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Robert G. Parker

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RESTRICTIVE DISTRIBUTION ARRANGEMENTS AFTER THE SCHWINN CASE

Under the franchise system of product distribution, a manufacturer or supplier grants the right to sell or use his product in a specified area. By distributing through franchises, a manufacturer is able to achieve wide market coverage and retain some control over product distribution but with much less capital outlay than would be required by outright ownership of distribution facilities. The national economy also benefits from franchise distribution: the system stimulates competition by introducing new and developing companies in markets often dominated by large, fully integrated, manufacturing-marketing enterprises.¹ In addition, franchise distribution provides opportunities for independent enterprise to those who otherwise would be employees of large companies.²

Successful operation of a franchise system requires that certain restrictions be placed on the economic freedom of both franchisor and franchisee. For example, a small or new manufacturer whose products are unknown and whose capital is limited will often have to grant special concessions in order to persuade a potential distributor to undertake the large capital expenditures and extensive promotional activities necessary to start a wholesale business in his products. As a result, a manufacturer's franchise arrangements frequently contain several vertically imposed restrictions that confine his distributors or dealers to a specified territory and clientele, but grant to each a virtual monopoly in that territory and clientele.

Although franchise distribution stimulates interbrand competition, the restrictions imposed by the franchise agreements clearly restrain intrabrand competition. Since distributors are frequently precluded from competing with each other for customers, prices do not reflect traditional market pressures. The question thus arises whether such vertically imposed restrictions, even absent price-fixing, are so unreasonably restrictive of competition that they violate Section 1 of the Sherman Act.³ This question has generated much comment in

¹ See Chadwell & Rhodes, *Antitrust Aspects of Dealer Licensing and Franchising*, 67 NW. U.L. REV. 1, 6 (1967); Covey, *Franchise and the Antitrust Laws: Panacea or Problem?*, 42 NOTRE DAME LAWYER 605, 625 (1967).

² See *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964), *cert. dismissed*, 381 U.S. 125 (1965), for judicial recognition of this advantage.

³ "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce . . . is hereby declared to be illegal." Ch. 647, § 1, 26 Stat. 209 (1890), *as amended*, 15 U.S.C. § 1 (1964).

recent years,⁴ and was faced recently by the United States Supreme Court in *United States v. Arnold, Schwinn & Co.*⁵ Although the *Schwinn* case has shed some light on the permissible extent of franchise restrictions, much of the pre-*Schwinn* confusion still exists. Businessmen are left to speculate on the legality of many franchise restrictions currently employed.

I

FRANCHISE RESTRICTIONS COMMONLY EMPLOYED

Although a number of restrictions are often involved in franchise arrangements, this Note will be limited to the three that have been most subject to judicial scrutiny: the exclusive franchise, territorial restrictions, and customer restrictions.⁶

A. *Exclusive Franchises*

In an exclusive franchise agreement the manufacturer agrees to refrain from granting others the right to distribute in the franchisee's geographical area. As a result, the manufacturer gains assurance of a strong selling effort and cooperation on promotional activities at the local level, and the distributor can establish his business with the confidence that potential customers will not be lured away by other distributors.

B. *Territorial Restrictions*

The manufacturer often provides additional security for his distributors by exacting from each a promise to limit solicitation of

⁴ See, e.g., Chadwell & Rhodes, *supra* note 1 (suggesting application of the "rule of reason" approach and consideration of the purpose of the franchise program and its effects upon competition); Covey, *supra* note 1 (suggesting that courts recognize the stimulating effect on competition and not be unduly concerned about intrabrand competition); Timberg, *Territorial Exclusives*, 21 BUS. LAWYER 59 (1965) (advocating a "rule of reason" approach); Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795 (1962) (suggesting that the degree of restrictions allowable should depend on a manufacturer's market share); Note, *Exclusive Territorial Arrangements and the Antitrust Laws*, 39 IND. L.J. 785 (1964) (opposing a per se approach in order to deaccentuate the trend toward bigness in the American economy); Note, *The Legal Status of Franchises That Specify That a Dealer Must Confine His Sales to a Designated Territory*, 42 NOTRE DAME LAWYER 412 (1967) (suggesting the categorization of different territorial restrictions and application of a per se approach in the interests of clarity and efficient administration); Note, *Newcomer Defenses: Reasonable Use of Tie-Ins, Franchises, Territorials, and Exclusives*, 18 STAN. L. REV. 457 (1966) (advocating judicial recognition of competitive needs of new companies).

