1978

The Legal and Economic Status of Vertical Restrictions

Joanne R. Alfano

Follow this and additional works at: https://digitalcommons.law.villanova.edu/vlr

Part of the Antitrust and Trade Regulation Commons

Recommended Citation
Available at: https://digitalcommons.law.villanova.edu/vlr/vol23/iss3/6

This Comment is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Law Review by an authorized editor of Villanova University Charles Widger School of Law Digital Repository.
Comment

THE LEGAL AND ECONOMIC STATUS OF VERTICAL RESTRICTIONS

I. INTRODUCTION

Vertical restrictions are contractual agreements between firms at different levels of the market as, for example, between a manufacturer and a retail dealer.1 They are to be distinguished from horizontal restrictions which exist between firms in direct competition with each other at the same market level.2 Vertical restrictions are used to facilitate distribution of products or services through contracts between manufacturers and other independent businesses that engage in wholesale or retail selling.3 There are a variety of vertical restrictions which do not involve resale price maintenance,4 but rather represent manufacturer imposed control over the

1. See ABA ANTITRUST SECTION, VERTICAL RESTRICTIONS LIMITING INTRABRAND COMPETITION 2 (Monograph No. 2, 1977) [hereinafter cited as ABA MONOGRAPH].
2. Id. at 43-44. Horizontal restrictions are governed by an independent body of antitrust precedent which is much more settled than that regarding vertical restrictions. For a discussion of horizontal restraints, see Bork, The Rule of Reason and the Per Se Concept: Price Fixing and Market Division (pt. 2), 75 YALE L.J. 373 (1966) [hereinafter cited as Bork II].

Although horizontal restrictions will not be discussed in this Comment, it is important to note that the distinction between vertical and horizontal restrictions is often unclear. For example, in United States v. Topco Assocs., 405 U.S. 596 (1972), a group of 25 small and medium size grocery store chains formed an association. Id. at 598. The association had developed its own grocery brand and acted as purchasing agent for the members. Id. It also imposed territorial and customer restrictions governing the members' sale of Topco brand goods. Id. at 601-02. See notes 7 & 8 and accompanying text infra. However, the Supreme Court refused to treat these restrictions as vertical since the individual members owned all of Topco Association's stock and completely controlled its board of directors. 405 U.S. at 609-10. Thus, the Court held that the restrictions were horizontal and illegal per se, citing well-established precedent for this holding. Id. at 608-12, citing United States v. Sealy, Inc., 388 U.S. 350 (1967). See also ABA MONOGRAPH, supra note 1, at 2-3 n.3.

3. See Keck, Alternative Distribution Techniques — Franchising, Consignment, Agency, and Licensing, 13 ANTITRUST BULL. 177 (1968). In contrast, a firm may utilize a vertically integrated system of distribution in which it both manufactures and ultimately distributes its products through its own divisions and employees. Id. at 177.

For a discussion of the view that more firms would integrate vertically if vertical restrictions were outlawed and that this result contravenes the policy of the Sherman Act, 15 U.S.C. § 131 (1976), see notes 121-29 and accompanying text infra.

4. Resale price maintenance is per se illegal. See Dr. Miles Medical Co. v. John D. Park & Sons, 220 U.S. 373 (1911). For a discussion of the state of the law on resale price maintenance, see ABA MONOGRAPH, supra note 1, at 71-96.

It is irrelevant whether the price-fixing agreement fixes maximum or minimum resale prices, as both deprive the independent businessman of the freedom to sell at prices determined by his own judgment. Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, 340 U.S. 211, 213 (1951).

Vertical territorial or customer restrictions of any type are also illegal per se when they are part of an agreement to fix prices. See United States v. Bausch & Lomb Optical Co., 321 U.S. 707 (1944). However, the vertical restrictions must be found to

(547)
territory in which or the customers to whom a distributor\textsuperscript{5} may sell the manufacturer's goods. These restrictive contractual clauses may be of the following types:\textsuperscript{6}

1. Territorial restriction — promise by the distributor not to sell the manufacturer's goods outside a specified geographic area or to consumers residing or having their business located outside that area.\textsuperscript{7}

2. Customer restriction — promise by the distributor not to sell the manufacturer's goods to specified individuals or classes of customers.\textsuperscript{8}

3. Location clause — prohibits the distributor from selling the manufacturer's goods from any location that the manufacturer has not approved, or from doing business under the manufacturer's name or method at an unapproved location.\textsuperscript{9}

4. Primary responsibility clause — assigns the distributor a territory within which he is to concentrate his sales efforts, although neither he nor other distributors of the same product are prohibited from crossing primary responsibility territory lines.\textsuperscript{10}

5. Profit pass-over clause — assigns the distributor a territory in which it may sell the manufacturer's goods but provides that profits on sales made outside this territory must, in whole or in part, be turned over to the distributor in whose territory the sale was made. Crossing territorial lines is not forbidden.\textsuperscript{11}

play an integral part in the resale price-fixing plan. For example, in United States v. Sealy, Inc., 388 U.S. 350 (1967), the Court found that territorial restrictions allowed Sealy to give "to each licensee an enclave in which it could and did zealously and effectively maintain resale prices, free from the danger of outside incursions." Id. at 356.


5. As used in this Comment, a distributor is a firm or business that purchases or consigns goods supplied by a manufacturer and subsequently resells them to retailers or the general public.


7. Id. at 282 n.33.

8. Id. at 282 n.34. Customer restrictions include promises by the distributor not to sell to certain customers reserved to the manufacturer himself and promises by wholesalers only to sell to the manufacturer's franchised retailers. See White Motor Co. v. United States, 372 U.S. 253, 255 (1963).

9. See ABA MONOGRAPH, supra note 1, at 3 n.5. Location clauses are frequently accompanied by an exclusive distributorship clause wherein the manufacturer promises not to authorize another distributor to sell its products in an area surrounding the first distributor's authorized location. Id.

For a discussion of exclusive franchising and the effect on this practice of declaring location clauses unlawful, see note 172 and accompanying text infra.

10. See ABA MONOGRAPH, supra note 1, at 3-4 n.6.

11. See Louis, supra note 6, at 282 n.37.
Vertical restrictions have presented an analytical problem for courts ever since 1963 when they were first brought to the attention of the United States Supreme Court in *White Motor Co. v. United States.* Although each of the aforementioned restraints has a different impact on the market, the precise economic effect of each limitation has been the subject of considerable dispute among lawyers, economists, businessmen and the federal government. The resulting uncertainty regarding the legality of these restraints and the antitrust analysis applicable thereto, has raised serious theoretical questions concerning the policy underlying the Sherman Act and the traditional modes of analysis utilized by courts in deciding the antitrust status of various business arrangements.

On the one hand, vertical restrictions either foreclose or significantly deter *intrabrand* competition, depending on the form of the restriction. On the other hand, they may increase *interbrand* competition and have a net procompetitive effect by improving distributional efficiency. The dispute regarding their economic effect has engendered similar disagreement as to the proper legal standard applicable to vertical restraints. One view proposes that vertical restraints be measured under the "rule of reason,"

13. One commentator has distinguished between these various market restraints as follows:
   At one end of an imaginary scale there are territorial restraints and customer limitations, which limit resale price fixing generally or bar competition, or some crucial aspect of it, absolutely; moving along the scale, there are the exclusive franchises and location clauses, which create significant territorial barriers to competition but do not explicitly prohibit it; finally, there are clauses providing for profit pass-overs and areas of primary responsibility, which do not prohibit intrabrand competition in the first instance, but only seek to 'discourage' it to one degree or another.

Primary responsibility clauses were upheld in *Colorado Pump & Supply Co. v. Febco,* Inc., 472 F.2d 637 (10th Cir.), *cert. denied,* 411 U.S. 987 (1973). Similarly, profit pass-over clauses were upheld in *Superior Bedding Co. v. Serta Assocs.,* 353 F. Supp. 1143 (N.D. Ill. 1972).

Moreover, vertical territorial and customer restrictions and location clauses have been held to be governed by the rule of reason. Continental T.V., Inc. v. *GTE Sylvania Inc.,* 433 U.S. 36, 59 (1977). See notes 177–85 and accompanying text infra.


17. *See* notes 98 & 99 and accompanying text infra.

18. *See* notes 90–96 and accompanying text infra.


while another maintains that these arrangements are clearly anticompetitive and per se illegal. 21

On the few occasions in which the Supreme Court has been confronted with vertical restraint cases, the results have been opaque and economically unrealistic. 22 Recently, however, the Supreme Court handed down a seminal decision concerning the legality of vertical restraints in Continental T.V., Inc. v. GTE Sylvania Inc., 23 and seemingly embraced the rule of reason approach. 24 It is the purpose of this Comment to explore the competitive effects of vertical restrictions and to assess these effects under antitrust law precedent and policy.

