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# VERTICAL RESTRAINTS AFTER *MONSANTO*

*George A. Hay**

## INTRODUCTION

The decision in *Monsanto Co. v. Spray-Rite Service Corp.*[1] represents the Supreme Court's latest effort to articulate the standards governing vertical restraints of trade[2] under the United States antitrust law.[3] It is unlikely that this will be the last time the Court addresses this topic. Notwithstanding the many Supreme Court decisions in this area, several issues remain unresolved. Indeed, *Monsanto* may have created (or resurrected) as many new questions as it answered, a phenomenon characteristic of most prior opinions in this area.

At least part of the reason for this unsettled state is that, from the outset, the Supreme Court has been reluctant to apply a comprehensive analysis to vertical restraints of trade. Rather, in each case it has applied a simple principle or rule of thumb to a discrete aspect of the vertical restraint problem.[4] Because of its piecemeal approach, the Court has failed to appreciate the incompatibility of these various principles. Hence, in each case one problem may have been resolved, but one or more new ones were created.[5]

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1 104 S. Ct. 1464 (1984).

2 Vertical restraints are imposed by a manufacturer on those distributors or retailers that deal with the manufacturer's product. Such restraints can be price restrictions, such as prohibitions against retailers selling the manufacturer's product below a set price, *see, e.g.*, United States v. Colgate & Co., 350 U.S. 300 (1919); or nonprice restrictions, such as prohibitions against retailers selling outside a designated region, *see, e.g.*, White Motor Co. v. United States, 372 U.S. 253 (1963).

Horizontal restraints, on the other hand, are price and nonprice restrictions which are self-imposed by the distributors or retailers. The manufacturer is not a party to the scheme to maintain a horizontal restraint.

3 Vertical restraints are tried under § 1 of the Sherman Act, 15 U.S.C. § 1 (1982), which makes "[e]very contract, combination . . . or conspiracy, in restraint of trade" illegal. Private plaintiffs may recover treble damages for injury resulting from such violations under the Clayton Act, 15 U.S.C. § 15(a) (1982).

4 *See* Baker, *Interconnected Problems of Doctrine and Economics in the Section One Labyrinth: Is* Sylvania *a Way Out?*, 67 VA. L. REV. 1457 (1981). For a discussion of the tendency of courts to eschew systematic analysis in favor of simple rules when dealing with antitrust problems, see Hay, *Pigeonholes in Antitrust*, 29 THE ANTITRUST BULL. 133 (1984).

5 *See* Baker, *supra* note 4, at 1457 ("[T]he resulting rules are a jumble of pieces that simply do not fit together.").

The process is not likely to reach "equilibrium" until the Court abandons its piecemeal approach in favor of a comprehensive analysis of vertical restraints.[6] This is not to argue that there is necessarily a single solution to all vertical restraint questions. Nevertheless, a uniform analysis applied to each question would result in a family of solutions that are doctrinally consistent.

## I
## THE LEGAL RULES OF THUMB

### A. The Court's Early Hostility towards Vertical Restraints: *Dr. Miles*

A brief review of the Court's treatment of vertical restraint cases serves to identify the principles and rules that have emerged over the past eighty years, while illustrating the present disarray to which the Court's piecemeal approach has contributed. The story begins in 1911 with *Dr. Miles Medical Co. v. John D. Park & Sons Co.*[7] Dr. Miles, a pharmaceutical manufacturing company, sought to enforce contractual agreements with wholesale and retail dealers of its products. These agreements prohibited the wholesalers and retailers from selling Dr. Miles's products at prices below those set by Dr. Miles.[8]

The Court invalidated these price restrictions, basing its holding on two principles. The first is that "a general restraint upon alienation is ordinarily invalid."[9] It follows that a manufacturer may

6 This conclusion is shared by many commentators. *See, e.g.*, Baker, *supra* note 4; Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division* (pts. 1 & 2), 74 YALE L.J. 775 (1965), 75 YALE L.J. 373 (1966); Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L. REV. 282 (1975).

7 220 U.S. 373 (1911). For earlier cases applying the Sherman Act to resale price maintenance of goods protected by patent or copyright laws, see Bobbs-Merrill Co. v. Straus, 210 U.S. 339 (1908); Scribner v. Straus, 210 U.S. 352 (1908); John D. Park & Sons Co. v. Hartman, 153 F. 24 (6th Cir. 1907), *cert. dismissed*, 212 U.S. 588 (1908).

8 *Dr. Miles*, 220 U.S. at 378.

9 *Id.* at 404.

This statement, which was later relied upon in United States v. Arnold, Schwinn & Co., 388 U.S. 365, 380 (1967), has been criticized as a misstatement of the law. Handler, *The Twentieth Annual Antitrust Review—1967*, 53 VA. L. REV. 1667, 1684 (1967) (arguing that common law permitted restraints on alienation "under a variety of circumstances"). Furthermore, the importance of this rule can be questioned given that the *Dr. Miles* Court recoguized an exception for patents. 220 U.S. at 400-04.

Under common law, the types of vertical arrangements that were valid if reasonable included exclusive selling agreements, Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899); territorial arrangements, Phillips v. Iola Portland Cement, 125 F. 593 (1903), *cert. denied*, 192 U.S. 606 (1904); restrictions on those to whom the buyer could sell or requirements that the purchaser use the product and not resell it, Chicago Sugar Co. v. American Sugar Ref. Co., 176 F.2d 1 (7th Cir. 1949), *cert. denied*, 338 U.S. 948 (1950); and agreements by the seller of a business not to compete with the buyer, *see* not ordinarily dictate the price at which its goods must be resold once the manufacturer has parted with those goods.[10]

The second principle emerges from the Court's analogy between Dr. Miles's price restrictions and an agreement among deal-

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cases cited in Robinson, *Restraints on Trade and the Orderly Marketing of Goods*, 45 CORNELL L.Q. 254 (1960).

There are also earlier cases which upheld blatant vertical price fixing restraints, e.g., D. Ghirardelli Co. v. Hunsicker, 164 Cal. 355, 128 P. 1041 (1912) (price fixing legitimate means of achieving product differentiation) and some commentators have asserted that until 1908, resale price maintenance was legal. E. SELIGMAN & R. LOVE, PRICE CUTTING AND PRICE MAINTENANCE (1932); Overstreet & Fisher, Resale Price Maintenance and Distributional Efficiency: Some Lessons from the Past, Western Economic Ass'n, Int'l 59th Annual Conference (June 25, 1984). However, the cases cited by these authors, Bobbs-Merrill Co. v. Straus, 210 U.S. 339 (1908); Scribner v. Straus, 210 U.S. 352 (1908); John D. Park & Sons Co. v. Hartman, 153 F. 24 (6th Cir. 1907), *cert. dismissed*, 212 U.S. 588 (1908), may not support this assertion.

Those cases involved the claim that the exemption from antitrust law afforded to patent holders should apply to copyright holders as well. The *John D. Park* court's reasoning indicates that the exemption for patented goods is an exception to the common law rule against vertical price fixing.

> The question . . . is whether the exemption from common-law rules . . . and the provisions of the federal anti-trust act, which has been extended to contracts affecting the sale and resale, the use or the price of articles made under a patent . . . extend also to articles made under a secret process. . . .
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> . . . .
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> . . . It follows therefore that contracts restraining subsequent sales or use of a patented article *which would contravene the common-law rules against monopolies and restraints of trade*, if made in respect of unpatented articles, are valid because of the monopoly granted by the patent.

*John D. Park & Sons Co.*, 153 F. at 26-28 (emphasis added). Nevertheless, the exemption from antitrust law was denied in all three cases, making the illegality of vertical price fixing more certain.

10 The Court's discussion suggests that resale price maintenance would be permissible as part of an otherwise legitimate consignment arrangement. This is because in a consignment arrangement, the manufacturer retains title and thus there is no "alienation." While in some consignment arrangements, such as a real estate listing, it is desirable to permit the original owner to dictate the retail price, the consignment exception is problematical because it provides an incentive to create "sham" consignments to circumvent the rule against restraint upon alienation. A further problem with this exception is that a vertically integrated firm can determine its own retail price, possibly creating an incentive to integrate. Although sham consignment arrangements can be uncovered, integration undertaken to circumvent the rule poses a dilemma because vertical integration itself is not discouraged.

In United States v. General Elec. Co., 272 U.S. 476 (1926), the Court upheld a consignment agreement in which the manufacturer determined prices. The opinion used langnage reflecting the rule against restraint on alienation. The Court determined that the arrangement was one of consignment or agency rather than sale, because title to the products passed directly to the consumer without ever vesting in the agent. *Id.* at 484.