⁵ 388 U.S. 365 (1967).

⁶ The others are tying arrangements, exclusive buying, exclusive selling, and "area of primary responsibility" restrictions. See generally Note, *Restricted Channels of Distribution Under the Sherman Act*. 75 HARV. L. REV. 795 (1962).

business to an assigned geographical area. A territorial restriction can take several forms. Limits might be imposed only upon the solicitation of business from "outside" customers who neither reside nor have a place of business in his territory, and not upon sales to "outside" customers who enter his territory and instigate the business relationship. On the other hand, the distributor might be required to avoid "outside" customers and to refer all such customers to their own local distributor.

Enforcement measures may differ for the various territorial restrictions. An errant distributor could be threatened with the loss of his franchise, or he might be required simply to make a "profit pass-over"—payment of all or some portion of his profit on the sale to the proper local dealer. In many cases, the addition of territorial restrictions has the practical effect of assuring each distributor a monopoly in the manufacturer's products within his assigned territory.

C. *Customer Restrictions*

Territorial restrictions indirectly limit the people to whom a distributor may sell. Customer restrictions may also be employed to limit directly the distributor's clientele. For example, a manufacturer may reserve to itself or to its own sales force certain large government accounts. It may require that its wholesalers sell only to approved retailers and that the retailers sell only to ultimate consumers, thereby eliminating discount houses. When one distributor has made an appreciable expenditure in anticipation of a sale, the manufacturer may impose a "hands-off period" on its other distributors, restraining them from selling to a particular customer for a specified period. Finally, customer restrictions may sometimes substitute for territorial restrictions. Rather than divide the market geographically, the manufacturer may allocate it among the distributors according to types of customers.

II

LEGAL BACKGROUND OF VERTICAL RESTRICTIONS

In 1949 the Justice Department adopted the view that territorial restrictions, whether vertically or horizontally imposed, constitute per se violations of Section 1 of the Sherman Act.⁷ But for many years this position was not tested in court, either because manufacturers were unwilling to litigate and therefore chose to enter consent decrees en-

⁷ See *Hearings Before the Subcomm. on Automobile Marketing Legislation of the House Comm. on Interstate and Foreign Commerce*, 84th Cong., 2d Sess. 362 (1956).

joining their use of such restrictions,⁸ or because the cases turned on the presence of price-fixing and therefore the courts never reached the question of the restrictions. In *White Motor Co. v. United States*,⁹ however, the Supreme Court squarely confronted the problem of the legality of vertically imposed territorial and customer restrictions.¹⁰ The appellant truck manufacturer had imposed vertical territorial and customer restrictions on its distributors and dealers. White Motor argued that the territorial clauses were necessary for it adequately to meet competition, and that maintaining retail outlets to sell directly to users was not feasible, since that would entail a costly, extensive sales organization.¹¹ The company also claimed that in order for its distributors and dealers to compete effectively against larger companies they must make vigorous and extensive sales efforts in a restricted territory. To encourage such efforts it was fair and necessary to protect their territories from invasion by other dealers and distributors of the same manufacturer.¹² The United States claimed that White Motor's franchise restrictions constituted a per se violation of the Sherman Act. The District Court granted the government's motion for summary judgment. The Supreme Court reversed, refusing to extend to vertical restrictions the per se ban imposed on horizontally initiated territory divisions.¹³ The majority pointed out that, since this was the first time the Supreme Court had investigated vertical restrictions, their legality should not be assessed until after a trial in which the purposes of such arrangements and their effect on competition could be illuminated.¹⁴ The Court indicated that, unlike horizontally imposed re-