II. Pre-Sylvania Supreme Court Precedent and Lower Court Interpretation

A. White Motor Co. v. United States 25

Prior to the White Motor case in 1963, the Supreme Court of the United States had not been confronted with a vertical restraint case. 26 Vertical restraint cases in the lower courts were uniformly private antitrust actions of trade or commerce,” 15 U.S.C. §1 (1976), it is clear that not every restrictive business arrangement is illegal under the antitrust laws. Evidence of this fact can be found in the classic definition of the rule of reason approach formulated by Justice Brandeis:

Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences.

Chicago Board of Trade v. United States, 246 U.S. 231, 238 (1918). Therefore, the rule of reason requires a court or jury to engage in a detailed study of the economic setting and effects of the restraints brought before it. Id. at 238. This approach has been severely criticized in the context of vertical restraints. See notes 147–59 and accompanying text infra.

21. Northern Pac. Ry. v. United States, 356 U.S. 1 (1958). Per se antitrust illegality frees a court or jury from the economic analysis mandated by the rule of reason and is imposed only on “agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.” Id. at 5.

Because of the harsh result of the application of a per se rule of illegality, practices are not condemned as illegal per se until courts become familiar with the practice and its true economic implications. See, e.g., United States v. Topco Assocs., 405 U.S. 596, 607–08 (1972); White Motor Co. v. United States, 372 U.S. 253, 261–63 (1963).


24. Id. at 59.


26. Id. at 261.
and, without exception, the legality of the restraints were upheld.\textsuperscript{27} \textit{White Motor} involved both territorial and customer limitations.\textsuperscript{28} White defended on the ground that these restrictions, although foreclosing intrabrand competition, were necessary for White to remain in the truck selling market.\textsuperscript{29} Furthermore, White maintained that operating its own retail outlet system would be too costly, and that territorial restraints were efficient because they forced distributors and retail dealers to concentrate on interbrand competition rather than competing among themselves.\textsuperscript{30} The United States District Court for the Northern District of Ohio had granted the Department of Justice’s motion for summary judgment, ruling that the restraints were per se unlawful.\textsuperscript{31} The Supreme Court, in an opinion written by Justice Douglas, summarily remanded the case to the district court for a

\textsuperscript{27} See, e.g., Chicago Sugar Co. v. American Sugar Ref. Co., 176 F.2d 1 (7th Cir. 1949), cert. denied, 338 U.S. 948 (1950); Fosburgh v. California & Hawaiian Sugar Ref. Co., 291 F. 2d (9th Cir. 1923).

Neither the Federal Trade Commission [FTC] nor the Department of Justice challenged vertical restraints before 1948. In that year, the Department of Justice announced that vertical customer and territorial restrictions that barred all interbrand competition were illegal per se. See ABA MONOGRAPH, supra note 1, at 6–7, citing Hearings on H.R. 528, 2688, 6544 before the Subcomm. on Automobile Marketing Legislation of the House Comm. on Interstate and Foreign Commerce, 84th Cong., 1st & 2d Sess. 89, 362 (1956). Following this announcement, the Department of Justice entered into consent decrees in territorial and vertical customer restraint cases. See, e.g., United States v. Lone Star Cadillac Co., 1963 Trade Cas. (CCH) ¶ 70, 739 (N.D. Tex. 1963); United States v. Sperry Rand Corp., 1962 Trade Cas. (CCH) ¶ 70, 495 (W.D.N.Y. 1962). See generally ABA MONOGRAPH, supra note 1, at 7.

Immediately prior to the Supreme Court’s decision in \textit{White Motor}, the FTC applied a rule of reason analysis to several vertical territorial and customer restrictions cases. See, e.g., Columbus Coated Fabrics Corp., 55 F.T.C. 1500 (1959); Roux Distrib. Co., 55 F.T.C. 1386 (1959).

\textsuperscript{28} 372 U.S. at 253. White Motor Company manufactured trucks and sold them to distributors who resold to retail dealers. \textit{Id.} at 255–56. The territorial restraints outlined geographic areas in which both distributors and dealers could sell White’s trucks. \textit{Id.} The customer restraints prohibited distributors from selling to dealers unapproved by White and prevented dealers from selling to any customer who was not a user (i.e., discount retail outlets). \textit{Id.} White also forbade its distributors and dealers from selling to certain customers with whom White preferred to deal directly, allegedly because these accounts were large and required special sales expertise and management. \textit{Id.} at 258–59.

\textsuperscript{29} \textit{Id.} at 256–57. White contended that the territorial restrictions were utilized for valid business reasons because they assured White’s competitive viability. \textit{Id.} There was no assertion, however, that White was a “failing company.” \textit{Id.}

\textsuperscript{30} For a discussion of the cost and efficiency comparisons that may be drawn between vertically integrated distribution systems and distribution through contracts with independent businesses, see notes 120–29 and accompanying text infra. White further argued that interbrand competition is heightened when the distractions of intrabrand competition are removed. 372 U.S. at 256–57. Vertical territorial limits were assertedly necessary to insure adequate sales efforts and market coverage by the distributors and dealers. \textit{Id.} For a more detailed analysis of this justification, see notes 90–100 and accompanying text infra.

\textsuperscript{31} United States v. White Motor Co., 194 F. Supp. 562, 566 (N.D. Ohio 1961). This summary disposition increased the Supreme Court’s uncertainty as to the effects and conditions surrounding White’s restraints of trade, since the Court did not have access to a trial record. In this connection, the \textit{White Motor} Court noted the often repeated doctrine that summary judgment is rarely appropriate in antitrust cases. 372 U.S. at 259.
full trial, noting that "[t]his is the first case involving a territorial restriction in a vertical arrangement; and we know too little of the actual impact of both that restriction and the one respecting customers to reach a conclusion on the bare bones of the documentary evidence before us." 32

The White Motor Court's refusal to commit itself to either a rule of reason or per se approach should be and has been read in the context of the concurring opinion submitted by Justice Brennan and the dissenting opinion written by Justice Clark. 33 In the former, Justice Brennan demonstrated that vertical territorial restrictions, although similar to resale price maintenance and horizontal market division, were actually distinguishable from these per se unlawful practices. 34 Justice Brennan was also convinced that vertical territorial restraints could be justified, possibly through proof of their necessity in insuring adequate dealer servicing or in aiding new manufacturers, new products, and failing companies to gain a foothold in the market. 35 Finally, Justice Brennan expressed strong reservations concerning the legitimacy of the customer restrictions imposed by White. 36 In contrast to territorial limitations, these restrictions suppressed all competition between a manufacturer and its distributors to secure the most profitable accounts. 37 Without the countervailing encouragement of interbrand competition normally accompanying territorial limitations, Justice Brennan viewed customer restrictions as requiring more

32. 372 U.S. at 261. After reviewing the justifications advanced by White in support of its use of vertical restraints, the Court briefly outlined the per se and rule of reason approaches. Id. at 261–62. See notes 20 & 21 supra. The Court was unable to conclude that these restraints were without any redeeming virtues and could not determine whether the vertical restraints formed an integral part of the price fixing which had been found by the district court. 372 U.S. at 260–61. See note 4 supra. Therefore, the case was remanded for a new trial. 372 U.S. at 264.


34. 372 U.S. at 268–69 (Brennan, J., concurring). Justice Brennan's concurring opinion aimed at developing guidelines for the district court to follow on remand. Id. As to territorial restraints, Justice Brennan clearly espoused a rule of reason approach, noting that resale price maintenance and horizontal market divisions were restrictive of intrabrand and interbrand competition, whereas vertical market divisions were not. Id.

35. Id. at 269 (Brennan, J., concurring). Justice Brennan noted that it was also pertinent to consider whether the vertical restraints employed were the least anticompetitive means available to the manufacturer to satisfy his business needs. Id. at 271–72 (Brennan, J., concurring). It was therefore incumbent upon the trial court to inquire whether alternatives, such as profit pass-over or primary area of responsibility clauses, could be equally as effective. Id.

36. Id. at 272 (Brennan, J., concurring). Justice Brennan felt that distributors and dealers could be trained to handle fleet and large governmental customers and that the customer limitations could be upheld only if the dealers and distributors were shown to be completely unable to compete with the manufacturer for the forbidden accounts. Id. at 272–73 (Brennan, J., concurring). Otherwise, White was merely protecting its own noncompetitive pricing structure for these customers. Id. at 275 (Brennan, J., concurring).