Then in Simpson v. Union Oil Co., 377 U.S. 13 (1964), the Court ruled that a manufacturer may not use a consignment arrangement to avoid § 4 of the Clayton Act. The Court struck down an arrangement seeking to restrict "nominal 'consignees' who are in reality small struggling competitors seeking retail . . . customers." *Id.* at 21. Although the Court did not provide a concrete test for distinguishing between a legitimate consignment and a sham, it was clear that the form of the transaction was not determinative.

ers to set their own minimum prices. The Court observed that a requirement by the manufacturer that all dealers adhere to specified minimum prices is identical in its effect on dealer prices to a horizontal scheme among the dealers to adhere to those prices. The Court reasoned that these two forms of dealer price restrictions should be treated similarly.[11] Because, even in 1911, it was clear that a horizontal agreement among dealers to fix prices would be improper,[12] the Court concluded that Dr. Miles's vertical price restriction should also be illegal.[13]

A major problem with the Court's analogy between Dr. Miles's

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*Id.* at 22-23. The Court attempted to distinguish *General Electric* on the ground that the goods involved in that case were patented. *Id.* at 23-24.

Three years later, in United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967), the Court revived the importance of the transaction's form. The Court stated that a rule of reason would apply to those nonprice restrictions on products over which the manufacturer had "retain[ed] title, dominion, and risk," while per se illegality would apply to restrictions on articles which were sold. At the same time, however, the Court implied that, under *Simpson,* a consignment which fixes prices would meet a stricter standard of validity. *Id.* at 380. It follows that a price fixing consignment may still be invalidated under a per se rule, while a nonprice consignment arrangement is likely to be judged by a rule of reason. The Court found that the net effect of the consignment arrangements was to preserve competition and therefore upheld them. *Id.* at 382. It struck down the nonconsignment arrangements because such restrictions frequently restrict output. *Id.*

Ten years later in Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977), the Court criticized the *Schwinn* decision for reducing the issue to passage of title, and questioned the presumption that competition is harmed when restrictions are incorporated in a sale agreement, but benefitted when those same restrictions are included in a consignment arrangement. By holding that all nonprice restraints are subject to the rule of reason, *id.* at 54, *Sylvania* eliminates the distinction between sale and consignment agreements incorporating nonprice restrictions. However, the Court left open the question of when price restraints which are part of a consignment arrangement will be judged per se illegal.

11 *Dr. Miles,* 220 U.S. at 408 ("The [manufacturer] can fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other.").

12 At that time, horizontal price fixing had not been labelled illegal per se, but there was no doubt about the substantive rule. The Court in Standard Oil Co. v. United States, 221 U.S. 1 (1911), indicated that a "reasonableness defense" was not available for price fixing. *Id.* at 64-65.

13 Although *Dr. Miles* focuses on price fixing, the Court's reasoning suggests a more general rule: A vertical restraint violates the Sherman Act when it produces the same result as an invalid horizontal agreement. This rule makes no distinction between price and nonprice restraints. It follows that vertical nonprice restraints should be treated as harshly as vertical price restrictions. For example, under this rule, territorial restrictions imposed on the dealers by the manufacturer would be invalid because a horizontal agreement among dealers to stay out of each other's territory would violate the Sherman Act.

The question of whether price and nonprice restraints should be treated similarly remains unsettled. The Court on several occasions has rejected the idea of symmetry. *See infra* notes 48-63 and accompanying text. Today there is considerable support for symmetric treatment in the sense of treating both favorably. *See infra* notes 89-92 and accompanying text.

vertical restrictions and a horizontal agreement among the distributors is that it fails to provide a coherent rationale for the manufacturer's interest in enforcing a vertical restraint. *Ceteris paribus*, a dealers' cartel injures the manufacturer, whether price or nonprice restraints are used, because any agreement that permits higher retail margins will normally reduce the total number of units sold and consequently reduce the manufacturer's profit. Vertical restrictions presumably provide a net benefit to the manufacturer, however, because the manufacturer initiates them.[14] Therefore, it cannot be the case that vertical restraints always have precisely the same effect as horizontal restraints.

A tidal wave of subsequent economic literature elaborated upon this distinction.[15] Although dealers will almost always wish to restrict competition among themselves, manufacturers, in general, are better off if their dealers compete vigorously, driving retail margins to the minimum sustainable under competition. The manufacturer will benefit from diminished price rivalry among its dealers only in certain unusual circumstances. In those circumstances, the higher dealer margins must generate some other effect on sales that more than compensates for the sales lost due to higher retail prices.

The *Dr. Miles* Court danced around the edges of this insight, but never fully embraced it.[16] Only many years later, benefitting

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14 Where the dealers have some market power vis-a-vis the manufacturer, the dealers could possibly coerce the manufacturer into instituting vertical restraints. The sweep of the Court's language suggests, however, that it was not limiting its analysis or its legal rules to this special situation. Moreover, subsequent cases suggest that the Court does not generally view the dealers' bargaining strength as superior to that of manufacturers. For example, in Simpson v. Union Oil Co., 377 U.S. 13, 21 (1964), the Court found that dealers were "coercively laced into an arrangement under which their supplier [was] able to impose noncompetitive prices on thousands of persons whose prices otherwise might be competitive." In United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967), the Court found that "[t]he source of the restrictions is the manufacturer. These are not horizontal restraints, in which the actors are distributors with or without the manufacturer's participation." *Id.* at 372. The Court in Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977), also stressed the economic interest of manufacturers in instituting the restraint.

15 *E.g.*, Baker, *supra* note 4; Bork, *supra* note 6; Handler, *supra* note 9; Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing*, 71 GEO. L.J. 1487 (1983); Posner, *supra* note 6; Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards*, 30 LAW & CONTEMP. PROBS. 506 (1965); Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983); Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. L. & ECON. 86 (1960); Letter from Assistant Attorney General William F. Baxter to William K. Daines of the American Retail Federation, *reprinted in* 14 ANTITRUST L. & ECON. REV. No. 4, at 14 (1982).

16 The Court stated:

> [T]he advantage of established retail prices primarily concerns the dealers. The enlarged profits which would result from adherence to the established rates would go to them and not to the [manufacturer]. . . . If there be an advantage to a manufacturer in the maintenance of fixed retail prices, the question remains whether it is one which he is entitled to

from the economic literature that ensued, did the Court begin to develop a reasonably coherent rationale for the manufacturer's interest in vertical restraints,[17] one which would pose a challenge to the similar legal treatment of vertical and horizontal restraints.

B. The *Colgate* Defense and Its Limitations

In *United States v. Colgate & Co.*,[18] the Court appeared to shed some of its hostility towards vertical restraints. The facts of the case do not differ substantially from those in cases where courts have found Sherman Act violations.[19] Nevertheless, the *Colgate* Court found no antitrust violation.[20]

The Court confined itself to the district court's interpretation of the indictment.[21] According to the Court, the district court interpreted the indictment as failing to charge defendants with "selling its products to dealers under agreements which obligated the [dealers] not to resell except at prices fixed by the [manufacturer]."[22] The indictment merely charged that the defendant specified resale prices and refused to sell to dealers failing to maintain those prices.[23] The Court then concluded:

> In the absence of any purpose to create or maintain a monopoly, the [Sherman A]ct does not restrict the long recognized right of trader or manufacturer . . . freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell.[24]

Because of the peculiar circumstances under which the Court

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> secure by agreements restricting the freedom of trade on the part of dealers who own what they sell.

220 U.S. at 407.

17 *See infra* notes 43-68 and accompanying text.

18 250 U.S. 300 (1919).

19 Colgate, a producer of soaps and toilet articles, attempted to maintain a minimum price for its goods by urging dealers to adhere to Colgate's uniform prices and requesting that they inform Colgate of dealers that sold at other prices. Colgate announced that it would not sell to those who did not adhere to its prices and that it would put violators on "suspended lists." Both suspended and new dealers were asked to assure future compliance. *Id.* at 303.

At least one commentator suggests that, under the facts of *Colgate*, the plaintiff would have had no difficulty establishing an agreement if one had been alleged. Baker, *supra* note 4, at 1474-75.

20 250 U.S. at 306-07.

21 " 'We must accept [the district court's] interpretation of the indictments and confine our review to the question of the construction of the statute involved.' " 250 U.S. at 301 (quoting United States v. Carter, 231 U.S. 492, 493 (1913)).

22 *Id.* at 307.

23 *See id.* at 305-06.

24 *Id.* at 307.

decided the case, the scope of *Colgate* has always been unclear.[25] Narrowly construed, *Colgate* merely holds that under section 1 of the Sherman Act a plaintiff must allege an agreement between the manufacturer and dealers. If read more broadly, however, *Colgate* limits the application of the Sherman Act in the area of vertical restraints.[26]

Subsequently, in *United States v. Parke, Davis & Co.*,[27] the Court suggested that limitations imposed by *Colgate* were not very significant.[28] The Court emphasized that the Sherman Act extended to situations in which no formal contractual restraint exists: "[A]n unlawful combination is not just such as arises from a price maintenance *agreement*, express or implied; such a combination is also organized if the producer secures adherence to his suggested prices by means which go beyond his mere declination to sell to a customer who will not observe his announced policy."[29] The dissent, favoring a broader reading of *Colgate,* stated that "the Court has done no less than send to its demise the *Colgate* doctrine . . . ."[30]

Cases that followed continued to restrict *Colgate*.[31] These cases indicate that the agreement required by *Colgate* may be easily

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25 Soon after the *Dr. Miles* decision, legislators began reviving the manufacturer's right to maintain prices. Thus, in the years immediately following *Colgate*, there was little litigation involving resale price maintenance. *See* Baker, *supra* note 4, at 1478-81, nn.76-79 (discussing some post-*Colgate* cases).