⁸ *E.g.*, *United States v. United Merchants & Mfrs., Inc.*, 1966 Trade Cas. ¶ 71864 (S.D.N.Y. 1966); *United States v. Pyrotronics, Inc.*, 1966 Trade Cas. ¶ 71858 (D.N.J. 1966); *United States v. Studebaker Corp.*, 1965 Trade Cas. ¶ 71410 (D. Neb. 1965); *United States v. Elgin Corp.*, 1965 Trade Cas. ¶ 71339 (N.D. Ill. 1965); *United States v. York Corp.*, 1963 Trade Cas. ¶ 70946 (M.D. Pa. 1963); *United States v. National Wrestling Alliance*, 1956 Trade Cas. ¶ 68507 (S.D. Iowa 1956); *United States v. Philco Corp.*, 1956 Trade Cas. ¶ 68409 (E.D. Pa. 1956); *United States v. Austral Labs., Inc.*, 1950-51 Trade Cas. ¶ 62880 (S.D.N.Y. 1951); *United States v. Bendix Home Appliances, Inc.*, 1948-49 Trade Cas. ¶ 62346 (S.D.N.Y. 1948).

⁹ 372 U.S. 253 (1963).

¹⁰ The franchise agreements of the White Motor Co. did contain a price-fixing clause, but that part of the District Court's injunction prohibiting the use of this clause was not challenged on appeal to the Supreme Court. *Id.* at 256 n.2.

¹¹ *Id.* at 256.

¹² *Id.* See, however, *Timken Roller Bearing v. United States*, 341 U.S. 593 (1951), and *United States v. General Motors Corp.*, 384 U.S. 127 (1966), where it was held that the fact that the defendant acted honestly in its own interest was not controlling.

¹³ 372 U.S. at 263.

¹⁴ *Id.* at 263-64.

We do not know enough of the economic and business stuff out of which these ar-

strictions, vertical restrictions might be justifiable, and therefore legal, if the manufacturer had a good business reason for imposing them and they were not unduly restrictive of competition.¹⁵

Within a year after the Supreme Court had indicated in *White Motor* that the rule of reason rather than the per se approach would be applied, two circuits confronted similar franchise restrictions. Both *Snap-On Tools Corp. v. FTC*¹⁶ and *Sandura Co. v. FTC*¹⁷ involved reviews of Federal Trade Commission orders finding that the franchise restrictions were unfair methods of competition in violation of Section 5 of the Federal Trade Commission Act.¹⁸ Both courts purported to follow the lead of the Supreme Court in *White Motor* by adopting the rule-of-reason approach and accepting "good business reasons" as justification for restraints on intrabrand competition. In *Snap-On Tools* the court held that Snap-On's territorial confinement arrangements were reasonable and therefore legal. The court noted that territorial restrictions are not illegal per se merely because they curtail intrabrand competition, and that the ultimate effect of the restrictive clauses was actually to promote competition among different brands.¹⁹ Similarly, in the *Sandura* case territorial and customer restrictions were held legal, the court noting that Sandura was "a relatively small concern competing with and losing ground to the 'giants' of the floor-covering industry,"²⁰ and that it had been suffering from near-bankruptcy, bad product reputation, and a severely demoralized distribution system.²¹ Additional "good business reasons" for the restrictions were that, in view of the company's difficulties, Sandura

rangements emerge to be certain. They may be too dangerous to sanction or they may be allowable protections against aggressive competitors or the only practicable means a small company has for breaking into or staying in business and within the "rule of reason."

Id. at 263 (citations omitted).

¹⁵ *Id.* at 263-64.

¹⁶ 321 F.2d 825 (7th Cir. 1963). It should be noted that the territorial restrictions presented by the *Snap-On Tools* case were less strict than those in *White Motor*; though the dealers were to make sales only in their respective territories, they could sell to "outside" customers who came in to buy. *Id.* at 830-31.

¹⁷ 339 F.2d 847 (6th Cir. 1964).

¹⁸ "Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful." Ch. 311, § 5, 38 Stat. 719 (1914), *as amended*, 66 Stat. 632 (1952), 15 U.S.C. § 45(a)(1) (1964). The section also authorizes the FTC to prevent use of unfair methods of competition. It has been held that any arrangement proscribed by § 1 of the Sherman Act will justify the Commission's exercise of its preventive powers. *See Virginia Excelsior Mills, Inc. v. FTC*, 256 F.2d 538 (4th Cir. 1958).

¹⁹ 321 F.2d at 831-32.

²⁰ 339 F.2d at 850.