37. Id. at 272 (Brennan, J., concurring). See note 8 supra.
substantial justification than White's desire to service directly its large accounts.\textsuperscript{38}

Justice Clark, in a dissent joined by Chief Justice Warren and Justice Black, argued that both the territorial and customer restraints were illegal under the per se analysis, since they admittedly foreclosed intrabrand competition and could not be justified by any balancing of interbrand procompetitive effects.\textsuperscript{39}

Both Justices Brennan and Clark interpreted the majority as holding that vertical restrictions were to be judged under the rule of reason, rather than as holding that the Court intimated no opinion as to their legality and had therefore maintained a temporarily neutral position.\textsuperscript{40} More significantly, perhaps, as one commentator has noted, "the White Motor opinion reveals a surprising degree of disagreement on the Supreme Court concerning the very fundamental question of whether agreements eliminating competition are justifiable under any circumstances."\textsuperscript{41}

B. Lower Court Interpretation of White Motor

Two Circuit Courts of Appeals rendered decisions in vertical restraint cases after White Motor. In 1963, the United States Court of Appeals for the

\textsuperscript{38} Id. at 272–75 (Brennan, J., concurring). Justice Brennan rejected the three justifications asserted by White in support of its use of customer restrictions: 1) that dealers were not qualified to satisfy the sophisticated demands of large customers; 2) that distributors could not be relied upon to solicit and service government and fleet accounts; 3) that direct sales by White to reserved customers were necessary for White to compete effectively with its competitors. Id.

\textsuperscript{39} 372 U.S. at 278 (Clark, J., dissenting). Justice Clark was adamant in contending that none of White's business necessity defenses were adequate to justify the restraints. Id., citing United States v. McKesson & Robbins, Inc., 351 U.S. 305 (1956); Fashion Originators' Guild of America, Inc. v. FTC, 312 U.S. 457 (1941); Dr. Miles Medical Co. v. John D. Park & Sons, 286 U.S. 373 (1911). Moreover, Justice Clark argued that the application of a different analysis to vertical and horizontal market division cases was illogical since it was impossible to believe that all of the dealers and distributors were unaware of the fact that their counterparts were signing the same contracts. 372 U.S. at 279–80 (Clark, J., dissenting). The contracts benefited the dealers, the distributors and the manufacturer only if all the dealers and distributors were subject to similar restraints. Id. See generally Turner, The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal, 75 HARV. L. REV. 655 (1962).

\textsuperscript{40} 372 U.S. at 264 (Clark, J., dissenting). See id. at 264 ("we do not intimate any view on the merits"). See generally Note, supra note 33, at 619–20. See also Sandura Co. v. FTC, 339 F.2d 847 (6th Cir. 1964); Snap-On Tools Corp. v. FTC, 321 F.2d 825 (7th Cir. 1963).

\textsuperscript{41} Bork I, supra note 16, at 778. Professor Bork cited White Motor as a prime example of the Supreme Court's theoretically inconsistent approach to the meaning and application of the per se and rule of reason formulations. Id. Since the White Motor majority failed to provide the district court with any guidelines for determining whether White's vertical restraints were per se unlawful or justifiable, Bork suggested that the opinion might mean either that only economic considerations were controlling or that other values, i.e., the importance of the small businessman, may enter the analysis. Id. On the other hand, Bork argued that Justice Clark's dissent was based on purely economic factors. Id. Thus, White Motor might represent a conflict on the Court as to pure economic theory or as to which ultimate values — economic or otherwise — should control the per se rule of reason choice. Id.
Seventh Circuit decided *Snap-On Tools Corp. v. FTC*, in which the Federal Trade Commission (FTC) challenged Snap-On's territorial and customer limitations on its dealers who distributed Snap-On's hand tools out of mobile, walk-on trucks. The Seventh Circuit, relying on *White Motor*, employed a rule of reason analysis and upheld the restrictions. Refusing to accept the FTC's contention that Snap-On's practices should be considered together as an integrated plan to suppress competition, the court considered the restraints seriatim. The Seventh Circuit determined that the restraints were necessary to preserve Snap-On's effectiveness as an interbrand competitor in a highly competitive industry where adequate sales coverage of each territory was indispensable. Therefore, the court concluded that the procompetitive interbrand effects outweighed the intrabrand anticompetitive effects.

One year later, the United States Court of Appeals for the Sixth Circuit pursued a similar line of inquiry in *Sandura Co. v. FTC* and upheld the territorial restrictions imposed by Sandura on its vinyl floor product distributors. The court reasoned that since Sandura was a small company in a concentrated and competitive industry suffering severe operating losses due to product failures, Sandura needed to impose protective territorial restrictions to induce dealers to handle its products and to expend capital on advertising which Sandura itself could not afford. Finally, the Sixth Circuit held that although Sandura had experienced a substantial strengthening in market power, the vertical restrictions continued to be reasonably necessary to its survival as a viable though small competitor.

---

42. 321 F.2d 825 (7th Cir. 1963).
43. *Id.* at 827. Snap-On assigned geographic territories (sales routes), limited customers, and restricted its dealers' right to compete for a specified period after they ceased to be dealers for Snap-On. *Id.* at 827.
44. *Id.* at 828, 837.
45. *Id.* at 830.
46. *Id.* at 829, 831-32. The court stressed that the anticompetitive effects of the restraints, even on intrabrand competition, were minimal since no reprisals were imposed on dealers who sold to outside customers who came into their territories. *Id.* at 833. Moreover, the Seventh Circuit was convinced that Snap-On might fail were it to eliminate its vertical restrictions. *Id.* Interestingly, the Seventh Circuit stated that consumers were only entitled to the protection afforded by unfettered *interbrand* competition. *Id.*
47. *Id.* at 833.
48. 339 F.2d 847 (6th Cir. 1964).
49. *Id.* at 849. The FTC had held Sandura guilty of price fixing and had found its territorial restraints unlawful. *Id.* at 859. The finding of price fixing was not appealed. Apparently, however, the Sixth Circuit did not feel that the territorial restrictions contributed to the resale price maintenance system. *Id.* at 859-60. These restrictions consisted of the assignment of "closed territories" in which wholesale distributors could sell Sandura's products only to retail dealers located within the assigned territories. *Id.* at 849. See note 4 *supra*.
50. 399 F.2d at 850.
51. *Id.* at 850-51.
52. *Id.* at 851.
53. *Id.* at 853-55. The Sixth Circuit did find that Sandura's vertical restraints foreclosed intrabrand competition, although the court also stated that there was no "showing of detriment to *intrabrand* competition." *Id.* at 858. It is suggested that the
Sandura and Snap-On clearly indicated that White Motor had been interpreted as requiring the application of the rule of reason in vertical restraint cases. Despite this ascendancy of the rule of reason analysis, the per se rule was soon revived in a derivative form by the Supreme Court in its next confrontation with vertical restraints.

C. United States v. Arnold, Schwinn & Co.54

Schwinn was the most comprehensive and definitive Supreme Court statement on the antitrust status of vertical restraints of trade until 1977.55 Only four years after White Motor, the Schwinn Court formulated a partial per se rule to govern these cases.56

Schwinn was a bicycle manufacturer which had experienced a substantial decline in its market share under a prior distribution system.57 In order to reestablish its competitive strength, Schwinn implemented a system of distribution through wholesalers and franchised retailers that confined retail sales of Schwinn bicycles to franchised retail dealers, handpicked by Schwinn as qualified sales and service representatives.58

court meant that the effects on intrabranded competition were insignificant because "[n]o dealer . . . has been subjected to the caprice of his area distributor, and no distributor is shown to have made unreasonable profits." Id. at 854. One commentator, noting this internal problem in Sandura, concluded that intrabranded competition was indeed foreclosed. Bork II, supra note 2, at 433–34.


55. After Schwinn, the Supreme Court was not confronted with another vertical restraint case until 1977, when it decided Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977).

56. 388 U.S. at 379–80. See Louis, supra note 6, at 275 n.3. See also ABA MONOGRAPH, supra note 1, at 13–14.

57. 388 U.S. at 367–70. The actual decline in market share was from 22.5% of national sales in 1951 to 12.8% in 1961. Pollock, The Schwinn Per Se Rule: The Case for Reconsideration, 44 ANTI TRUST L.J. 557, 559 (1975). In 1952, Schwinn terminated its prior method of distribution whereby wholesalers resold to any retailer they chose. Id. at 559.

