new method of conducting business to inefficiency and waste, or to disrupt it entirely. Such a course neglects the fact that, while title technically passes to the retailer, the manufacturer is in reality, to a considerable degree, the seller by reason of his having done a large and expensive part of the work of selling to the ultimate consumer. It overlooks the fact that he is, in a sense, a partner with the retailer until the goods have come to the ultimate consumer, and as such is entitled to control the price in the interest of his method of distribution.

Economists and students of business may discuss whether the method of manufacturing and selling "specialty" and "branded" goods coupled with contracts on the part of the retailer to keep up the price on resale is a valuable or the wisest method or not. There may be differences of opinion about the matter. Where, however, there are opposing advantages and disadvantages in the way the business is conducted and where it remains a matter of opinion or speculation whether good or ill to the public preponderates, the fundamental social interest in the freedom of economic action requires the courts to refrain from throwing a monkey wrench into the commercial effort in question.

When the court declares the contract to keep up the price on re-sale is invalid because it is the same as a contract or combination between all the retailers to eliminate competition between themselves and fix prices, we again have a faithful adherence to the form of a legal rule without the slightest regard for its substance or the reasons which determine its limitations. When retailers who are competing combine and eliminate competition between themselves by agreements as to prices, we have the recorded assumption that in their sphere of business, at least, they have a preponderant or monopolistic position, and that they will keep it by using their power to exclude others by unfair and illegal methods of competition.[8] The agreement as to price is the admission of facts which make an illegal attempt at monopoly. But where the manufacturer sells his "specialty" or "branded" goods to distributors who agree to keep up the price on re-sale, we have no such admission or, at least, the inference of any such admission is rebutted. The manufacturer has no preponderant position in the business. He is in competition with many other manufacturers who sell goods of the same sort. Nor is the posi-

[8]See A. M. Kales, Good and Bad Trusts, 30 Har. L. Rev. 830, 852.

tion of the manufacturer preponderant because he deals through a large number of retailers who agree to keep up the price on re-sale. These retailers may handle the goods of the competitors of the manufacturer on exactly the same terms or on terms more favorable to the buyers. The manufacturer by reason of having taken care of the advertising, standardizing and packing of the goods and requiring of the retailer only the function of distributing and receiving payment is in substance a partner with the retailer in selling, and has a legitimate interest in controlling the price to prevent the disorganization of his distributing system. This does not eliminate any competition between the manufacturer and other manufacturers who are doing the same sort of business. There is no exclusion of others from the manufacturing business or from the business of retailing. It is the free competition among the manufacturers which determines the price to the public. The contract to keep up the price on re-sale is thus reduced to a device to preserve the most effective distributing organization for the manufacturer who is also in part, at least, the actual seller as well.

In *Bobbs-Merrill Co. v. Straus*[9] the Supreme Court held that the holder of a copyright on a book who had sold it with a restriction that it was not to be resold for less than $1.00 could not have an injunction against the violation of the restriction by a third party who had notice of it. This ruling seems to have proceeded solely upon a construction of the copyright act, for the jurisdiction of the court was founded, not on diverse citizenship and the specific performance of a restrictive agreement, but upon the protection afforded by the Federal statutes against infringement of copyrights. The copyright act gave the holder of the copyright the "sole right of vending the same." This was construed to include no right whatever to fix the price at which the copyrighted article might subsequently be sold. In *Bauer v. O'Donnell*[10] the same ruling was made where a patented article was involved. This also proceeded upon the construction of the patent act which gave the patentee "the exclusive right to make, use and vend the invention or discovery." In *Straus v. Victor Talking Machine Co.*[11] an attempt to retain title to the patented article in the manufacturer who merely licensed the use subject to a condition and covenant that the article should not be resold for less than a certain price was equally ineffective and unenforceable. Again an injunction against a third party who had no contract relations with the plaintiff, but who had notice of the restriction, was denied.

[9]210 U. S. 339 (1908). [10]229 U. S. 1 (1913).
[11]243 U. S. 490 (1917).

Suppose in these cases the complainant had abandoned all reliance upon the copyright or patent act and had treated the articles sold as the "specialty" product of his manufacture which he desired to market by securing a covenant requiring the price to be kept up on re-sale. Suppose the United States court secured jurisdiction on the basis of diverse citizenship, or suppose the suit were in a state court and the covenants were of the sort which equity gave specific performance of by injunction even against third parties with notice. Would the result have been the same? Clearly it would if the *Dr. Miles Medical* case were followed.[12] But suppose the result in that case had been to enforce the restriction by injunction, would the same result have been reached in a case where a patented or copyrighted article was being marketed? Perhaps so and perhaps not. If the patent were a fundamental one which controlled an entire industry like the original Bell Telephone patent, a court of equity might say: "You have a monopoly by the patent or copyright act, but we shall not aid that monopoly by giving you anything beyond what you are entitled to by the terms of the statute." On the other hand if the patent or copyright gave no monopoly in the given business—if the patented or copyrighted article was in competition with other articles of the same sort—the patented or copyrighted article should not be any worse off for that reason. The same relief, therefore, might be given as in the case of "specialty" or "branded" goods which are in competition with others of the same sort.