²¹ *Id.* at 850-51.

needed to provide some special inducement to attract distributors and to persuade them to assume the bulk of the advertising burden.²² Thus, until the *Schwinn* case, territorial restrictions were permissible as long as they were vertically initiated, justifiable by sound business reasons, not inextricably connected with a system of resale price maintenance, and not unduly restrictive of competition in the industry involved.

III

THE *Schwinn* CASE

In the early 1950's Arnold, Schwinn & Co., a bicycle manufacturer, revised its marketing policies in an effort to assure quality and efficiency in its distribution system, eliminate inactive retail outlets, provide adequate customer service for its products, and avoid wasted promotional expenditures. The new policies were designed to meet the competition of large chain distributors who sell their products to mass merchandisers such as Sears, Roebuck and Montgomery Ward. Schwinn franchised about 5,500 small independent dealers to market its products.²³

The franchise arrangements included each of the three types of restrictions discussed earlier.²⁴ Schwinn granted the dealers exclusive franchises and imposed customer restrictions limiting distributors' sales to franchised retailers and precluding retailers' sales to non-franchised retailers, including discount houses. Schwinn also used three principal modes of selling: sales to distributors, who in turn resold to retailers; sales to retailers by means of consignment or agency arrangements with distributors; and sales directly to retailers under the "Schwinn Plan." The Schwinn Plan entailed direct shipments to the retailer under credit arrangements and payment of a commission to the distributor taking the order.²⁵ The franchise restrictions were applied equally to each method of sale.

The District Court rejected the government's charge that the purpose and effect of the franchise system was to fix prices,²⁶ but nevertheless held the territorial limitation illegal per se as applied to products that Schwinn had *sold* to its distributors.²⁷ The District Court did not, however, find territorial restrictions unlawful where Schwinn had

²² *Id.*

²³ *United States v. Arnold, Schwinn & Co.*, 387 U.S. 365, 368-71 (1967).

²⁴ See pp. 515-16 *supra*.

²⁵ 388 U.S. at 370.

²⁶ *United States v. Arnold, Schwinn & Co.*, 237 F. Supp. 323, 343 (N.D. Ill. 1965), *modified*, 388 U.S. 365 (1967).

²⁷ *Id.* at 342.

sold to franchised retailers with the distributor acting merely as agent or consignee, or directly to retailers under the Schwinn Plan.²⁸

On the government's direct appeal, the United States Supreme Court modified the lower court judgment.²⁹ The Court not only outlawed territorial restrictions after sales to distributors, but also extended the per se prohibition to encompass territorial and customer restrictions applied after goods have been sold by the manufacturer to retailers and distributors. In so holding, the Supreme Court abandoned the rule-of-reason approach which had been foreshadowed by *White Motor* and applied by the various circuits. "Good business reasons," such as enhancing the company's ability to compete with larger firms,³⁰ were deemed insufficient to justify imposing restrictions after sale.³¹

The Court did, however, retain the rule-of-reason approach for franchise arrangements that have an agency or consignment basis.³² That part of Schwinn's distribution system based on agency or consignment relationships, including the Schwinn Plan, was upheld, even though identical territorial and customer restrictions were there imposed. The Court indicated that where a franchise system has an agency basis, good business justifications will be acceptable in defense of such restrictions.³³ The Court formulated the following test for assessing the legality of franchise restrictions in an agency distribution system: such vertically imposed restrictions, assuming the absence of price-fixing and the presence of adequate sources of alternative products to meet the needs of the unfranchised, will be illegal only if the impact of the resulting confinement of distribution outlets is "unreasonably" restrictive of competition.³⁴

²⁸ *Id.*

²⁹ *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).

³⁰ The business justification asserted by Schwinn was merely that it needed a distribution system to compete more effectively with other bicycle manufacturers who sold primarily to mass merchandisers. Unlike the Sandura firm, however, Schwinn could not claim to be a new or struggling company trying to break into the market. The Court's opinion points out that at the time Schwinn instituted its franchising policies, it had the largest single share of the national bicycle market—22.5%—even though its market share had dropped to 12.8%. *Id.* at 368. The Court's rationale was that restrictions after sale constituted an illegal restraint upon alienation rather than that the restrictions had any deleterious effect on competition. *Id.* at 380.