58. 388 U.S. at 370–71. Schwinn contended that the competitive pressures of the bicycle market mandated a special approach, one which stressed the particular quality and longstanding reputation of the Schwinn brand products. United States v. Arnold, Schwinn & Co., 237 F. Supp. 323, 338 (N.D. Ill. 1965). To achieve this, Schwinn sought to improve its retail representation, sales, and service. Id. at 338. See also Pollock, supra note 57, at 559. For a discussion of product differentiation, see notes 101–17 and accompanying text infra.
Under this system, Schwinn sold some bikes to wholesale distributors for resale, others directly to retail dealers by means of consignment or agency arrangements with distributors, and some under the "Schwinn Plan" whereby Schwinn shipped the product directly to the retailer and paid a commission to the distributor who took the order.\footnote{59}

The vertical restraints imposed by Schwinn on its retailers were threefold: 1) retailers were franchised only as to certain locations; 2) they could purchase Schwinn products only from the distributor located in their area; and 3) they were prohibited from selling bikes to unfranchised dealers.\footnote{60} The vertical restraints applicable to distributors were assigning each distributor a sales territory and preventing such distributor from selling Schwinn products to anyone except franchised retailers operating in that territory.\footnote{61}

Before the Supreme Court, the Government abandoned the theory of per se illegality which it had asserted in the district court and instead argued that these contractual restrictions were illegal even under a rule of reason analysis.\footnote{62} The Court, in an opinion written by Justice Fortas, stated that it would follow the suggestion of the Government and the implications of the <i>White Motor</i> decision by inquiring into the economic background and effects of Schwinn's restraints.\footnote{63}

Initially, the Court noted that Schwinn's territorial and dealer restrictions were not accompanied by a price-fixing arrangement that could taint the vertical restrictions.\footnote{64} Nevertheless, Justice Fortas concluded that since Schwinn was neither a new nor a failing company, Schwinn could not justify its restrictive practices by claiming that they were implemented by a legitimate desire to improve its competitive position.\footnote{65}

\footnote{59} 388 U.S. at 370.
\footnote{60} Id. at 370-71.
\footnote{61} Id.
\footnote{62} Id. at 373. Earl E. Pollock, attorney for the defense in the <i>Schwinn</i> case, has maintained that the Government actually argued for a rule of presumptive illegality. Pollock, supra note 54, at 598. According to Pollock, the Department of Justice proposed that the interbrand competitive effects of Schwinn's restrictive practices should be ignored and that the burden should be placed on Schwinn to rebut the presumption of illegality. Id. Further, in Pollock's view, the Government argued that Schwinn could not sustain this burden since it was neither a failing company nor a new entrant to the market. Id. See notes 150-57 and accompanying text infra.
\footnote{63} 388 U.S. at 373-74. Interestingly, the <i>Schwinn</i> court cited <i>White Motor</i> as controlling precedent for the proposition that vertical restraints must be considered under the rule of reason, and then proceeded to formulate a partial per se rule to test the legality of these restraints. Id. at 373-74, 379-80.
\footnote{64} Id. at 373. The United States District Court for the Northern District of Illinois had decided against the Government on the price-fixing charge and the Government did not appeal. Id. See United States v. Arnold, Schwinn & Co., 237 F. Supp. 323, 332 (N.D. Ill. 1965).
\footnote{65} 388 U.S. at 374-75, citing United States v. White Motor Co., 372 U.S. 253 (1963). With respect to these restraints not accompanied by a price-fixing scheme, the Court noted:

[A] manufacturer of a product other and equivalent brands of which are readily 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 . . . . If the restraint stops at that point — if nothing more is involved than vertical
With respect to the sales by Schwinn to distributors or dealers for resale, the Court articulated the following sale-nonsale distinction:

[Where a manufacturer sells products to his distributor subject to territorial restrictions upon resale, a per se violation of the Sherman Act results. And . . . the same principle applies to restrictions of outlets with which the distributor may deal and to restraints upon retailers to whom the goods are sold . . . . On the other hand, as indicated in White Motor, we are not prepared to introduce the inflexibility which a per se rule might bring if it were applied to prohibit all vertical restrictions of territory and all franchising, in the sense of designating specified distributors and retailers as the chosen instruments through which the manufacturer, retaining ownership of the goods, will distribute them to the public.]

Under this analysis, if the manufacturer retained title, risk of loss and all other indicia of ownership, and the distributor or dealer functioned exactly as though he were the agent or salesman of the manufacturer, vertical restraints were to be governed by the rule of reason. Under the rule of reason, nonsale transaction restraints were to be held reasonable only if they were unaccompanied by price fixing, were reasonably necessary to meet competition, and were utilized in a market where other interchangeable

'confine's' of the manufacturer's own sales of the merchandise to selected dealers and if competitive products are readily available to others, the restriction[s], on these facts, alone, would not violate the Sherman Act. 388 U.S. at 376 (citation omitted). The continuing validity of this portion of Justice Fortas' opinion is evidenced by the "veritable avalanche of precedent to the effect that, absent sufficient evidence of monopolization, a manufacturer may legally grant such an exclusive franchise . . . ." GTE Sylvania Inc. v. Continental T.V., Inc., 537 F.2d 980, 997 (9th Cir. 1976) (en banc), aff'd, 433 U.S. 36 (1977).

For a comprehensive list of cases holding exclusive franchises presumptively legal, see ABA MONOGRAPH, supra note 1, at 21 n.60. For further discussion of exclusive franchises and exclusive dealerships and their relation to the effectiveness of other vertical restraints, see note 172 and accompanying text infra.

66. It should be noted that the Court upheld the program known as the "Schwinn Plan," under which the sales were consignment-type transactions, by applying the rule of reason analysis. See 388 U.S. at 380–82. See also Pollock, supra note 54, at 579–80.

67. 388 U.S. at 379–80. Justice Fortas stated that vertical restraints imposed on consignees and agents were justifiable because application of a per se rule of illegality in these situations would impair the ability of smaller firms to compete and would encourage vertical integration of the distribution process. Id. at 380. See notes 118–29 and accompanying text infra.

68. 388 U.S. at 380. It has been strenuously argued that the Schwinn Court intended to create a very narrow exception to its per se rule when it spoke of agency or consignment transactions. Zimmerman, supra note 54, at 1188–90. Edwin Zimmerman, writing in support of the Schwinn doctrine while he was First Assistant of the Antitrust Division of the Department of Justice, stressed that the economic units to which the per se rule would apply were those which were independent in substance and not form. Id. He described them as "independent economic entities in the distribution business, whose business decisions on the sale of the products would reflect functions, investments, and goals which in fact differ from those of the producer . . . ." Id. In his view, restraints imposed on these entities were to be governed by the per se rule, despite the possible "nonsale" form of transactions. Id.
brands were available and handled by the distributors or dealers in question.\textsuperscript{69}

The Schwinn decision has been criticized by numerous commentators, who are generally in accord regarding the basic analytical problems presented by the Court's reasoning.\textsuperscript{70} As a threshold matter, it has been questioned whether the Schwinn Court actually constructed a per se rule for vertical restraints following sales transactions.\textsuperscript{71} The Court's statement that "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,"\textsuperscript{72} might be expressive of a per se rule.\textsuperscript{73} However, this language might also connote that vertical restraints in these situations are unlawful only if they stand "without more," i.e., without a valid business excuse.\textsuperscript{74}

Assuming, as have the majority of the lower courts,\textsuperscript{75} that the Schwinn Court did fashion a partial per se rule for vertical restrictions, the question arises as to why the Court placed controlling weight on the distinction between sale and agency or consignment transactions.\textsuperscript{76} While Justice Fortas' majority opinion justified this distinction as necessary to preserve "the ancient rule against restraints on alienation,"\textsuperscript{77} it is suggested that the resurrection of this "ancient" property law doctrine in the context of a group of contemporary business practices seems oddly misplaced.\textsuperscript{78} Furthermore,

\textsuperscript{69} 388 U.S. at 381. The Court thus made it clear that it was not establishing a rule of presumptive legality even as to nonsale transactions. See Zimmerman, supra note 54, at 1189.

\textsuperscript{70} See note 54 supra.

\textsuperscript{71} See ABA Monograph, supra note 1, at 11-12; Note, supra note 33, at 626-27.

\textsuperscript{72} 388 U.S. at 379.


\textsuperscript{74} See ABA Monograph, supra note 1, at 11-12; Note, supra note 33, at 626-27. With reference to this "without more" language, the Schwinn opinion has been construed as having incorporated the two defenses to the per se prohibition of vertical restraints suggested by White Motor, i.e., failing company or new entrant status. Note, supra note 33, at 626-67.

The Department of Justice also recognized the possibility of exceptions to the Schwinn Court's apparent endorsement of a per se doctrine. ABA Monograph, supra note 1, at 11 n.30, citing Hearings on Exclusive Territorial Franchise Act Before the Subcommittee on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 93d Cong., 2d Sess. 17-18 (1974). Bruce B. Wilson, then Deputy Assistant Attorney General, believed that the Schwinn opinion left "some room... for consideration of the economic exigencies of particular situations." Id.

\textsuperscript{75} See cases cited in note 73 supra.

\textsuperscript{76} See 388 U.S. at 379-80.

\textsuperscript{77} Id. at 380.