California enacted the first "fair trade" law in 1931, followed by a majority of states. Under these laws, manufacturers could enforce contracts whereby dealers agreed not to sell at below a fair price. Nonsigner provisions allowed manufacturers to enforce price contracts even against price cutters who had not agreed, provided that any reseller in the state had agreed.

The Miller-Tydings Act of 1937, ch. 690, 50 Stat. 693, amended § 1 of the Sherman Act to allow these contracts in interstate commerce if valid under state law. However, in 1951, the Supreme Court limited the application of the Act to actual parties to the contract. Schwegmann Bros. v. Calvert Distillers Corp., 341 U.S. 384, 387-90 (1951). The following year, Congress amended § 5(a) of the FTC Act, 15 U.S.C. § 95 (1982), with the McGuire Bill, ch. 745, §§ 1, 2, 66 Stat. 632 (1952), allowing enforcement against both signers and nonsigners distributing goods in interstate commerce. Meanwhile, some states repealed their Fair Trade acts and others repealed nonsigner provisions, thereby curtailing the sweep of the McGuire Bill. *See, e.g.*, CAL. BUS. & PROF. CODE § 16902(a)(1) (West 1983). The McGuire Bill and the Miller-Tydings Act were repealed in 1975. Pub. L. No. 94-145, § 2, 89 Stat. 801 (1975).

26 *See* Baker, *supra* note 4, at 1476-77 (arguing that Court was establishing substantive rights for manufacturer rather than merely reiterating the technical requirement of proper § 1 pleading).

27 362 U.S. 29 (1960).

28 *See id.* at 44.

29 *Id.* at 43.

30 *Id.* at 49 (Harlan, J., dissenting).

31 *See, e.g.*, George W. Warner & Co. v. Black & Decker Mfg. Co., 277 F.2d 787, 790 (2d Cir. 1960) (suggesting that "[t]he Supreme Court has left a narrow channel through which a manufacturer may pass even though the facts would have to be of such Doric simplicity as to be somewhat rare in this day of complex business enterprise").

shown.[32] For example, if a manufacturer enlisted dealers to police a price maintenance scheme,[33] threatened to terminate noncomplying dealers,[34] or offered reinstatement to dealers previously terminated,[35] *Colgate*'s agreement requirement would be satisfied. Consequently, few cases arose in which a manufacturer successfully invoked the *Colgate* defense.[36]

In *Russell Stover Candies, Inc. v. FTC*,[37] the Federal Trade Commission (FTC) sought to end all ambiguity about the limited scope of *Colgate*, and in effect to eliminate the defense altogether.[38] The case raised the question of whether a manufacturer who coerced dealers to sell at the manufacturer's suggested minimum prices by threatening to terminate noncomplying dealers constituted an agreement in violation of the Sherman Act.[39] The FTC concluded that this conduct was illegal. The Commission reconciled its conclusion with *Colgate* by reasoning that *Colgate* only protects a manufacturer's right to initially select its customers.[40]

On appeal, the Eighth Circuit rejected the FTC's narrow interpretation of *Colgate*. The court held that a manufacturer can termi-

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32 In Albrecht v. Herald Co., 390 U.S. 145 (1968), a newspaper company terminated a carrier for overcharging and then hired another carrier to solicit sales away from the terminated carrier. The Court found that the newspaper's conduct was not unilateral and therefore not protected by *Colgate*.

In Cernuto, Inc. v. United Cabinet Corp., 595 F.2d 164 (3d Cir. 1979), the court found an unlawful combination when a manufacturer terminated one dealer at the urging of another. The court ruled that "[w]hen a marketing decision, although ostensibly taken by a manufacturer, is in fact the result of pressure from another customer, such a decision must be scrutinized more closely than solely unilateral action might be." *Id.* at 168.

33 *See* Bowen v. New York News, Inc., 366 F. Supp. 651, 658 (S.D.N.Y. 1973).

34 *See George W. Warner & Co.*, 277 F.2d at 788.

35 *See Albrecht*, 390 U.S. at 148.

36 One approach that succeeded was proof that no coercion was present in the pricing policies. For example, in Enbrecht v. Dairy Queen Co., 203 F. Supp. 714 (D. Kan. 1962), the court relied on testimony by the terminated franchisee that he alone determined his prices despite the manufacturer's suggestions. *Id.* at 719. Similarly, in United States v. O.M. Scott & Sons, Co., 303 F. Supp. 141 (D.D.C. 1969), a manufacturer who preticketed its products was not found to have caused any dealer to change its normal course of business because, even though discounting occurred, no dealers were terminated. *Id.* at 154. The general trend, however, has been to narrow *Colgate* by expanding the term "combination" under § 1 of the Sherman Act. *See* Baker, *supra* note 4, at 1477-83; Comment, *The* Colgate *Doctrine: Its Past and Present*, 12 HOUS. L. REV. 409, 414 (1975).

37 718 F.2d 256 (8th Cir. 1983).

38 Apparently, the case was deliberately structured to test the *Colgate* doctrine. "Petitioner and the Commission agree that the continuing vitality of the doctrine announced in *United States v. Colgate & Co.* is the sole issue on appeal." 718 F.2d at 256-57. A footnote to this passage adds: "It is clear that complaint counsel framed the proof of their case to require a decision dealing squarely with the meaning of the *Colgate* doctrine." *Id.* at 257 n.1.

39 *Id.* at 256-57.

40 *Id.* at 258.

nate, or threaten to terminate, noncomplying dealers, even if the threat of termination induces dealers to adhere to the suggested minimum prices.[41] The court did not, however, specifically state whether an agreement could have been found on the facts, leaving some ambiguity about whether it viewed *Colgate* as going beyond the mere evidentiary requirement to find an agreement and granting a substantive right to the manufacturer to engage in certain forms of vertical restraints. Nevertheless, it is certain that whether *Colgate* is read narrowly or broadly, a tension exists between the *Colgate* doctrine and the judicial hostility towards vertical restraints.[42]

### C. Manufacturer's Motive as a Possible Justification

A further conflict with the principles dictating hostility towards vertical restraints began to emerge in *White Motor Co. v. United States*.[43] The manufacturer, White Motor, restricted the territories within which its distributors or dealers could sell and limited the persons or classes of persons to whom they could sell.[44] The Department of Justice argued that such restaints violated the Sherman Act. This position is consistent with the rationale behind the *Dr. Miles* decision. The challenged restrictions were obviously restraints on alienation; furthermore, a horizontal agreement among the dealers achieving the same territorial restrictions would be per se illegal.[45] Thus, if the *Dr. Miles* test were applied, White Motor's territorial restrictions would violate the Sherman Act. The Supreme Court found, however, that the restrictions were not unlawful per se,[46] with some of the discussion suggesting a willingness to consider the manufacturer's motives for instituting vertical nonprice restraints.[47]

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41 *Id.* at 260.

42 Even the *Russell Stover* court acknowledged the tension between *Colgate* and the judicial hostility towards vertical restraints. *Id.* at 259 n.5.

43 372 U.S. 253 (1963).

44 *Id.* at 255.

45 *Id.* at 266 & n.3. The case also involved price restraints; however, the district court's view that these were per se illegal was affirmed by the Court. *Id.* at 260.

46 In reversing the trial court's summary judgment, the Court stated:

> We conclude that the summary judgment, apart from the price-fixing phase of the case, was improperly employed in this suit. Apart from price fixing, we do not intimate any view on the merits. We only hold that the legality of the territorial and customer limitations should be determined only after a trial.

*Id.* at 264.

47 *See id.* at 256-59. One result, as Justice Clark's dissent suggests, is that the symmetry between the treatment of price restraints and that of nonprice restraints is broken.

> This Court . . . has never held whether there is a difference between market divisions voluntarily undertaken by a manufacturer . . . and those of dealers in a commodity, agreed upon by themselves. . . . [The manufacturer] seems to place some halo around its agreements because they

This apparent retreat from the rigid rules implied by *Dr. Miles* was short-lived. Four years later, in *United States v. Arnold, Schwinn & Co.*,[48] the Court partially restored the restraint on alienation principle. It held that territorial restrictions by the manufacturer were per se violations of the Sherman Act for the portion of Schwinn's business involving sales of the bicycles to dealers. Astonishingly, the Court applied the rule of reason to Schwinn's consignment sales.[49] The Court reasoned that the same territorial restrictions might promote competition when sales are made on consignment.[50] The Court never explained why these restrictions are "so obviously destructive of competition" when the manufacturer parts with title and yet are procompetitive when there is a consignment arrangement.[51]

The Court's rehabilitation of the restraint on alienation principle did not last long. The Court in *Continental T.V., Inc. v. GTE Sylvania, Inc.*[52] recognized the irrationality of treating restraints as per se unlawful when the manufacturer parts with title but otherwise subjecting them to the rule of reason.[53] Emphasizing the importance of

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> are vertical. But the intended and actual effect is the same as, if not even more destructive than, a [horizontal] price fixing agreement or any of its *per se* counterparts.