³¹ *Id.* at 378-81.

³² The Court noted that, although Schwinn was itself a large manufacturer, its franchise program was necessary to compete with other manufacturers who sold primarily to mass merchandisers. *Id.* at 382.

³³ *Id.* at 381.

³⁴ *Id.*

IV

FUTURE IMPLICATIONS OF *Schwinn*

The *Schwinn* case has not completely eliminated the prior confusion regarding the legality of franchise restrictions on territory and customers. The Supreme Court took a major step toward establishing their legitimacy in the agency situation, however, by rejecting the Justice Department's original view that vertical franchise restrictions were indistinguishable from horizontal restrictions and were likewise *per se* illegal.

Franchisors can also find solace, even under the now-applicable rule-of-reason test, in the Court's exoneration of the use, by a manufacturer with a relatively strong market position, of agency-based restrictions. The Court appears to have rejected the notion, suggested by its *White Motor* dictum,³⁵ that vertical restrictions would be permissible only for a struggling company or a newcomer in the market. The "*Schwinn* rule," however, may be applied differently depending on the size of the franchisor. Examination of the Court's view of *Schwinn*'s peculiar market situation should help to clarify the rule to be applied to franchisors of differing size and strength.

A. *The Small Manufacturer and Restrictions After Sale*

Even after *Schwinn* there is some doubt whether a new or failing manufacturer will be precluded from using customer or territorial restrictions after actual sales to its distribution outlets. Although the Court purported to establish a *per se* proscription, there are several indications that the Court did not intend the term "*per se*" to mean that restrictions after sale will be *automatically* illegal in every case. At one point the majority opinion suggests that restrictions after sale might be permissible:

Under the Sherman Act, it is unreasonable *without more* for a manufacturer to seek to restrict and confine areas or persons with which an article may be traded after the manufacturer has parted with dominion over it.³⁶

Although the Court clearly rejected *Schwinn*'s sound business reasons or motives as a defense to the *per se* violation, the opinion may have left room for a defense in the case of a struggling company. The position of *Schwinn* was distinguished from the illustrative situation presented in *White Motor*, where the Court had indicated that a newcomer or a

³⁵ *White Motor Co. v. United States*, 372 U.S. 253, 263 (1963).

³⁶ 388 U.S. at 379 (emphasis added).

failing company might be sheltered under the rule of reason, because its franchise restrictions are not "anticompetitive."³⁷

Similarly, in *United States v. Sealy*,³⁸ decided the same day as *Schwinn*, the Court held horizontal market-splitting in conjunction with price-fixing by Sealy licensees to be per se illegal, but recognized the possibility of a distinction in the situation in which a number of small grocers, as an incident to the use of a common name and common advertisements, allocate territory among themselves on an exclusive basis. The Court intimated, by leaving the question open, that an allocation of territories among *small* grocers, a "quite different situation" from that of the Sealy licensees, might be justifiable.³⁹ Another example of the Court's broad but imprecise use of the "per se" concept is found in *Northern Pacific Railway v. United States*.⁴⁰ The Court there announced that a tying arrangement is

unreasonable in and of [itself] whenever a party has *sufficient economic power* with respect to the tying product to appreciably restrain free competition in the market for the tied product and a "not insubstantial" amount of interstate commerce is affected.⁴¹

In *Northern Pacific*, as in *Sealy*, the Supreme Court leaves open the possibility of a distinction on the basis of the size of the franchisor. Thus, the *Schwinn* Court may mean that, whereas most restrictions after sale are "per se" illegal, there are some limited emergency cases where competitive needs dictate special consideration for such franchise restrictions.

Such an interpretation of *Schwinn* is desirable, since, if the Court meant to preclude a small manufacturer from employing restrictions after sale, it is guilty of creating the same inflexibility it sought to avoid by refusing to apply a per se rule to *all* franchise restrictions.

On the other hand, as indicated in *White Motor*, we are not prepared to introduce the inflexibility which a *per se* rule might bring

³⁷ We first observe that the facts of this case do not come within the specific illustrations which the Court in *White Motor* articulated as possible factors relevant to a showing that the challenged vertical restraint is sheltered by the rule of reason because it is not anticompetitive. *Schwinn* was not a newcomer, seeking to break into or stay in the bicycle business. It was not a "failing company." On the contrary, at the initiation of these practices, it was the leading bicycle producer in the Nation.