\textsuperscript{78} Justices Stewart and Harlan specifically dissented from the majority's dualistic approach to vertical restraints, arguing instead for a uniform rule of reason approach. Id. at 390-91 (Stewart & Harlan, J. J., concurring in part and dissenting in
use of the sale-nonsale distinction stresses form over substance and is overly simplistic in a world of highly complicated commercial dealings.79

The Schwinn decision took a surprising course for much of the antitrust bar, for it impliedly overruled the White Motor case, despite the fact that the Court had not attained any added familiarity with the economics of vertical restraints in the four years between White Motor and Schwinn.80

D. Lower Court Interpretation of Schwinn

Although most courts have read Schwinn as establishing a per se rule applicable to all vertical restraints imposed on distributors or dealers who buy goods from a manufacturer,81 many others have avoided Schwinn by formulating various defenses which validate vertical restraints.82 One common defense that has been accepted by a number of circuit courts is that

part). The dissenters were particularly disconcerted by the majority's reliance on the rule against restraints on alienation. Id. These justices contended that this "ancient rule" of property law was never a per se rule in itself, but only a prohibition of unreasonable restraints on alienation. Id. at 391-93 (Stewart & Harlan, J. J., concurring in part and dissenting in part). Since Justices Stewart and Harlan believed Schwinn's contractual restrictions were mandated by business necessity and were largely procompetitive in effect, the "ancient rule" was inapplicable. Id. See Pollock, supra note 57, at 563, citing Mitchel v. Reynolds, 24 Eng. Rep. 347, 352 (Ch. 1711). In Mitchel, the court stated: "In all restraints of trade, where nothing more appears, the law presumes them bad; but if the circumstances are set forth, that presumption is excluded, and the Court is to judge of the circumstances and determine accordingly; and if upon them it appears to be a just and honest contract, it ought to be maintained." Mitchel v. Reynolds, 24 Eng. Rep. at 357.

In addition to Justices Harlan and Stewart, many commentators also regard this property law doctrine as irrelevant to modern commercial life. See, e.g., Baker, supra note 54, at 537-38; Pollock, supra note 57, at 563-64; Robinson, supra note 54, at 270-71.

79. See Baker, supra note 54, at 538 (form of transaction clearly unrelated to the economic effects of the restraint).

Moreover, another commentator has noted:

In short, in a modern economy it is nonsense to say that it is none of the manufacturer's business how his product is marketed to the consuming public; that once he parts with legal title when he sells to the wholesaler or retailer, he has lost the right to participate in the marketing of his product to the consumer. Today's manufacturer not only has that right, but exercises it all the time; and he does so because he is competing, as he must and should, with manufacturer's [sic] of rival products and brands.


80. Indeed, the Court had not been confronted with a single vertical restraint case in the interim. United States v. Arnold, Schwinn & Co., 388 U.S. 365, 373-74 (1967).

Moreover, one commentator suggested that, given the time-table of the Schwinn case from oral argument to brief filings to decision, the Court could not even have reviewed the entire Schwinn trial record. See McClaren, supra note 54, at 141-44.

81. See cases cited in note 73 supra.

82. See notes 83-87 and accompanying text infra. Justice Powell indicated in the majority opinion in Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977), that the Court was well aware of the ingenuity with which some lower courts had managed to avoid the per se implications of Schwinn. Id. at 48 n.14 (citations omitted). See Carter-Wallace, Inc. v. United States, 449 F.2d 1374 (Ct. Cl. 1971) (per se rule held inapplicable when the constraints can be avoided by a purchaser if he elects to buy the product at a higher price).
those vertical restraints that are not "firmly enforced" by the manufacturer are not illegal since they cannot foreclose intrabrand competition.83

Another fairly common justification accepted by lower courts has been that vertical territorial or customer restrictions were reasonably necessary for the protection of the health or safety of the ultimate users, or for the preservation of the quality of a particular product.84 These defenses have not been universally accepted, however, especially where the vertical restraints were accompanied by other anticompetitive practices, such as resale price maintenance.85

Not surprisingly, the per se rule announced in Schwinn has not been applied where the form of the transfer of goods from the manufacturer to the distributor was not a sale.86 Moreover, some courts, without any rational basis, have refused to apply Schwinn beyond its factual context of resales by bicycle distributors.87


86. See Williams & Co. v. Williams & Co. East, 542 F.2d 1053 (9th Cir. 1976).

III. ECONOMIC ANALYSIS OF VERTICAL RESTRICTIONS:
HOW SHOULD COURTS DEAL WITH THESE BUSINESS
ARRANGEMENTS UNDER THE ANTITRUST LAWS?

As a result of the Schwinn decision, the obvious legal and economic confusion surrounding vertical territorial and customer restrictions intensified. Those favoring vertical restraints attempted to demonstrate their necessity in fostering dealer services and investment, stimulating interbrand competition, and helping new firms and products gain entry to a market.88 Those arguing for the per se illegality of these restraints stressed the necessity of upholding contractual limitations on intrabrand competition to protect the consumer, the independence of the small business firm, and the free competitive market which the Sherman Act envisions.89

A. Vertical Territorial and Customer Restrictions:
Competitive Effects and Business Justifications

1. Encouragement of Dealer Investment and Maximization
   of Dealer Sales Effort and Servicing

Although the assertion is not subject to concrete proof, it is often posited that vertical restraints offer dealers protection from raiding by other dealers. Consequently, dealers with a defined exclusive territory are said to be more willing to market an otherwise untried product, to serve as a dealer for a new entrant, to invest in advertising and other promotional services, and to cultivate every account in their territory with maximum diligence.90 The underlying premise of this argument is that manufacturers should be able to insulate their dealers from the competitive tactics of other dealers and thereby intensify interbrand competition.91 The presumption is that if each dealer is forbidden from selling in other dealers' territories, he will provide more services in his own area, because he will not fear that another dealer will "free-ride."92 Free-riding occurs when one dealer keeps his advertising, display, and other costs very low and sells to consumers from other territories who have been drawn to the product through their own area dealer's intense and costly sales efforts.93

88. See notes 90-96 and accompanying text infra.
89. See notes 99-100 and accompanying text infra.
91. See Bork II, supra note 2, at 430-33.
92. Id.
93. Id. To avoid this practice, territorial restrictions are imposed to minimize intrabrand price competition by encouraging all dealers to provide basically uniform services, incur the same costs and charge the same prices. See Comanor, supra note 14, at 1428–29. By seeking to increase interbrand product competition over intrabrand price competition, the manufacturer controls competitive forces, a function normally left to the marketplace. Id.
Territorial restrictions may also encourage the post-sale service which is essential to maintain the quality of many products. 94 If the price of the service is included in the original sales price, a dealer will be reluctant to provide post-sale service unless he was the dealer who made the original sale and therefore was already paid for rendering it. 95 Also, this method of pricing has a potential for encouraging a dealer to free-ride on other dealers' post-sales servicing. 96

Many commentators have disagreed with the theories outlined above because they dispute whether these are the effects of vertical restrictions. 97 In addition, many feel that the use of vertical restraints to achieve these effects is fundamentally inconsistent with antitrust policy. 98

Overall, the effectiveness of vertical restraints in encouraging dealer efforts and servicing is subject to serious question. 99 Where the use of such

94. See Bork II, supra note 2 at 447-48.
95. Id.
96. Id. This argument also applies to customer limitations. Id. If the manufacturer reserves customers to itself because it possesses the expertise necessary to provide post-sale service, the manufacturer alone would be paid in the sale price for the service it provided. Id. If other dealers could also sell to these customers, they may be paid in the original sales price for a post-sale service only the manufacturer could provide. Id.

Alternative means of avoiding free-riding, such as charging a separate price for the services, may be undesirable to the consumer who wants a single price established prior to purchase. Id. See notes 99 & 100 and accompanying text infra.

To illustrate, if a small manufacturer is attempting to enter a concentrated industry, he arguably should be permitted to protect his dealers only until he achieves normal profits and recovers his initial costs. See Louis, supra note 6, at 297. If, however, this manufacturer is attempting to market a unique product capable of achieving relative immunity from interbrand competition, it is likely that territorial protections will not be necessary to attract dealers since they will be drawn by the prospect of high sales levels and profits. Id. at 297-98.

97. See, e.g., Blecher, supra note 54, at 552-54; Comanor, supra note 14, at 1428; Louis, supra note 6, at 297-99.
98. See Comanor, supra note 14, at 1428-29.

Some commentators who criticize vertical restraints as methods of recruiting dealers and their capital have noted that the use of such restraints, if permitted at all, should be limited in light of the needs of the particular manufacturer. Louis, supra note 6, at 296. As a threshold consideration, it is submitted that in many cases vertical restrictions will be unnecessary to attract new dealers. Thus, where this justification is tendered in defense of a vertical restriction, the defendant should be required to prove that the product and market involved were not such that new dealers would have been anxious to be one of the first on the scene. Id. at 298 n.117. For example, a unique product with considerable consumer goodwill would not require territorial restrictions to draw dealers into the new market. Id. See generally Comanor, supra note 14.