II

The Supreme Court of the United States first held in *Henry v. A. B. Dick Co.*[13] that where the holder of a patented article licensed its use, the license may be made subject to the condition or stipulation that the licensee would use with the patented article only unpatented accessories, manufactured and sold by the licensor, and that upon the violation of this stipulation there would be an infringement by the user of the patented article. In the recent case of *Motion Picture Patents Co. v. Universal Film Manufacturing Co.*[14] the decision in the *Dick* case was overruled, and it was held that the violation of the condition or stipulation does not make the use of the patented article an infringement. In both cases alike the court appears to have been obliged to deal with a controversy between the parties as if it involved the infringement of a patent, for only on that ground did the United States Court obtain jurisdiction. The *Dick*

[12] Dr. Miles Medical Co. v. Park & Sons Co., *supra*, note 1a.
[13] 224 U. S. 1 (1912).
[14] 243 U. S. 502 (1917).

case proceeded upon the theory that the act relating to patents permitted the holder of the patent to license the use of the patented article upon such terms as he saw fit, and if the conditions and stipulations which he imposed were not lived up to, then the license failed and there was a user without license,—that is to say, an infringement. This line of reasoning the *Motion Picture Patents* case denies. It declares that the holder of the patent may license the use of the article or not, as he pleases, but that the act gives him no authority to license subject to the condition or stipulations in question which if not adhered to, will cause the user to be an infringement.

The *Dick* case and the *Motion Picture* case have to do only with a construction of the patent act; but behind the decision in the *Motion Picture* case is the intimation that the arrangement there attempted is so far contrary to the public interest that the patent act should not be construed to permit it. Suppose, then, that instead of seeking relief for an infringement, the complainants in the *Dick* case and the *Motion Picture* case sought damages for the breach of a contract on the part of the licensee to use only such accessories with the patented article as were furnished by the licensors. Is it a defense to such a suit that the contract is illegal?

The reasoning of the court in the *Dr. Miles Medical* case has nothing to do with this problem. The result of the *Dr. Miles* case went upon the illegality of a restraint or forfeiture on alienation which was attempted to be imposed, and the fact that there was in effect a combination of retailers under contract with each other to fix the price of a commodity. Neither line of reasoning touches the contract by a purchaser to use only certain accessories with the article purchased. If such contracts are illegal between the parties, it must be on some ground not articulated or applied in the *Dr. Miles* case. What can it be?

Suppose A has a mule, can he sell him to B subject to the covenant by B to curry him only with such combs as are furnished by A? Why not? A does not have to sell. Can he not, as one of the terms of the selling, require the purchaser to buy something else? What is the objection to limiting what B must also buy to an article used in connection with the chattel sold? The courts have not been troubled with such a case because trading in mules is carried on in such a way as to make stipulations of the sort suggested impracticable. Such conditions and stipulations can only be exacted where the article sold is of special and peculiar value—as is more frequently the case with patented articles. Suppose, then, that A had a valuable collection of paintings: could he sell each article with the stipulation that the purchaser should use only such cleaning and preserving

preparations for the picture as were sold by A? Why not? The only difference in the cases is that now A is in a strong enough position in the market to exact the stipulation.

Where A has a patented article the situation is precisely the same. The patent laws, by giving him the right to prevent anyone else from making the patented article, place A in the unique position of being able to control absolutely the sale of an article of special and peculiar value. He can sell it or not as he pleases. He can prevent anyone else from selling it. Having such an article, A bargains for the sale or license of it as he would any other piece of personal property. Is he, then, debarred from selling it on the best terms possible? Is he barred from saying, "I will not sell unless the purchaser buys something else with it which is not patented"? Is he forbidden to make a bargain that unpatented accessories which are used in connection with the patented article shall be only those made and sold by the licensor or holder of the patent? How can there be any other answers to these questions than an emphatic negative? When A has goods to sell, is it not in the public interest that he should get as much for them as possible? Is he not free to make the best terms possible? If he can require the purchaser to buy other goods, and thus secure a market for the sale of such other goods, in competition with other parties, is not that his privilege? Since when has it been true that this time honored method of trading has become illegal? If such terms are legal, is it not equally legal for the purchaser to require that unpatented accessories used with a patented article sold shall be purchased from the seller? Are the rights of a patentee in this respect less than the rights of the owner of a mule or a picture?