Id. at 374.

³⁸ 388 U.S. 350 (1967).

³⁹ *Id.* at 357.

⁴⁰ 356 U.S. 1 (1958).

⁴¹ *Id.* at 6 (emphasis added). See BNA ANTITRUST & TRADE REG. REP. No. 315, July 25, 1967, at B-1, B-4.

if it were applied to prohibit all vertical restrictions of territory and all franchising . . . Such a rule might severely hamper smaller enterprises resorting to reasonable methods of meeting the competition of giants and of merchandising through independent dealers, and it might sharply accelerate the trend towards vertical integration of the distribution process.⁴²

A literal "per se" reading of *Schwinn* would force every company, even the weakest, that desires to distribute through franchises and retain some control over the distribution process to assume the financial and risk burdens of ownership as well as the additional tort liability imputed to it for acts of its agent-distributors. If the additional burdens of an agency system are too great for a struggling newcomer, the *Schwinn* case, as Justice Stewart's separate opinion points out, may lead to vertical integration in an industry and the elimination of small independent competitors.⁴³

Whereas literal interpretation of *Schwinn's* per se rule would deprive small companies of one of their most effective competitive weapons, larger companies could adjust more easily, perhaps even by integrating into the distribution process. The balance between the needs of the business community and of society would better be achieved by interpreting *Schwinn* to allow restrictions after sale when the manufacturer is so small or financially unstable that the additional burdens of agency franchising are prohibitive⁴⁴ than by applying an inflexible rule to all manufacturers regardless of their competitive position.⁴⁵

B. *Medium-Sized Franchisors—Permissible Restrictions*

The *Schwinn* case drastically affects the franchise arrangements of established franchisors with some market strength. The use of exclusive franchises, even where the manufacturer sells to the distributor, was expressly endorsed.⁴⁶ But franchisors who in the past have imposed

⁴² 388 U.S. at 379-80.

⁴³ *Id.* at 382, 386-87.

⁴⁴ Such a franchisor should perhaps be required to show that its franchise distribution system is essential to its survival and that an alternative to its policy of restrictions after sale would be especially burdensome. The *Sandura* case provides an example. The company supported its claim that closed-distributor territories were necessary to its survival by showing (1) that "it could not have existed without distributor advertising and the closed territories required to make that possible," (2) that distributor assistance and closed territories were necessary for the company to overcome its bad product reputation, and (3) that distributors would not have accepted the *Sandura* franchise without closed territories. 339 F.2d at 851-52.

⁴⁵ 388 U.S. at 386-87 (Stewart, J., concurring in part and dissenting in part) (by implication).

⁴⁶ "[A] manufacturer of a product, other and equivalent brands of which are readily

restrictions after sale clearly will have to revise their franchise agreements. The following factors will be relevant in a post-Schwinn determination of whether such franchise arrangements satisfy current requirements:

1. *Valid Agency Relationship*

To fall within the Schwinn Court's approval of territorial and customer restrictions, a manufacturer-distributor-dealer relationship must be genuine agency relationship. The manufacturer must retain title to all goods until final sale to customers, must pay insurance premiums and taxes on goods even when in the hands of distributors, and can accept payment from the distributor only after the ultimate consumer sale has been consummated.⁴⁷ Even where franchises are conducted on an agency basis, however, further limitations may be necessary to satisfy Schwinn's "reasonableness" test.

2. *Self-Imposed Limitations*

a. *Territorial and Customer Restrictions.* The Court indicated that the legality of territorial and customer restrictions employed in a valid agency relationship may depend on whether they are more anti-competitive than the "sound business reasons" for adopting them would warrant.⁴⁸ One method of minimizing the anticompetitive effects of such restrictions might be to employ a "profit pass-over," rather than the threat of losing a franchise for enforcement purposes. The profit pass-over should be limited to an amount necessary to reimburse the rightful distributor for the estimated expense he will incur in servicing the product upon the customer's return home.⁴⁹ Similarly, a time limitation could be imposed upon restrictions for which the only business justification is to help introduce a new prod-

available in the market, may select his customers, and for this purpose he may 'franchise' certain dealers to whom, alone, he will sell his goods. Cf. *United States v. Colgate & Co.*, 250 U.S. 300 (1919)." *Id.* at 376.