99. See Comanor, supra note 14, at 1432-33. Another antitrust law scholar has expressed serious reservations about the utility of subjecting the market to the artificial constraints imposed by vertical restrictions:

On the issue of the utility of restrictions in encouraging the dealers to provide special promotion and service, or the importance of customer restrictions in enabling the manufacturer to preserve the integrity of its own promotional efforts to stress the distinctive quality of the product, at least two observations are pertinent. Often the nature of the manufacturer's interest in avoidance of resale by non-prestigious outlets is cloaked in ambiguity; it may correspond closely to little other than an effort to avoid the outbreak of "disruptive" price
restraints would be effective in this regard, it may be persuasively argued that the manufacturer should be required to resort to alternative means, such as financing his dealer's sales campaigns or insisting that his dealers charge separately for post-sale services in order to prevent free-riding.100

2. Product Differentiation

Closely related to the practice of encouraging dealer services through the use of vertical restrictions is the concept of product differentiation, for this is the goal of many manufacturers' efforts to assure extensive dealer advertising and promotion.101 Product differentiation is the use of advertising or similar methods to distinguish a product from that of competitors.102 This partially insulates the product from interbrand competition and allows it to achieve a larger and virtually unassailable market share.103 However, it is submitted that promotional product differentiation as a means of obtaining market power is inconsistent with the antitrust laws.104

---

Zimmerman, supra note 54, at 1185.
100. See Comanor, supra note 14, at 1432–33. The practice of supplying both the product and services for a single joint price has been criticized. Id. at 1430. For example, it has been posited that providing services and goods for a single price forces consumers to buy services they would not otherwise demand. Id. Thus, the result is a higher price than consumers would otherwise be required to pay: "A system of joint supply leads to the achievement of product differentiation, increased market power at both the manufacturing and distribution levels, and thereby to both higher manufacturers' prices and higher dealer markups." Id.

Equally viable and effective means of insuring full market penetration and conscientious dealer servicing include conditioning the grant of a franchise on the maintenance of a uniform level of services, imposing areas of primary responsibility or requiring territorial sales quotas and profit pass-overs. See notes 10 & 11 and accompanying text supra. See generally Louis, supra note 6, at 301; Zimmerman, supra note 54, at 1184–85.

101. See Louis, supra note 6, at 301 n.137. The goal of product differentiation is to protect dealer markups (the difference between the manufacturer's price to the dealer and the dealer's price to the consumer) so that dealers will have sufficient profits to reinvest in such services as promotion and maintenance of attractive outlets. Id. However, there is no guarantee that dealers will not pocket their profits or use them to foster price competition with other brands. Id.

102. Id. at 280–81.
103. Id.
104. See notes 114–17 and accompanying text infra. In the opinion of many economists and lawyers, the use of vertical restraints to aid companies in entering
Vertical restrictions, by insulating dealers from intrabranch competition, may result in higher dealer profit margins which the dealers may then use to differentiate the product, decrease interbrand competition, and gain market power for the manufacturer. Vertical restrictions may also enable the manufacturer to draw dealers who will maintain attractive, quality-controlled outlets where the unique image of a particular product will be carefully preserved and promoted.

new markets, introducing new products, or recovering a lost market share should not be permitted. See, e.g., Comanor, supra note 14, at 1427–29; Zimmerman, supra note 54, at 1186–88. In the opinion of these economists and lawyers, such manufacturers should not be given support which they would not receive in the normal course of supply and demand in an open market. Zimmerman, supra note 54, at 1186–88. If they lose the competitive battle, neither the consumer nor the market suffers any loss. However, if the manufacturers are given the support that territorial insulation from intrabranch competition offers, consumers are forced to pay higher prices to subsidize this manufacturer’s otherwise unprofitable venture. Id. See also Hearings on S.2549 Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm., 89th Cong., 2d Sess. 1088 (1966) (statement of Donald E. Turner).

In rebuttal, other economists have argued that notwithstanding the presence of vertical restraints, the free operation of supply and demand is not interrupted, and consumers do not lose their control over distribution resource allocation. Bork II, supra note 2, at 473. Ultimately, the decision by the manufacturer to impose vertical restraints and thus increase dealer servicing is like any other decision to incur costs. Id. It will not be made unless it contributes to a higher profit, which in turn depends on consumer response. Id. If the dealer services are unnecessary and ineffective in drawing customers, the vertical restrictions will not be implemented. Id.

105. See Comanor, supra note 14, at 1426–27; Louis, supra note 6, at 281.

106. See Bork II, supra note 2, at 430–33. This was largely the reason why Arnold, Schwinn & Company employed vertical territorial and customer limitations. United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967). In an attempt to recover a falling market share, Schwinn tried to stress its prestigious name by insuring that their bikes were sold only by retail dealers who would concentrate on promoting Schwinn bicycles and employing high quality marketing and servicing techniques. Id. at 368–69. If the manufacturer attempts to accomplish this end by selling only to authorized dealers, it is presumptively legal under Schwinn. Id. at 376. However, the manufacturer cannot, under Schwinn, prohibit his dealers from reselling to unauthorized dealers. Id. at 379. See notes 54–79 and accompanying text supra.

Professor Comanor has suggested that manufacturers often wish to avoid resale to discount houses because they undermine the existing price structure. See Comanor, supra note 14, at 1426–27.

Since the dealer’s and manufacturer’s interests are the same when these customer limitations are employed, it has been persuasively argued that these vertical restrictions should be treated the same as horizontal restrictions, i.e., as illegal per se. See generally Note, Restricted Channels of Distribution Under the Sherman Act, 75 How. L. Rev. 795 (1962). Significantly, the major distinction many economists find between horizontal and vertical market division is based on the perceived difference of interests between the manufacturer and his dealers. Id. at 823–24. Since vertical restrictions supposedly cannot increase the manufacturer’s market share, although they can benefit the dealers by eliminating intrabranch price competition, the manufacturer may employ the vertical restraints to improve the efficiency with which his products are marketed. Id. However, when the market division is horizontal (based on agreements between the competing dealers), the only purpose is to eliminate price competition which is illegal per se. Id. Consequently, it has been asserted that vertical restrictions and their possibly procompetitive effects are justifiable, whereas horizontal constraints are not. Id. at 800, 823–24.

This theory is based on a difference in the motivation of the dealers and the manufacturer. When the manufacturer uses vertical restraints to free his brand, to some degree, from interbrand competition, his purpose is as anticompetitive as the dealers’ would be in a horizontal arrangement. See Zimmerman, supra note 54, at
If the manufacturer can prove that his use of vertical restraints is truly aimed at selecting dealers who will not falsely differentiate the product, but who will rather reinvest their higher profit margins in efforts to ensure the preservation of the inherent quality and unique superiority of the product, the vertical restraints may still not be appropriate.107 There exist less anticompetitive means than vertical restrictions that are equally able to ensure and police quality control. For example, the manufacturer may market his products exclusively through franchised dealers whose contracts contain minimum quality control requirements under threat of franchise termination.108

If the manufacturer's goal is truly promotional product differentiation, the use of vertical restrictions to accomplish this result may still be illegal.109 Competition in an industry depends not only on the number and size of the firms therein, but also on the interchangeability of consumer demand for products made by these firms.110 If product substitutability is great, prices will be lower as manufacturers compete for business.111 Product differentiation liberates a manufacturer from these competitive pressures and permits him to charge retailers higher prices.112 On the other hand, differentiation based on inherent product or service superiority is not necessarily a negative economic influence, for its anticompetitive effect is a trade-off to consumers for benefits such as product quality and variety.113 In contrast, differentiation of products with no genuine superiority is a process that disrupts the functioning of the competitive market.114 Arguably, it should be left to the market and the consumers to decide whether intrabrand competition should

1184–85. The eventual result and purpose is to raise the manufacturer's price, thereby increasing both his return and the dealers' mark-ups. See Zimmerman, supra note 54, at 1184–85. See also Louis, supra note 6, at 280. In this situation, the often futile inquiry into who imposed the restrictions is unnecessary, for the effect and purpose are the same. See Louis, supra note 6, at 280. The difficulties encountered in any attempt to determine a manufacturer's true motives in imposing vertical restraints also present an argument for some type of per se rule. Id. But see Bork II, supra note 2, at 398–405.


108. See Blecher, supra note 54, at 553; Louis, supra note 6, at 302 n.142.

109. See Comanor, supra note 14, at 1424–26; Louis, supra note 6, at 281.


111. Id.

112. See id. at 1424.

113. See id. However, vertical restrictions are arguably unjustifiable, even when imposed in an effort to enhance or preserve inherent product superiority. See notes 107 & 108 and accompanying text supra.

114. See Comanor, supra note 14, at 1424–25, 1427. Another evil of product differentiation is the restriction of entry into the market for new manufacturers. Id. Another commentator has stated:

A new entrant is being assisted in the creation of product differentiation and a dealer network [by allowing him to use vertical restrictions], the very things that those already in the market used to create the entry barriers that necessitate this assistance. Thus, there is the danger that the new entrant will surmount
exist, or whether it should be eliminated to enable dealers to focus all of their efforts on interbrand product competition with the goal of differentiating their own brand.\textsuperscript{115}

This analysis of promotional product differentiation illustrates the fallacy in the argument that vertical restraints, while eliminating intrabrand competition, encourage interbrand competition.\textsuperscript{116} It is submitted that the latter is only temporarily increased, for when the product is sufficiently differentiated, both intrabrand and interbrand competition are eliminated.\textsuperscript{117}

3. \textit{Vertical Integration and the Preservation of Small Business}

In addition to the goal of promoting free competition, the antitrust laws were promulgated to effectuate another social end — the preservation of the small, economically independent businessman.\textsuperscript{118} The two goals are

\begin{quote}
these barriers, join those already behind them, and in the process raise entry barriers even higher.
\end{quote}

\textit{Louis, supra} note 6, at 297 n.115.