*Id.* at 279 (Clark, J., dissenting).

Clark went on to quote from the portion of the *Dr. Miles* opinion analogizing the effects of manufacturer and dealer imposed restrictions. *Id.* at 282 (Clark, J., dissenting) (quoting *Dr. Miles*, 220 U.S. at 408).

48 388 U.S. 365 (1967).

49
> [W]here a manufacturer *sells* products to his distributor subject to territorial restrictions upon resale, a *per se* violation of the Sherman Act results. . . . Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it. . . . Such restraints are so obviously destructive of competition that their mere existence is enough. If the manufacturer parts with dominion over his product or transfers risk of loss to another, he may not reserve control over its destiny or the conditions of its resale.

*Id.* at 379 (emphasis in original).

50 *Id.* at 379-80. *See* Baker, *supra* note 4, at 1461.

51 *See* R. POSNER & F. EASTERBROOK, ANTITRUST 246 (2d ed. 1981) (noting this apparent anomaly).

52 433 U.S. 36 (1977).

53 The *Sylvania* Court was quite critical of *Schwinn*'s reliance on the restraint on alienation principle.

> The [*Schwinn*] Court also stated that to impose vertical restrictions in sale transactions would "violate the ancient rule against restraints on alienation." . . . This isolated reference has provoked sharp criticism from virtually all of the commentators on the decision, most of whom have regarded the Court's apparent reliance on the "ancient rule" as both a misreading of legal history and a perversion of antitrust analysis. . . . We quite agree with MR. JUSTICE STEWART's dissenting comment in *Schwinn* that "the state of the common law 400 or even 100 years ago is irrelevant ot the issue before us: the effect of the antitrust laws upon vertical distributional restraints in the American economy today."

*Id.* at 53 n.21.

using economic analysis rather than "formalistic line drawing," the Court declared that all vertical nonprice restraints should be analyzed by the rule of reason.[54]

The *Sylvania* Court also went further than previous opinions in explaining why, under certain circumstances, a manufacturer might benefit from limited competition among its dealers.[55] For instance, manufacturers can use restrictions to induce retailers to provide services or repair facilities, and engage in promotional activities.[56] Although these restraints diminish intrabrand competition, they increase interbrand competition to the extent that such restraints enhance the attractiveness of the manufacturer's product.[57]

However, in utilizing its analysis of the manufacturer's motive to provide a rationale for subjecting all nonprice vertical restraints to the rule of reason, the Court failed to take this analysis of the manufacturer's motives to what some economists argue is its logical conclusion. These critics maintain that if the manufacturer freely and independently implements the restraints, they should be presumed to promote interbrand competition because the restraints improve the attractiveness of the product more than would lower prices resulting from intrabrand competition.[58] The obvious conclusion to this argument is that vertical restraints should never be held to violate the antitrust laws. Instead, the Court applied a rule of reason analysis to all vertical nonprice restraints.[59] Unless the Court intended that the rule of reason analysis would be used sim-

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54 Although the restraint in *Sylvania* was merely a location clause, the Court clearly intended to require rule of reason analysis for all nonprice restraints. The Court claimed that this was the rule before *Schwinn*. *Id.* at 57. Perhaps the Court was referring to the four years between *White Motor* and *Schwinn*.

55 433 U.S. at 54-55.

56 *See id.* at 55.

57 *See id.* at 54 ("Vertical restrictions reduce intrabrand competition. . . . Vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. These 'redeeming virtues' are implicit in every decision sustaining vertical restrictions under the rule of reason.").

58 *See, e.g.*, Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 22-23 (1981) (arguing that courts should adopt per se legality standard for vertical restraints).

59 433 U.S. at 57-59.

The Court provided no guidelines in applying this rule of reason analysis. *See* Posner, *supra* note 59, at 14-18; Pitofsky, *The* Sylvania *Case: Antitrust Analysis of Nonprice Vertical Restrictions*, 78 COLUM. L. REV. 1 (1978).

On remand, the Ninth Circuit stated that the rule of reason analysis requires an inquiry into whether the restraint promotes or suppresses competition. Continental T.V., Inc. v. GTE Sylvania, Inc., 694 F.2d 1132, 1136 (9th Cir. 1982). Other courts have applied the rule of reason differently. *See, e.g.*, Eiberger v. Sony Corp., 622 F.2d 1068, 1076 (2d Cir. 1980) (weighing enhancement of interbrand competition against loss of intrabrand competition); H & B Equip. Co. v. International Harvester Co., 577 F.2d 239, 242 (5th Cir. 1978) (requiring plaintiff to show defendant has achieved monopoly or that there is probability of monopolization); Harold Friedman, Inc. v. Thorofare Mkts., ply to screen out situations where the restraint is actually imposed on the manufacturer by the dealers or where the restraint results from or is intended to facilitate collusion among manufacturers, it appears as though the Court was concerned that the restraint might actually diminish interbrand competition even where the restraint is freely and independently chosen by the manufacturer.[60]

In addition, the Court focused its challenge of the *Dr. Miles* doctrine on nonprice restraints only.[61] However, "free rider"[62] concerns that motivate manufacturers to impose nonprice restraints might lead them to institute resale price maintenance as well.[63] Therefore, if the Court had actually based its decision entirely on an appreciation of the manufacturer's motives for implementing a restraint, it is unlikely that the Court would have drawn such a sharp distinction between price and nonprice restraints.

### D. Analytic and Evidentiary Problems Created by *Sylvania*

The effect of *Sylvania* was to eliminate the unsatisfactory distinction between nonprice restraints where manufacturers part with title and the identical nonprice restraints incorporated into consignment arrangements, but in the process to introduce two new distinctions. The first distinction is between price and nonprice restraints; the second is between nonprice restraints that promote interbrand competition and those that restrict it. Furthermore, *Sylvania* failed to justify or eliminate two previously existing distinctions. The first is between price restraints resulting from an express agreement between the manufacturer and the dealers and those resulting from the manufacturer's refusal to sell to dealers who fail to adhere to the manufacturer's suggested price. The second is between price restraints contained in an agreement whereby the manufacturer parts

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Inc., 587 F.2d 127, 143 (3d Cir. 1978) (instructing court below to consider purpose of restraint, structure of industry, and strength of competition).

60 Another interpretation is that the Court wants to balance the loss in intrabrand competition against the gain in interbrand competition. As Frank Easterbrook points out, the idea that there is a balance to be struck lacks analytical support. If the restraint makes the product more attractive to consumers than competing products (i.e., interbrand competition is enhanced), consumers are by definition better off, and even though intrabrand competition has been altered, no adverse consequences to consumers result from that alteration. Hence, there is no harm to be weighed against the gain. *See* Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J. 135 (1984).

61 433 U.S. at 51 n.18.

62 *See infra* text accompanying notes 76-77.

63 The opinion contains only a passing effort to justify the disparate treatment of price and nonprice vertical restraints. Although the Court recognized that "commentators have argued that the manufacturer's motivation for imposing vertical price restrictions may be the same as for nonprice restrictions," the Court maintained that there are "siguificant differences that could easily justify different treatment." 433 U.S. at 51 n.18. *See* Posner, *supra* note 6, at 292-93.

with title and those incorporated into consignment agreements.[64]

In retrospect, it is easy to see how the Court's preference for simple rules of thumb rather than a comprehensive economic analysis could have produced such complex distinctions. Nevertheless, the end result is unfortunate. To the extent these distinctions are analytically unsupportable, they will undoubtedly generate inconsistent, and sometimes incorrect, results from the perspective of the theorist. Some legitimate behavior will be penalized while some anticompetitive conduct will escape condemnation.[65]

This result is an inevitable consequence of every "bright line" rule. It is often tolerated because the increased predictability and reduced administrative costs that result from the rule more than compensate for the costs of under or over inclusion.[66] In the area of vertical restraints, however, simple rules of thumb do not necessarily reduce administrative costs. In part, this is because the various "pigeonholes" the Court has suggested as a way to sort out lawful and unlawful conduct have not been particularly well-defined from an evidentiary standpoint.

For example, the disparate treatment of price and nonprice restraints requires courts to classify the restraints as price or nonprice. Although this distinction appears simple, it has proven more difficult than originally anticipated. The problem is exacerbated because there is an incentive for plaintiffs to argue that facially nonprice restrictions are designed to control the retail price and should therefore be categorized as price restraints. Similarly, it is exceedingly difficult for a court to determine whether a diminution in price cutting stems from an agreement between the manufacturer and the dealers or is merely the result of a manufacturer exercising its *Colgate* rights. Consequently, the Court's bright line rules regarding vertical restraints have decreased the predictability of outcomes and increased administrative costs by creating confusing evidentiary requirements. The Court in *Monsanto Co. v. Spray-Rite Service Corp.*[67] focused on these evidentiary problems.[68]

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64 Courts must also distinguish between vertical nonprice restraints, imposed by the manufacturer on the dealers, and horizontal nonprice restraints, initiated by the dealers themselves, since the latter are per se unlawful. *See* Baker, *supra* note 4, at 1488-1515 (discussing this distinction).