⁴⁷ See Stewart, *Antitrust Considerations Involved in Product Distribution*, 19 BUS. LAWYER 967, 972-73 (1964).

⁴⁸ In approving Schwinn's agency-based franchise restrictions, the Court said: "[T]here is nothing in this record . . . to lead us to conclude that Schwinn's program exceeded the limits *reasonably necessary* to meet the competitive problems posed by its more powerful competitors. In these circumstances, the rule of reason is satisfied.

388 U.S. at 380-81 (emphasis added). The Court went on to say that "the challenged program . . . was justified by, and went no further than required by, competitive pressures . . . its net effect is to preserve and not to damage competition in the bicycle market." 388 U.S. at 382.

⁴⁹ See Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795, 828-29 (1962).

uct. The restriction should be maintained only so long as it is reasonably necessary to introduce the product and establish its market image. If a manufacturer's distribution system is sufficiently well established that exclusive franchises are required only in certain geographic areas where it is a newcomer to the local market, an additional safeguard would be to impose territorial restrictions only in those areas where a grant of exclusive franchises is necessary to attract distributors.

b. *Area of Primary Responsibility.* A manufacturer might do well to institute, in lieu of territorial restrictions, an "area of primary responsibility" policy. A distributor or dealer would be given the responsibility of cultivating a particular geographic area as fully as possible, but would not be restricted to the assigned area. The primary-responsibility policy may well have substantially the same effect as a territorial restriction, since thorough cultivation of an assigned area might require most of the dealer's effort. If the policy is enforced by sales quotas and the threat of loss of franchise for inadequate representation in the assigned area, concentration of the dealer's effort is still more likely.⁵⁰ Nothing in the *Schwinn* case precludes the use of an "area of primary responsibility" policy even where the relationship between manufacturer and distributor or dealer is based on sales rather than agency. But, since enforcement of such policy by threat of franchise termination for failure adequately to cultivate a designated area yields results only slightly less anticompetitive than those produced by a territorial restriction, an established manufacturer should hesitate to adopt the primary-responsibility policy unless enforcement is accomplished only by means of a moderate profit pass-over.

3. Price-Fixing

A manufacturer reviewing his franchise system must bear in mind the *Schwinn* Court's caveat that the application of the rule of reason to the investigation of a franchise system depends on the absence of any price-fixing infection.⁵¹ Several price-fixing pitfalls face manufacturers. Franchise arrangements based on agency or consignment relationships must avoid the prohibition of *Simpson v. Union Oil Co.*,⁵² in which the manufacturer had "consigned" gasoline to retail dealers for sale, retaining "title" to the gasoline but placing the risk of loss on the dealers. Under the consignment agreement the manufacturer set

⁵⁰ See Note, *Newcomer Defenses: Reasonable Use of Tie-Ins, Franchises, Territorials, and Exclusives*, 18 STAN. L. REV. 457, 467 (1966).

⁵¹ See Stewart, *supra* note 47, at 975.

⁵² 377 U.S. 13 (1964).

the prices at which the retailer-consignees sold the gasoline. The Supreme Court held that the consignment agreement violated Sections 1 and 2 of the Sherman Act, as well as Section 4 of the Clayton Act,⁵³ since it was being used to police the retail prices charged by the dealers.⁵⁴ Strict compliance with the *Schwinn* rule may avoid difficulties under the *Simpson* case. The agency system demanded by *Schwinn* will require franchisors to retain both title to the goods and risk of loss, whereas the manufacturer in *Simpson* did not retain sufficient indicia of ownership to be entitled to set prices on "his" goods. But a manufacturer who attempts to side-step the *Simpson* rationale by giving its agents some pricing discretion may encounter price-discrimination problems.⁵⁵ If the price-fixing pitfall is not avoided, then any amount of effort to construct a "reasonable" franchise system will be fruitless, as illustrated by *United States v. Bausch & Lomb Optical Co.*⁵⁶ and *United States v. Sealy.*⁵⁷ These cases held that price-fixing that forms an integral part of a distribution system is per se illegal regardless of the effects of the distribution system.⁵⁸

C. *The Large Manufacturer*

The *Schwinn* case also holds important implications for the manufacturer who occupies a large or dominant share of its particular industry. Industrial "giants," like smaller manufacturers, will have to observe the rule-of-reason tests set forth in *Schwinn*; but they will

⁵³ 15 U.S.C. § 14 (1964).