\textsuperscript{115} See \textit{Comanor, supra} note 14, at 1426–27. If the manufacturer is permitted to utilize vertical restrictions at all to encourage dealers to finance high cost services necessary to gain a market position, the use should be for a very limited time. See \textit{Louis, supra} note 6, at 302.

\textsuperscript{116} For a discussion of this argument, see notes 90–93 and accompanying text \textit{supra}.

\textsuperscript{117} Obviously, the degree of market power enjoyed by a manufacturer will influence the extent to which his elimination of intrabrand competition will affect interbrand prices. Therefore, concentration at the manufacturing level necessitates greater intrabrand competition so as to preclude the manufacturer from obtaining an even greater retail market share. See \textit{ABA Monograph, supra} note 1, at 63–64, \textit{citing Adolph Coors Co., [1973] 3 Trade Reg. Rep. (CCH) ¶ 20,403 (F.T.C. 1973), aff’d, 497 F.2d 1178 (10th Cir. 1974), cert. denied, 419 U.S. 1105 (1975)}.

\textsuperscript{118} To ensure that the general price structure will be maintained at a sufficiently profitable level, oligopolists may favor the use of vertical restraints by every other oligopolist in the concentrated industry. See \textit{Baker, supra} note 54, at 541.

\textsuperscript{119} However, another commentator has stated that the reduction of price competition and reduction of the number of competing outlets for a manufacturer’s products may be the result of any “marketing program based on selective distribution rather than random selling.” See \textit{Pollock, supra} note 54, at 599.


\textsuperscript{121} It should be noted that not all economists agree that the preservation of the small businessman is a goal of antitrust law. For example, Professor Robert Bork has consistently maintained that per se antitrust rules are deficient because they ignore the specific economic phenomena underlying business practices and fail to account for the values served by the antitrust laws in relation to which these practices must be measured. Bork I, \textit{supra} note 16, at 777.

\textsuperscript{122} The main tradition of antitrust law, which Bork discovers through a detailed analysis of Supreme Court decisions from the late 19th century to the present, does not indicate that competition in and of itself is the goal of antitrust law. \textit{Id.} at 830. Rather, the policy underlying these decisions is “the maximization of wealth or
interrelated to the extent that a deconcentrated market characterized by numerous, independent decisionmaking firms will most likely lead to effective competition. Accordingly, it has been posited that the franchising system of distribution which utilizes independent firms instead of employees of large vertically integrated firms is more consonant with antitrust policy. The proponents of this argument contend that the per se prohibition of vertical restrictions will lead to the demise of the franchise system by accelerating vertical integration and business "bigness." However, it is submitted that although the policy favoring small business is clear, the impact on this policy of a per se rule to govern vertical restrictions is not.

At least one commentator writing shortly after the Schwinn decision predicted that vertical integration would increase and noted that, after the Court's disposition of its case, the Schwinn Company itself resorted to such integration. These predictions were based on the perceived inefficiency of other distribution systems, such as the exclusive use of consignment transactions, which would avoid Schwinn's prohibition. More recently,

consumer want satisfaction." Id. In Bork's view, "competition is the name of a process, not of an ultimate desideratum, and so implies a further value." Id. at 831.

In adopting this view, Bork believed that courts would be capable of creating a consistent body of antitrust precedent, for "[i]t is only when competition is viewed as subordinate to the ultimate value of creating wealth that there exists a social science — that of economics — which courts may properly use to measure the amount of competition that is desirable . . . . [I]t stops the policy of promoting competition short of the complete atomization of society." Id. at 832.

The thrust of Bork's argument is that vertical restrictions should be lawful because their ultimate economic effects go to the maximization of consumer wealth by promoting distributional efficiency. Id. at 830-32. Since competition alone, outside of economic considerations of market share and levels of output, is not a goal of antitrust law, vertical restraints cannot be condemned merely because they foreclose intrabrand competition. Id. Any restraint of trade which lessens competition but does not restrict output and increase a firm's market power therefore should be lawful. Id. The latter effects are, in Bork's opinion, only created by horizontal action. Id.

See ABA MONOGRAPH, supra note 1, at 28 n.95. 120. Id. at 27-29.

121. Id. For a discussion of the view that vertical contractual restraints are legal because a manufacturer could lawfully achieve the same effects by vertically integrating, see Bork II, supra note 2, at 472. It is important to note that a corollary to the antitrust policy of preserving small business is the economic freedom of the small firm to determine its pricing and marketing policies. ABA MONOGRAPH, supra note 1, at 29-31. The exercise of this freedom may include, however, the option of entering into contractual relationships that restrict a firm's freedom in order to achieve other efficiencies. Id. These contractual restrictions have generally been judged by a standard of reasonableness. Id. However, in the area of vertical restrictions, the Schwinn prohibition of restraints on alienation suggests that such contracts are per se unlawful, without regard to the degree to which they restrict the small businessman's independence. Id. See also GTE Sylvania Inc. v. Continental T.V., Inc., 537 F.2d 980, 1019-22 (9th Cir. 1976) (en banc) (Browning, J., dissenting), aff'd, 433 U.S. 36 (1977).

122. See Pollock, supra note 57, at 569-70.

123. See Pollock, supra note 54, at 609-10. It is suggested that the use of agency or consignment transactions could be viewed as mere forms for what are in substance sale transactions utilized to avoid the prohibition of Schwinn in violation of the antitrust law.
however, commentators have denied that vertical integration has resulted from Schwinn's per se rule.\textsuperscript{124}

In fact, the efficiency of vertically integrated distribution is questionable on several grounds. First, integration may threaten a manufacturer with other antitrust violations under section 2 of the Sherman Act (monopolization)\textsuperscript{125} or section 7 of the Clayton Act (integration through merger or acquisition).\textsuperscript{126} Second, distribution is a low-profit activity, requiring a managerial staff that is familiar with local problems and able to provide a high quality level of personal service.\textsuperscript{127} Finally, many manufacturers will not produce a product mix sufficiently varied to draw consumers to their outlets.\textsuperscript{128}

Perhaps the most convincing argument disputing the assumption that the prohibition of vertical restrictions would encourage vertical integration is the fact that "bigness" is already a part of American economic life. As one commentator has aptly stated, "[I]f it is concentration we fear, let us relax. We already have been eaten."\textsuperscript{129}

4. Economic Summary

Evidently, there is no concurrence of economic opinion as to the effects and purposes of vertical territorial and customer restrictions. One view posits that although these restrictions are often legitimate attempts to deal with compelling problems in the distribution process, they often result in excessive product differentiation and do not confer any actual benefit upon

\textsuperscript{124} See, e.g., ABA MONOGRAPH, supra note 1, at 29–31; Zimmerman, supra note 54, at 1187. See also GTE Sylvania Inc. v. Continental T.V., Inc., 537 F.2d 980, 1029 n.32 (9th Cir. 1976) (en banc) (Browning, J., dissenting), aff'd, 433 U.S. 36 (1977).

Edwin M. Zimmerman, for instance, has noted that the elimination of vertical restraints would not turn independent distribution systems into a "rat's nest of chaotic, inefficient, fly-by-night competition." Zimmerman, supra note 54, at 1186. In his view, vertical integration would therefore not be necessary to achieve efficient distribution. Id. at 1186–87.


\textsuperscript{127} Comanor, supra note 14, at 1435–36.

\textsuperscript{128} Id. See Zimmerman, supra note 54, at 1186. See generally Phillips, Schwinn Rules and the "New Economics" of Vertical Relations, 44 ANTITRUST L.J. 573 (1975).

It has been suggested that a per se rule against vertical restraints will not only encourage vertical integration by large firms, but will also eliminate small competitors who are financially incapable of integrating, thereby allowing the "big ones" to become bigger. See Pollock, supra note 54, at 610–12.

\textsuperscript{129} Blecher, supra note 54, at 555, citing Keeffee, The Lawyer’s Washington — What Hath I.T.T. Wrought: A New Poker Game?, 61 A.B.A.J. 877 (1975). As Keeffee has stated:

So the trend toward corporate bigness has picked up steam in recent years: 110 of the Fortune 500 largest industrials disappeared by merger from 1962 to 1968, and the average number of mergers each year from 1967 to 1969 was 3,605. From 1950 to 1974 the 200 top industrial firms increased their control over manufacturing assets from 46 to 66 per cent. And 115 “billion dollar” companies now have 52 per cent of all the manufacturing assets in our trillion dollar economy.