65 As a result, business decisionmakers will choose safer, although probably less efficient, behavior. For instance, manufacturers may opt to consign the product to distributors rather than sell outright, or may impose exclusive territories in lieu of minimum resale prices.

66 The per se rule for horizontal price fixing is an example of a preferable bright line rule.

67 104 S. Ct. 1464 (1984).

68 The Solicitor General and several other amici attempted to raise the issue of whether vertical price fixing agreements should be per se illegal. The Court declined

E. *Monsanto Co. v. Spray-Rite Service Corp.*—Clarification or Further Confusion?

Spray-Rite was a wholesale distributor of agricultural chemicals including herbicides manufactured by Monsanto. After Monsanto terminated Spray-Rite's distributorship, Spray-Rite brought suit against Monsanto under section 1 of the Sherman Act. Spray-Rite alleged that Monsanto conspired with some of its distributors to fix the prices of Monsanto's products and that Monsanto had terminated Spray-Rite in furtherance of that conspiracy.[69]

The district court instructed the jury that Monsanto's conduct was per se unlawful if it was in furtherance of a price fixing conspiracy. Spray-Rite produced evidence that before the termination, other distributors had complained that Spray-Rite was selling Monsanto products below the suggested prices. The jury, answering special interrogatories, found that the termination was pursuant to a vertical price fixing agreement.[70]

On appeal, the Seventh Circuit affirmed the district court's denial of defendant's motion for a directed verdict.[71] The court based its holding on the fact established at trial that Monsanto terminated Spray-Rite in response to or following complaints about the price cutting by other distributors.[72] Therefore, the Seventh Circuit's holding implies that price cutting by a distributor, followed by complaints by other distributors and termination of the price cutting distributor by the manufacturer, would be a sufficient basis for an inference *both* that a vertical price fixing agreement existed and that the distributor's termination was in furtherance of that agreement.

1. *The Criteria for a New Evidentiary Requirement*

Although the Supreme Court affirmed the judgment against Monsanto,[73] it explicitly rejected the Seventh Circuit's standard of

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the invitation to address this question since neither party to the case had argued in the district court or on appeal that the rule of reason should apply to a vertical price fixing conspiracy. *Id.* at 1469 n.7.

69 *Id.* at 1465.

70 *Id.* at 1467.

71 Spray-Rite Serv. Corp. v. Monsanto Co., 684 F.2d 1226, 1233 (7th Cir. 1982).

72 *Id.* at 1238.

73 The Court found "substantial *direct* evidence of agreements to maintain prices." 104 S. Ct. at 1471 (emphasis in original). This evidence consisted of communications between Monsanto and price cutting distributors in which Monsanto threatened to withhold adequate supplies if the price cutting continued. Furthermore, at least one distributor expressly agreed to adhere to Monsanto's suggested price. Given the existence of an agreement, the Court concluded that a jury could reasonably find that Spray-Rite's termination was a result of that agreement since "it is necessary for competing distributors contemplating compliance with suggested prices to know that those who do not comply will be terminated." *Id.* at 1472. In addition, the Court found circumstantial evidence of a direct link between Spray-Rite's price cutting and its termination in that

proof.[74] The Court found that standard to be deficient in two respects. First, it could effectively undermine the manufacturer's right, established in *Sylvania,* to impose nonprice restraints, subject only to the rule of reason.[75] Second, it could vitiate the manufacturer's right established in *Colgate* to refuse to deal with price cutting dealers and to announce this policy to potential dealers.[76]

Problems inherent in the Seventh Circuit's approach may be illustrated in the following scenario. A manufacturer imposes costly nonprice restrictions. A dealer who does not abide by those restrictions, a "free rider," will have lower costs, and consequently will be able to charge lower prices and still make a profit. These lower prices directly threaten dealers who are abiding by the restrictions. As a result, those dealers will complain to the manufacturer. Their complaints will likely focus on the price cutting rather than on the free rider's noncompliance with the nonprice restrictions, because the price cutting threatens them more directly and is more noticeable than the free rider's noncompliance with nonprice restrictions.

Because the free rider is not honoring the nonprice restrictions (presumed to be legitimate), the manufacturer apparently has a valid reason for termination. Yet, if the manufacturer terminates the free rider after the dealers' complaints, the Seventh Circuit's standard allows the jury to infer that a price agreement exists. Therefore, under this standard a manufacturer will be reluctant to terminate a dealer for failing to comply with a legitimate nonprice restraint if the manufacturer receives a price-related complaint concerning that dealer before it initiates the termination process.

Moreover, *Colgate* allows the manufacturer to not deal with, and presumably to terminate dealers, who refuse to comply with the manufacturer's suggested prices whether or not they comply with nonprice restrictions. A manufacturer who combines suggested resale prices with costly nonprice restraints will probably receive complaints from dealers about another dealer's price cutting. However, the mere receipt of complaints which "arise in the normal course of business and do not indicate illegal concerted action"[77] should not cause the manufacturer to forfeit its *Colgate* rights. The Court reasoned that "[t]o bar a manufacturer from acting solely because the information upon which it acts originated as a price complaint

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Monsanto sought agreement at a time when herbicide was in short supply. *Id.* at 1471 n.10.

74 *Id.* at 1468.

75 *Id.* at 1469 n.6.

76 *Id.* at 1470.

77 *Id.* (quoting Roesch, Inc. v. Star Cooler Corp., 671 F.2d 1168, 1172 (8th Cir. 1982), *aff'd on rehearing,* 712 F.2d 1235 (8th Cir. 1983)).

would create an irrational dislocation in the market."[78]

The *Monsanto* Court sought an evidentiary standard that distinguishes a manufacturer's independent action or concerted action on nonprice restrictions from an invalid vertical price fixing agreement.[79] Such a standard is needed to preserve the rules of thumb inherited from prior decisions: price agreements are per se illegal; vertical nonprice agreements are subject to the rule of reason; and a manufacturer has the right, absent a monopoly, to choose with whom it will deal.[80] The Court's opinion fails, however, to offer any specific guidance as to how such a standard should be formulated. Indeed, in discussing its proposed alternative,[81] the Court says nothing about how to distinguish between price and nonprice restraints. Furthermore, the Court's only advice regarding how to distinguish a manufacturer's independent action from a concerted price agreement is given in a brief footnote.[82] In a remarkable admission, the Court acknowledges that making the appropriate distinctions may be difficult in practice and that the distinctions may have no economic significance.[83] Nevertheless, by retaining its rules of thumb, the Court evidently believes that these distinctions are both feasible and appropriate.

### 2. *Problems Created by* Monsanto

The failure of the Court to provide more detailed guidance will undoubtedly create difficulties for lower courts in applying the *Monsanto* decision. This problem is exacerbated by the Court's acknowl-

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78 *Id.*

79 *Id.* at 1469-70.

80 *See id.* at 1470.

81 The Court stressed that there must be evidence that tends to exclude the possibility of independent action by the manufacturer and distributor. That is, there must be "direct or circumstantial evidence that reasonably tends to prove that the manufacturer and others 'had a conscious commitment to a common scheme designed to achieve an unlawful objective.'" *Id.* at 1471 (quoting Edward J. Sweeney & Sons, Inc. v. Texaco, Inc., 637 F.2d 105, 111 (3d Cir. 1980), *cert. denied*, 451 U.S. 911 (1981)).

82 The concept of "a meeting of the minds" or "a common scheme" in a distributor-termination case includes more than a showing that the distributor conformed to the suggested price. It means as well that evidence must be presented both that the distributor communicated its acquiescence or agreement, and that this was sought by the manufacturer.

*Id.* at 1471 n.9.

83 While these distinctions in theory are reasonably clear, often they are difficult to apply in practice. In *Sylvania* we emphasized that the legality of arguably anticompetitive conduct should be judged primarily by its "market impact.". . . But the economic effect of all of the conduct described above—unilateral and concerted vertical price-setting, 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.

*Id.* at 1470.

edgment that the economic effects of price and nonprice restrictions are often indistinguishable, as are those of a manufacturer's individual actions and concerted actions. Otherwise, an effect-oriented analysis might have provided a suitable basis for distinction. Under such analysis, a system of exclusive retail territories would be per se unlawful because it would produce the same effect as a retail price maintenance scheme; that is, it would insulate the dealers from intrabrand price competition. However, the Court's insistence on distinguishing between price and nonprice restraints,[84] despite their identical economic effects, precludes such an approach.

As a result, the price-nonprice distinction seems to be an exercise in semantics. A manufacturer may, subject to the rule of reason, implement nonprice restraints for the purpose, and with the effect, of eliminating intrabrand price competition.[85] The manufacturer who attempts to accomplish the same result by setting retail prices directly, however, is violating the Sherman Act per se. Hence the jury's characterization of the restraint as price or nonprice determines the manufacturer's fate. Unfortunately, the Court provides no guidelines as to how this labeling should be done.