⁵⁴ 377 U.S. at 24.

⁵⁵ See Robinson-Patman Act, 15 U.S.C. § 13 (1964). Unequal treatment by the "agents" may be imputed to the franchisor and thus constitute a violation of § 2(a) of the Clayton Act, ch. 323, § 2, 38 Stat. 730 (1914), as amended, Robinson-Patman Act, 49 Stat. 1526 (1936), 15 U.S.C. § 13(a) (1964):

It shall be unlawful for any person engaged in commerce . . . to discriminate in price between different purchasers of commodities of like grade and quality . . . where such commodities are sold for use, consumption, or resale . . . and where the effect of such discrimination may be substantially to lessen competition

The franchisor's territorial and customer restrictions, however, may provide him with the defense that the price differentials have not substantially injured competition among his customers. See *Minneapolis-Honeywell Regulator Co. v. FTC*, 191 F.2d 786, 790 (7th Cir. 1951). See also C. AUSTIN, PRICE DISCRIMINATION AND RELATED PROBLEMS UNDER THE ROBINSON-PATMAN ACT 50 (2d ed. 1959). If the system of territorial and customer restrictions has the effect of precluding sales by a distributor to "outside" customers, all customers in a given geographical area will be confined to purchasing from their local outlet, from whom they will presumably receive equal treatment.

⁵⁶ 321 U.S. 707 (1944).

⁵⁷ 388 U.S. 350 (1967).

⁵⁸ "Within settled doctrine, they are unlawful under § 1 of the Sherman Act without the necessity for an inquiry in each particular case as to their business or economic justification, their impact in the marketplace, or their reasonableness." *Id.* at 357-58.

encounter additional problems simply by virtue of their size. Thus, although adoption of agency relationships, "profit pass-over" policies, and "area of primary responsibility" policies are equally applicable to large manufacturers, *Schwinn* poses the additional problem of adequate market supply. The *Schwinn* case may well mean for these manufacturers that no matter how diligently they attempt to establish an agency relationship with their distribution system, or how careful they are to make their restrictions "reasonable" in light of their competitive needs, they simply will not be allowed to control the distribution of their products by means of franchise restrictions, because their market position is too strong. If "equivalent" products made by other manufacturers are in too short supply to meet the needs of retail outlets that do not have the manufacturer's franchise, the rule-of-reason test is failed.

For a manufacturer with substantial market dominance, it would be no defense that the restrictions employed were mild enough to permit substantial competition among its own sales outlets. The *Schwinn* Court made it clear that it could not, as requested by the government, look solely to the effects of restraints upon intrabrand competition. Rather, the competitive reasonableness of a restriction must be determined by examining its effect on the market as a whole.⁵⁹ In setting up its test to guide franchisors' future conduct, the Supreme Court expressly stated that future approval would be conditioned in part upon the ability of competing distributors to obtain "equivalent" or "alternative" products.⁶⁰ Thus, presence of a sufficient alternative market supply seems to be an absolute condition to the right to impose vertical franchise restrictions. As in the case of price-fixing, franchise restrictions resulting in an inadequate alternative market supply would be per se illegal, despite the manufacturer's claims of "good business reasons" and despite the agency basis of its franchise agreements. The prohibition would simply be the result of large size and strong market position. Thus, the *Schwinn* case may have put vertical franchise restrictions beyond the reach of a few dominant companies for reasons that are beyond their power to change.

Robert G. Parker

⁵⁹ *United States v. Arnold, Schwinn & Co.*, 388 U.S. 367, 382 (1967).

⁶⁰ But certainly, in such circumstances, the vertically imposed distribution restraints—*absent price fixing and in the presence of adequate sources of alternative products to meet the needs of the unfranchised*—may not be held to be per se violations of the Sherman Act.

Id. at 381 (emphasis added).