If the stipulation in question makes a legal and enforceable contract at law, then the question arises whether equity will give specific performance of it as between the original parties and as against third parties who take the patented article with notice. This depends upon whether the remedy at law is inadequate. Suppose it is. Suppose, also, the fact that the restrictive covenant is connected with the sale or license of a chattel is no objection to the specific enforcement of the covenant against third parties taking the chattel with notice.[15] Is there any defense to an action of specific performance that the contract, while not illegal in law, is so far unfair, unconscionable or contrary to the interests of the public that equity

[15]Abergarw Brwg. Co. v. Holmes, L. R. [1900] 1 Ch. 188; Francisco v. Smith, 143 N. Y. 488 (1894); Standard Co. v. Methodist Co., 33 App. Div. (N. Y.) 409 (1898); Murphy v. Christian Press Assn., 38 App. Div. (N. Y.) 426 (1899); New York Co. v. Hamilton Co., 83 Hun. (N. Y.) 593 (1895); 28 App. Div. (N. Y.) 411 (1898).

should not give specific performance? Such a defense might exist, especially where the contract was supplementary to a combination occupying a preponderant position in the business, and part of a system of contracts used for the purpose of compelling others to come into the combination or be excluded entirely from the business. It is submitted, however, that no such defense to specific performance existed in the *Dick* case or the *Motion Picture* case.

If, then, the condition or stipulation entered into by the licensee or purchaser of a patented article, that he will not use the same except with unpatented accessories furnished by the licensor or seller is not illegal,—and if it is specifically enforceable in equity as between the parties and as against third parties taking with notice,—what possible objection is there to permitting a construction of the patent act which would permit the holder of a patent to make a license or sale of a patented article subject to the condition or stipulation that it be used only in connection with certain unpatented accessories sold by the licensor, with the result that upon a breach of the stipulation or condition the continued user of the patented article would become an infringement? Perhaps this: That so long as the stipulation is justified under the patent act it confers an absolute statutory right in equity to obtain specific performance in the guise of enjoying an infringement. On the other hand, so long as it is merely a contract of which equity gives specific performance under certain terms and conditions, its enforcement by injunction may be so far limited and controlled that the results will not be unconscionable as between the parties or contrary to the interests of the public. In short, a stipulation which requires specific performance as a matter of right might be regarded as contrary to public policy, when a stipulation which was valid at law between the parties and the specific performance of which was in the control and discretion of a court of equity, might be regarded as valid.

III

What has been said by way of objection to the *Dr. Miles* case and the *Motion Picture Patents* case has been based upon the assumption that there was no objection to a court of equity giving specific performance of restrictions as to the use of chattels even against third parties taking the chattels with notice of the restrictions. This proposition, however, may be open to question. It is only recently that courts have been called upon to give specific performance in such cases. While the justice of so doing in particular instances may be apparent, the courts must face the fact that they are opening up a wide field for the creation of what are in effect property interest

servitudes in chattels. When the covenantee or promisee can say to the buyer of a chattel, "You cannot use what you have bought unless you do so in the following manner," or, "You cannot sell it unless at a certain price," and if this position on the part of the seller can be enforced specifically against any holder of the chattel taking with notice, a servitude has been created in the chattel in favor of the promisee and perhaps in favor of whoever is running the business of the promisee. It may be that the *Dr. Miles* case and the *Motion Picture Patents* case both indicate a reaction against permitting the specific performance of restrictions as to chattels against third parties with notice. Perhaps the undesirable features of having vast numbers of chattels in commerce subject to all manner of property servitudes has been borne in upon the Supreme Court of the United States. Perhaps a general dislike for such servitudes may have been translated by the Court into what appears to the casual reader of the opinions to be a condemnation of the particular restrictions involved.

The following discriminations are suggested:

1. Stipulations and conditions requiring the buyer of a chattel to keep up the price on re-sale, or to buy or use other articles in connection with those sold, are valid between the parties and may be enforced in suits at law for damages.

2. When the articles sold are patented or copyrighted, the license to use them cannot be made subject to such conditions and stipulations so that the failure to observe them will give rise to the statutory action in equity for an infringement.

3. Such restrictive contracts may be specifically enforceable in equity as between the parties.

4. Whether specific performance will be given to the promisee against third parties taking the chattel with notice of the restrictions may be open to debate. Specific performance should not, however, be refused because the contract is illegal as between the parties. It should not be refused because there is anything inimical to the interests of the public in such restrictions as were involved in the *Dr. Miles* and *Motion Picture Patents* cases. It is entirely conceivable, however, that some restrictions might be of such a character that while they were valid at law or even in equity, as between the parties, it would be proper, in the interests of the public, to refuse enforcement of them against third parties, even with notice. If specific performance against third parties is refused in the case of restrictions such as were involved in the *Dr. Miles* and *Motion Picture Patents* cases, it should be on the ground that it is against public policy that any servitudes be created in chattels by the specific performance in equity of restrictions against third parties with notice.