Moreover, the *Monsanto* Court's revitalization of the *Colgate* doctrine heightens the importance of this characterization. Most facially nonprice restraints, such as exclusive territories or areas of primary responsibility with a profit passover agreement, will require contractual intercourse between the manufacturer and its dealers. Consequently, the plaintiff will have little difficulty establishing the existence of an agreement between manufacturer and dealers. In the face of an agreement, the manufacturer cannot raise the *Colgate* defense that it was taking unilateral action. Therefore, the plaintiff will focus on these restraints and seek to characterize them as price agreements.

In most other respects, the defendant's position is strengthened by the *Monsanto* opinion. This is particularly true as regards the defendant's use of the *Colgate* doctrine to resist the inference of the price agreement from circumstantial evidence. Indeed, the impact of the *Monsanto* Court's reaffirmation of *Colgate,* combined with its endorsement of *Sylvania*'s price-nonprice distinction may be to breathe more life into *Colgate* than it had even in 1918. This occurs because, in the Court's view, situations where dealers are subject to costly nonprice restraints are conducive to dealer complaints about price cutting even without any obligation or pressure from the manufacturer to do so. Therefore, the Court's argument concludes,

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84 *Id.*

85 This is because eliminating price competition will have some additional impact that will promote sales of the product. *See supra* notes 44-47 and accompanying text.

dealer complaints alone do not create an inference that a price agreement exists.

In addition, the Court's approach reduces the relevance of dealer termination in establishing the existence of a price agreement where nonprice restraints exist. The termination will instead be attributed to the manufacturer's enforcement of the nonprice restraints absent evidence to the contrary. Alternatively, when the dealer complied with every nonprice obligation, the termination may be attributed to the manufacturer's legitimate refusal to deal with price cutting dealers.

Finally, the Court's requirement that evidence be presented "both that the distributor communicated its acquiescence or agreement, and that this was sought by the manufacturer"[86] also increases a plaintiff's burden in establishing a price agreement. Although the Court did not define its terms, this remark suggests that something close to a formal offer and acceptance is necessary, and that the distributor's mere adherence to the suggested price is not an adequate acceptance. Thus, a plaintiff must show more than that the threat of termination induced a distributor (silently) to comply in order to establish that a price agreement existed between the manufacturer and the distributor.

The underlying rationale behind this requirement is not immediately apparent. The contract, combination, or conspiracy language of the Sherman Act does not dictate this result. The Court would not have strained common usage or precedent if it had found that a manufacturer's refusal to deal with distributors or its threat of such action resulting in distributors' compliance with announced policy constituted concerted action.[87] Similarly, economic analysis cannot explain this result because the economic effect of the distributors' compliance is identical to that of a formal agreement. Rather, the *Monsanto* Court seems to confer an elevated independent status for the manufacturer's right to refuse to deal, despite the analytical and practical difficulties created by such an evidentiary requirement.[88]

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86 104 S. Ct. at 1471 n.9.

87 *See* Baker, *supra* note 4, at 1474; *see also* United States v. Parke, Davis & Co., 362 U.S. 29, 49 (1960) (Harlan, J., dissenting).

Precedent for allowing compliance by dealers to establish that a tacit agreement exists is found in Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968). In that case the Supreme Court held: "In any event each petitioner can clearly charge a combination between [the manufacturer] and himself, as of the day he unwillingly complied with the restrictive franchise agreements, . . . or between [the manufacturer] and other franchise dealers, whose acquiescence in [the manufacturer's] firmly enforced restraint was induced by 'the communicated danger of termination.' " *Id.* at 142 (quoting United States v. Arnold, Schwinn & Co., 388 U.S. 365, 372 (1967)).

88 Joe Sims has captured nicely the practical implications of *Monsanto*:

## II
## Proposals For a New Approach

The theoretical inconsistencies and the evidentiary complications inherent in the current matrix of rules and principles governing vertical restraints necessitate an alternative approach. Such an approach should be based on a comprehensive analysis of the entire problem of vertical restraints, rather than on the piecemeal approach that the Court has employed thus far.

### A. Presumed Legality—The Appeal and the Resistance

The simplest solution would be to presume the legality of all vertical restraints, except those that the dealers' collective action imposes on the manufacturer and those that facilitate agreement among otherwise competing manufacturers.[89] This would eliminate the need for the many distinctions that have been the source of litigation and the focus of academic scorn over the past seventy years. The price-nonprice distinction, the difference between concerted action and the manufacturer's independent refusal to deal, and the question of whether an agency agreement is legitimate or merely a sham, would all become irrelevant. In addition, a presumption that vertical restraints were not anticompetitive would dispense with the need to inquire into the competitive effect of the restraints.

The advantages of making vertical restrictions effectively per se lawful go beyond administrative simplicity. This approach would accord with the general economic intuition regarding manufacturer-imposed restraints that forms the basis for most of the criticism of *Dr. Miles* and its progeny.[90] Proponents of this theory argue that a manufacturer will not choose to impose vertical restraints that limit price competition among the dealers unless, in the manufacturer's

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> It's ok for a manufacturer to announce a suggested price, and to inform the world that it will cut off anyone who doesn't comply, and it's ok for a distributor to comply with the suggested price, and it's ok for the manufacturer to cut off any distributor that does not comply. But it's a per se violation, subject to mandatory treble damages, for a manufacturer to "threaten" to cut off a distributor, if the distributor tells the manufacturer that it will conform with the suggested prices.

Legal Times, Apr. 16, 1984, at 14, col. 3.

89 In theory, neither really represents an exception since in each case there is a horizontal agreement and the normal rules governing such agreements would apply. However, when parallel vertical restraints are imposed, it can be argued that to require the plaintiff to prove the existence of a horizontal agreement, such as an agreement to adopt the restraints or a price agreement facilitated by vertical restraints, is unnecessarily burdensome especially because, frequently, there is no formal agreement, but merely a tacit or implicit agreement of the kind often found in a tight oligopoly. But this concern, even if legitimate, would not justify the blanket prohibition of vertical price restraints.

90 *See* Telser, *supra* note 15.

view, the restraints induce dealers to behave in such a way that the product is made more attractive to the consumer than it would be under vigorous intrabrand price competition. The manufacturer benefits only if consumers view the product more favorably with the restraints than without them.

This intuition is perhaps crude, but very powerful. Taken at face value, it argues that consumers as a group cannot be harmed by vertical restraints.[91] Moreover, this line of reasoning explains why manufacturer-imposed restrictions and dealer cartels do not have precisely the same impact on consumers. Dealers want to avoid intrabrand price competition, whether or not their actions are likely to raise the overall demand for the product. If dealers avoid competition among themselves, they capture a larger percentage of the profits even though the total profit pie shrinks. Therefore, while it is possible that a dealer cartel will lead to nonprice activity that improves the demand for the product, this is certainly not a necessary result, and probably a highly unlikely one.[92] Manufacturers, however, will impose vertical restraints only when such restraints would increase demand for the product more than price competition among dealers. In sum, manufacturers should not be prevented from instituting vertical restraints because the manufacturers' interests in this area coincide with those of consumers.

However powerful and analytically appealing this approach appears, it does not yet command a consensus. Doctrinal inertia is the most obvious of several possible explanations for the resistence to the approach. For seventy years courts have consistently declared vertical price restraints pernicious. Thus, they find it difficult to confront the possibility that this view may have no validity. As a result, courts tend to presume that a solid basis for this approach exists, despite their difficulty in articulating it. Another possible explanation for the judicial hostility towards vertical restraints is the doctrine of stare decisis. Nevertheless this principle has not prevented the Court from discarding unsatisfactory approaches to aspects of vertical restraints. For example, stare decisis did not prevent the *Sylvania* Court from rejecting *Schwinn*'s hostility toward

91 Dealer-imposed restraints or restraints that facilitate horizontal collusion among manufacturers are exceptions. However, one commentator argues that these exceptions will rarely be encountered. Easterbrook, *Vertical Arrangements and the Rule of Reason,* 53 ANTITRUST L.J. 135, 141-42 (1984).

92 Even if it is theoretically possible that a horizontal agreement among dealers would promote interbrand competition, it can be argued that dealers' motives are so inherently untrustworthy tbat a per se prohibition is warranted. *See* R. POSNER & F. EASTERBROOK, *supra* note 51, at 247-49 (discussing possibility that horizontal agreements among dealers would increase interbrand competition in connection with United States v. Sealy, 388 U.S. 350 (1967)).

nonprice restrictions.[93]

Some commentators that argue against the presumed legality of manufacturer-imposed restrictions tentatively accept the economic tenet that vertical restraints can enhance interbrand competition. Nevertheless, they argue that manufacturers do not always behave rationally. A manufacturer may impose vertical restraints even if they make the product less attractive to consumers and reduce interbrand competition. This not only harms consumers, but it harms the manufacturer as well. This is especially likely to be the case with vertical price restraints.

Robert Steiner most clearly articulates this "mistake" theory.[94] Steiner argues that vertical restraints may assist the manufacturer in the early years of the product's life cycle. Nonprice restraints that induce dealer promotional efforts may help create a favorable image for the product. But in Steiner's view, many manufacturers continue to impose the restraints longer than necessary. These manufacturers would benefit if discount retailers marketed the product, because the product has established an image that no longer depends on "full-service" retailers, or other dealer promotional efforts. However, manufacturers, according to Steiner, often fail to realize when their product has reached the point in its life cycle where vertical restraints become detrimental.

While it would be foolish to argue that manufacturers never make mistakes of the kind articulated by Steiner, if these were the only circumstances under which vertical restraints could have an adverse impact, the policy implications would be limited. Unless big mistakes by manufacturers are the rule rather than the exception, per se illegality for some or all forms of vertical restraints would be unwarranted, since it would prevent the "correct" manufacturer from implementing the most efficient policy. An intermediate policy in which courts attempt to determine when the restraint is, in fact, mistaken would be sensible only if one has confidence that courts will be generally accurate (more accurate than the manufacturer) in assessing when elimination of vertical restraints would improve competition.[95]

Other objections to presumptive legality come from commenta-

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93 *See supra* notes 44-63 and accompanying text.

94 Steiner, *Vertical Restraints and Economic Efficiency*, FTC BUREAU OF ECON. WORKING PAPER, No. 66 (June 1982). For a summary and discussion of Steiner's model as well as an excellent summary of all the economic literature dealing with resale price maintenance, see T. Overstreet, Jr., Resale Price Maintenance: Economic Theories and Empirical Evidence (FTC Bureau of Economics Staff Report, Nov. 1983).

95 *See* T. Overstreet, Jr., *supra* note 94, at 28-30. Moreover, this is not a sufficient reason to abandon the rule of presumed legality because doing so would increase uncertainty and raise administrative costs. *See* Easterbrook, *supra* note 91, at 157-58.

tors that reject the proposition that what benefits the manufacturer necessarily benefits the consumer.[96] These commentators also concede that there are circumstances in which vertical restraints, perhaps even resale price maintenance, may induce dealer services that are critical in creating or expanding product demand.[97] However, they observe that many products that were sold under fair trade and many products that are now the focus of manufacturers' efforts to restrict intrabrand price competition seem not to require extensive dealer efforts to educate consumers or to provide other services that are capable of being undermined by free-riders. Hence a manufacturer's efforts to insulate dealers from price competition are seen as an attempt to differentiate its product from other similar products, by inducing high-margin retailers to carry its product, and thereby create a quality image, or by inducing dealers to engage in other forms of nonprice marketing efforts that will not benefit consumers, in part because it is likely that such efforts will merely offset similar efforts by dealers of competing products.[98]

In response, one could argue that the possibility of quality certification by retailers creates an incentive for the manufacturer to produce quality merchandise. Even where the high priced item is indistinguishable, apart from its label, from discount merchandise, the imprimatur of the high priced retail establishments may increase consumer utility by assuring the quality. Furthermore, the notion that creating a favorable image for a product in order to increase demand does not benefit consumers is based on a value judgment that not all economists share. Finally, the argument that promotional activities by dealers of competing manufacturers are largely offsetting and therefore wasteful is incomplete without an explanation of why a low-priced, no-frills product does not capture the bulk of the demand.

Nonetheless, while subsequent discussion and research may alter some economists' objections to vertical restraints, it is likely to eliminate the possibility, as a matter of economic theory, that vertical restraints can produce an anticompetitive effect. Moreover, as the survey by Overstreet shows, the empirical research that has been

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96 *See, e.g.*, Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983); *see also* Overstreet & Fisher, Resale Price Maintenance and Distributional Efficiency: Some Lessons from the Past, (paper delivered at Western Economics Assoc., Int'l, 59th Annual Conf., June 25, 1984; forthcoming in CONTEMPORARY POLICY ISSUES) (summarizing other objections to vertical restraints).

97 *See* Scherer, *supra* note 96, at 692-94 (discussing such circumstances).

98 Levi Straus' efforts to maintain the price of blue jeans is put forward as a classic example of a situation in which the dealer services argument is not relevant. *See* T. Overstreet, Jr., *supra* note 94, at 120-22. For a discussion of the quality certification explanation for resale price maintenance, see Marvel and McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346 (1984).

done, while subject to severe methodological criticism, similarly fails to support the proposition that vertical restraints are incapable of producing anticompetitive results.[99]

B. Replacing Per Se Rules with a Rule of Reason

The argument for presumptive or per se legality of vertical restraints loses some persuasiveness given the lack of consensus on their possible impact. Accordingly, it is appropriate to consider alternative approaches that would improve upon the status quo, while avoiding the major objections to per se legality. One alternative is to apply the rule of reason to all vertical restraints. This approach is consistent with the spirit of the *Sylvania* decision.[100] Furthermore, it would avoid a difficult evidentiary requirement arising from the *Monsanto* opinion: the need to distinguish between price and nonprice restraints.

Under the rule of reason analysis, the *Colgate* issue would still be present,[101] but would no longer play such a critical role in determining the manufacturer's liability. Indeed, the *Colgate* doctrine could be eliminated as an antitrust principle. The standard for establishing concerted action would then be similar to the standard used in cases involving horizontal restraints. In particular, when a manufacturer successfully coerces dealers to adhere to minimum prices, a court would usually find that this constituted an agreement. In practice, the *Colgate* defense of unilateral action would rarely succeed, and the analysis would focus on the restraint's effect on competition.

Unfortunately, the *Sylvania* Court offered no guidance as to how a court should conduct a rule of reason inquiry into vertical restraints.[102] The *Sylvania* Court probably did not intend that a lower

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99 T. Overstreet, Jr., *supra* note 94, at 106-60. However, much of the empirical research involves the period when resale price maintenance was protected by state fair trade laws. Those laws added the state's enforcement power to that of the manufacturer. This factor would not be present if the prohibitions on vertical restraints are relaxed. In addition, much fair trade stemmed from the collective activity of dealers, rather than manufacturers. Restraints that result from dealer coercion, however, represent an exception to per se legality. *See supra* note 89 and accompanying text. Thus, these circumstances diminish the relevance of this empirical study to the present policy question.

100 This approach extends *Sylvania* by applying a rule of reason to price as well as nonprice restraints. *See supra* notes 52-60 and accompanying text.

101 Nonprice restraints such as exclusive territories are likely to involve sufficient formal interaction that the plaintiff will have no difficulty proving an agreement. Hence the *Colgate* defense of unilateral action will not be available.

102 *See* Pitofsky, *supra* note 60, at 34.

> There is no existing analytical framework for applying a rule of reason generally, and certainly none for applying it to non-price vertical restraints. The technique of the *Sylvania* majority—quoting a long list of

court perform a detailed analysis of the restraint's competitive impact. Courts have generally resisted that kind of full-scale inquiry, favoring rules of thumb or other specific guidelines.[103] Furthermore, rules of thumb were pervasive in vertical restraint cases prior to *Sylvania*.[104]

A particular source of confusion is the *Sylvania* Court's instruction to balance the loss of intrabrand competition against the gain in interbrand competition. As Frank Easterbrook points out,[105] the notion that there is a tradeoff to be measured is a false one. If the vertical restraint works for the manufacturer in the way suggested by the theory, the product is made more attractive to consumers (in the aggregate) despite the possible higher retail price. But if this is so, it is meaningless to speak of a reduction in intrabrand competition, since the ones whose interests are supposed to matter, the consumers, are better off. The only real question, therefore, is whether the restraint works in the suggested way, i.e. whether consumers are in fact better off. The Court is silent on how the trier of fact is supposed to decide this issue, and a review of the relevant economic literature hardly makes one optimistic about the feasibility of such an empirical inquiry.

### C. A Structural Analysis: Injecting Economic Reality into Legal Rules

There exists an alternative approach that avoids a full scale economic inquiry without immunizing all vertical restraints: a structural analysis. The goal of such an analysis is not to assess the actual impact of a particular restraint, but to determine from the nature of the restraint and from industry characteristics whether this type of restraint is likely to have an adverse impact on competition. The inquiry is similar in spirit to analysis of mergers under section 7 of the Clayton Act.[106]

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> factors without any indication of priority or weight to be accorded each factor—unfortunately is standard operating procedure.

*Id. See also supra* text accompanying notes 53-68.

The approach mandated by *Sylvania* might have been intended merely to distinguish individual manufacturer-imposed restraints from those resulting from dealer coercion and restraints resulting from collusion among manufacturers. This analysis is equivalent to the policy of presumptive legality for truly vertical restraints. As suggested earlier, this approach accords with basic economic theory. Nevertheless, such an approach is resisted by those perceiving a potential evil in all vertical restraints, even in those resulting from individual manufacturer-imposed price restrictions.

103 *See* Hay, *supra* note 4, at 133 (discussing such rules of thumb).

104 *See supra* text accompanying notes 7-52.

105 *See* Easterbrook, *supra* note 91, at 155-56.

106 15 U.S.C. § 18 (1982). Section 7 is generally characterized as mandating an incipiency standard. *See* Brown Shoe Co. v. United States, 370 U.S. 294, 317 (1961) ("[I]t is apparent that a keystone [of § 7] was its provision of authority for arresting mergers at

A structural analysis requires that a court examine the characteristics of the industry involved. The manufacturer's market share, along with the level of concentration in the industry, are important characteristics.[107] For example, if the firm imposing the restraint has little market power and if the industry is vigorously competitive, then it is difficult for the restraint, however pernicious in theory, to have any anticompetitive impact of consequence. The consumer has an array of alternatives; if the restraint does not make the manufacturer's product a better value in the consumer's mind, the restraint will cause a reduction in the manufacturer's market share. This prospect should deter the manufacturer from initiating the restraint; if it does not, the adverse consequences to consumers would be de minimis.

This structural screening process should satisfy advocates of the mistake theory[108] along with those who believe that manufacturers can use vertical restraints to enhance their market power or to benefit from their existing market strength.[109] The basic disadvantage of the method is that the economic intuition regarding vertical

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a time when the trend to a lessening of competition . . . was still in its incipiency."). Because § 7 is concerned with the likelihood rather than the actuality of an anticompetitive effect, the type of analysis used in merger situations is arguably inappropriate in § 1 Sherman Act cases, such that, except for per se offenses, the plaintiff must establish that the restraint has an anticompetitive effect. However, the inquiry discussed here is not dissimilar to that used in other Sherman Act issues, such as tie-in cases, where the inquiry focuses on certain structural features, such as the degree of market power, and avoids any real inquiry into the actual competitive effect.

107 Concentration is not, however, the only structural indicator of the presence or absence of competitive pressure. Other structural features can negate or exacerbate the effect of concentration. Although these other features could be included in the analysis, it would become more complicated. *See* Hay, *Oligopoly, Shared Monopoly, and Antitrust Law,* 67 CORNELL L. REV. 439, 447-57 (1982) (discussing other structural features influencing competition).

Fisher and Overstreet suggest having the legality of resale price maintenance efforts by a single manufacturer depend on whether the practice is prevalent in the industry. Overstreet & Fisher, *supra* note 96, at 17. The more common the practice, they point out, the greater the risk that it will facilitate collusion among manufacturers or lead to other anticompetitive effects. Hence resale price maintenance would be presumed not to be anticompetitive where the practice is not prevalent in the industry.

While the authors may be correct in linking the anticompetitive potential to the prevalence of the practice, their policy conclusions are problematic. They make the lawfulness of one firm's actions depend on other firms' behavior. Moreover, there may be a perceived unfairness if the rule immunizes the first firms to institute resale price maintenance. Fisher and Overstreet's suggestions are more feasible if the case is brought under § 5 of the FTC Act, which does not allow treble damages, seeking an industry wide cease-and-desist order. *See also* Easterbrook, *supra* note 58, at 158-67 (discussing market power and prevalence of use along with other possible filters).

108 *See supra* text accompanying notes 94-95.

109 Those who believe that the effect of some vertical restraints is to trick the consumer into paying more for the product than its intrinsic value may not be entirely satisfied with this structural screen. They might view the restraint as an attempt to siguificantly increase market power regardless of the initial structural conditions.

restraints, i.e. that manufacturers have an incentive to institute vertical restraints only when they improve the attractiveness of the manufacturer's product, extends even to a manufacturer who is a complete monopolist, since by making its product more attractive to consumers, the monopolist shifts the demand curve out. Therefore, although structural screening minimizes the risk of allowing a firm with market power to engage in vertical restraints that have an anticompetitive effect, some benefits to consumers will be lost when the screen prevents firms with market power from implementing beneficial restraints.[110]

The magnitude of this loss depends largely on how narrowly the market power criterion is defined. The spirit of the structural inquiry would appear to suggest a definition of market power that would be satisfied only in situations approximating monopoly (in the traditional Sherman Act sense) or reasonably tight oligopoly. Unfortunately, in other situations where a structural screen has been used, e.g., tie-in cases, the definition of market power that is employed seems often to be satisfied by any firm with a differentiated product regardless of the intensity of competition with rival producers of similar products. Such a narrow criterion would frustrate the primary purpose of a structural screen, especially since vertical restraints are most likely to be found in markets where manufacturers' products are differentiated from one another, or where the purpose of the restraint is precisely to accomplish such differentiation by offering the consumer a superior alternative or greater confidence in the performance characteristics of an existing alternative.

Another possible approach to vertical restraints would be to examine briefly the manufacturer's reasons for implementing the restraint. For example, a court might examine the nature of the product and the manufacturer's distribution system to see if the dealers' promotional activities are subject to free-riding. The court would then assess the importance of those activities to the effective marketing of the product.[111] If the court found a plausible business justification for the restraint, not anticompetitive on its face, there would be no further inquiry. Furthermore, a court could combine this approach with a structural screen. For instance, courts could

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110 This assumes that a restraint that does not pass the structural screen would be presumed anticompetitive. An alternative approach is to conduct a full scale economic inquiry when market power exists. However, the increased uncertainty and administrative costs of this approach may be unacceptable.

111 The inquiry would determine whether the restraints were a reasonable solution to the free-rider problem, but would not require the manufacturer to establish that no other alternative was available. Such second guessing would impose inordinate burdens on a manufacturer contemplating a solution to its free-rider problem.

treat vertical restraints by firms without market power as per se legal while examining briefly the business justification behind all other vertical restraints. Alternatively, courts could use rebuttable presumptions whereby the burden would shift depending on the manufacturer's market power and the plausibility of the restraint's justification.[112]

A potentially controversial aspect of the inquiry into the plausibility of the business motive arises where the restraint is designed to promote a quality image by inducing stores having an established reputation for carrying quality merchandise to carry the manufacturer's product. Although this image-creating activity is subject to free-riding from discount stores, some commentators argue that this activity is less worthy of protection than more traditional dealer activities and consequently should not be immunized.[113]

Casual empiricism suggests that manufacturers attempt to reduce intrabrand competition through image enhancement as often as they attempt to do so with traditional dealer services. Hence, the requirement for a full rule of reason inquiry for all vertical restraints designed to enhance the product's image would diminish the savings possible under the simplifying procedures suggested above. Moreover, there will be much litigation over whether the actual purpose of the restraint is image enhancement. Therefore, practical considerations argue against discriminating between image creating activities and other types of vertical restraints especially where market power is limited.

## CONCLUSION

This article has considered the status of vertical restraint analysis in the wake of the recent Supreme Court decision in *Monsanto Co. v. Spray-Rite Service Corp*. It is likely that *Monsanto* does not represent the last word on vertical restraints. Several issues remain unresolved; indeed, *Monsanto* might have raised as many questions as it resolved. No satisfactory equilibrium will be reached until the Court undertakes a comprehensive analysis of vertical restraints, rather than reacting piecemeal to individual issues as they arise. The cornerstone of a comprehensive approach is an analysis of the manufacturer's motives in instituting a vertical restraint from which conclusions may be drawn about the effect that restraint may have

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112 *See* Joskow & Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213 (1979) (advocating similar approach in predatory pricing cases); *see also* Overstreet, *supra* note 94, at 170-76 (discussing possibility of structural inquiry without advocating any particular set of rules).

113 *See supra* text accompanying notes 96-98 .

on competition. In turn, appropriate policy measures could be formulated.

The basic economic intuition supports per se legality for vertical restraints. However, there are enough variants on the basic model that it cannot be stated with confidence that vertical restraints are incapable of generating adverse competitive consequences. At the same time, a full economic inquiry into the actual impact of every vertical restraint would place an overwhelming burden on the courts, with few guidelines for conducting such an inquiry. Hence, this Article considered approaches to vertical restraints short of a traditional rule of reason treatment.

The easiest approach would limit section 1 scrutiny to restraints imposed on manufacturers by dealers acting collectively, and to restraints instituted in concert by supposedly competing manufacturers. In essence, this adopts per se legality for truly vertical restraints. Because such a policy would not satisfy all concerns about vertical restraints, this Article considered other ways to screen out the potentially troublesome restraints. A distinction between price and nonprice restraints is neither helpful in this regard, nor warranted by economic theory. In addition, this distinction causes considerable evidentiary problems.

The most attractive screening process would limit rule of reason analysis to restraints conducted by manufacturers enjoying market power. A second screening approach, which could be used to complement the first, would examine the plausibility of the business justification for the restraint.

These intermediate solutions will not appease those who argue that manufacturer-imposed restraints cannot cause competitive harm. Nor will they satisfy those who support per se prohibitions of resale price maintenance. Nevertheless, the current rules covering vertical restraints are unsatisfactory. If per se legality for vertical restraints is too bold, then these suggested approaches may provide the most viable alternatives for improvement.