Keeffee, supra at 877.
Furthermore, the problems in the distribution process may effectively be minimized by the use of less anticompetitive means. In contrast, those on the other side argue that alternative means are less efficient and more costly, and that vertical restrictions cannot be illegal since they only achieve contractually what the manufacturer could legally do by integrating his manufacturing and distributional systems.

Although the policies and theories urged in opposition to vertical restraints are in many regards more persuasive than those urged in favor of their use, the absence of any consensus as to the economic desirability of these restraints argues against a per se rule of unlawfulness.

B. Alternative Legal Theories

1. Per Se Illegality

One of the most compelling arguments in favor of a per se rule of unlawfulness is that courts are ordinarily capable of applying the rule to anticompetitive business arrangements without regard to the particular circumstances involved in each case. Unfortunately, the courts do not possess sufficient familiarity to utilize a per se rule in the context of controversial practices such as vertical territorial or customer restrictions.

It is submitted that in fact, there are few defensible reasons for imposing a blanket rule of per se unlawfulness upon the use of such restraints.

One argument advanced in support of a per se rule is that it would bring some consistency to the law regarding territorial restrictions by dealing with vertical restraints in the same manner as horizontal restraints. Since it is often impossible to determine whether the restraints are vertical or are instead the result of concerted dealer pressure on the manufacturer, a per se rule for both would preclude the necessity for deciding the issue.

More compelling and realistic, although somewhat extreme, is the view that antitrust law is no longer a functional tool for effecting economic policy. This pragmatic approach recognizes that the huge manufacturing

130. See notes 101-03 & 107-17 and accompanying text supra.
131. See Louis, supra note 6, at 305. See also text accompanying note 100 supra.
132. See, e.g., Bork II, supra note 2, at 472; Pollock, supra note 54, at 606-10.
133. See generally notes 107-17.
134. See Note, supra note 33, at 637.
135. See note 21 supra.
136. See Pollock, supra note 54, at 600-01; see also note 32 and accompanying text supra.
137. See Zimmerman, supra note 54, at 1188; see also note 2 and accompanying text supra.
138. The difficulty of deciding this issue is enhanced by the fact that often both dealers and manufacturers desire the use of vertical restraints. See note 106 supra. But see Bork II, supra note 2, at 405-10. Professor Bork has asserted that dealer cartels which force manufacturers to impose vertical restraints on their distributors are the exception rather than the rule. Id. Bork posited that dealers would rarely be able to enlist the support of a majority of the manufacturer's dealers and would be unable to police the observance of the restrictions. Id. Furthermore, enforcement agencies should be able to find at least one dealer who will reveal the true origin of the restraints. Id.
139. Blecher, supra note 54, at 555-56.
concerns which dominate our economy are already largely free from competition due to their size and power and suggests that antitrust law should instead focus on the protection of the interests of the small businessman — the distributor. This policy would prohibit the use of vertical restraints so as to free the distributors from the threat of franchise termination if they violate the restrictions.

Finally, it has been convincingly argued that courts are ill-equipped to weigh the complex economic effects of vertical restrictions. Since these restrictions indisputably ban intrabrand competition, and the Sherman Act clearly aims at the preservation of competition, it has been suggested that there is no need to balance the intrabrand and interbrand effects of these restraints. A per se rule is therefore appropriate under this approach and would lend predictability and ease of enforcement to the law.

Nevertheless, given the economic uncertainty concerning the ramifications of these restraints on the market, it is submitted that these considerations of efficiency and policy do not seem sufficiently compelling to support a blanket declaration of illegality as to vertical restraints.

2. Rule of Reason Approach

The rule of reason analysis, while providing businessmen a full opportunity to justify their practices, would entail a long and complicated balancing process for the courts in every instance. The variety of vertical restraints and the fact that they are most often found in combination adds to the difficulty of utilizing a balancing approach. This, in turn, would probably result in a majority of defendant verdicts if courts were unable to determine that the practices were so unreasonably anticompetitive as to be illegal.

Finally, the rule of reason would result in a flood of litigation as businessmen and the enforcement agencies tested various restrictions with the effect that many restrictions would continue for years while the litigation progressed.

140. Id.
141. Id.
142. See Louis, supra note 6, at 278.
145. See notes 90–129 and accompanying text supra.
146. See note 20 supra.
147. See Louis, supra note 6, at 278; Pollock, supra note 57 at 566–67.
148. See Blecher, supra note 54, at 553. One commentator has defined a rule of reason trial as "a euphemism for an endless economic inquiry resulting in a defense verdict." Id.
149. See Louis, supra note 6, at 277 n.14 (author noted the increase in vertical restriction litigation following Schwinn).
3. Alternative Legal Approaches

It would seem, therefore, that some other legal standard should be applied to vertical restrictions. Two such approaches have been suggested. The first, commonly called a “structural rule of reason” analysis, employs a presumption of illegality which may only be rebutted by proof of specified defenses. This approach is based on the premise that vertical restraints are more anticompetitive than economically beneficial. However, they may be procompetitive “when the product market is unconcentrated at the manufacturing stage and differentiation is weak; or when the producer restricting its distributors’ spheres of operation would otherwise have difficulty gaining or maintaining a foothold in the market.”

The rule of presumptive illegality would apply whenever vertical territorial or customer limitations were proven to have been imposed and the manufacturer had any demonstrable degree of market power in the relevant market or the restraints were designed to prevent price cutting. Once this requirement was satisfied, the burden would shift to the defendant to prove that the vertical restrictions are reasonably necessary to preserve customer confidence in its product; that the product involves some health or safety risks that are reduced by supervised distribution; or that the manufacturer is trying to break into the market. Moreover, regardless of the manufacturer’s defense, he would also be required to demonstrate that less anticompetitive means would not be sufficient to achieve his goals. It is submitted that this approach to vertical restriction litigation offers the advantage of reducing the harshness of a per se rule, while defining and rendering predictable the rule of reason approach.

150. See Baker, supra note 54, at 543–48. The Government argued for such a rule of presumptive illegality when it appealed Schwinn to the Supreme Court. See note 62 supra.

151. See Conman, supra note 14, at 1423–28. For a discussion that this in fact appears to be the situation, see notes 99–100 & 107–17 and accompanying text supra.


153. See Baker, supra note 54, at 545. Proof of market power at the manufacturer level may be established by showing large market share or by demonstrating a high level of product differentiation. Id. At the dealer level, although market power is more difficult to prove, a large market share is similarly an appropriate indicator of market power. Id. The presumption of illegality may also arise in other situations, such as where the territorial restraints are accompanied by exclusive dealerships. Id. at 546.

154. Id. In order to preserve the basic presumption of illegality, the acceptable defenses must be strictly defined. Id. For example, the defense of reasonable necessity to preserve the goodwill of a product would be sufficient only where the product was complex and required extensive servicing. Id. See Snap-On Tools Corp. v. FTC, 321 F.2d 825 (7th Cir. 1963).

155. See Baker, supra note 54, at 546–47.


157. The presumptive illegality approach has been criticized as overly simplistic and unresponsive to the “actual performance of specific markets.” Louis, supra note 6, at 307 (footnote omitted). Since the rule of presumptive illegality isolates certain
The second alternative to the per se or rule of reason analysis is the partial per se rule. This would forbid the use of vertical territorial and customer limitations while utilizing the rule of reason to evaluate other types of vertical restrictions.158 This approach, however, appears less effective than the rule of presumptive illegality since vertical territorial and customer limitations may be justifiable in certain narrowly defined situations.159

IV. THE Continental T.V., Inc. v. GTE Sylvania Inc. Decision

A. Factual Background

On June 23, 1977, the Supreme Court of the United States handed down the Sylvania decision, in which the court summarily overruled Schwinn by replacing the partial per se approach with a sweeping rule of reason theory governing all vertical restriction cases.160 However, it is submitted that the Court failed to resolve the conflicts outlined above and therefore the actual precedential significance of the Sylvania decision is open to serious question.

The Sylvania case involved a single vertical restriction — a location clause,161 which was firmly enforced by Sylvania. Under a previous dis-

decisive factors and limits the number of these factors to preserve predictable and efficient litigation, the correlation between the final judgment and the actual market situation is imperfect. Id. at 307–08. Further, there is the problem of choosing the economic indicia which will be acceptable as proof of business justification for the use of vertical restraints. Id. at 307–09.

158. Id. at 310. One form of this approach is represented by the Schwinn resale rule. See United States v. Arnold, Schwinn & Co., 388 U.S. 365, 370 (1967). This rule would ban the use of vertical territorial and customer restrictions except in cases where they were used for limited time periods to aid a new entrant or a failing company. Louis, supra note 6, at 310. Other restraints would remain subject to rule of reason analysis. Id.

159. See Louis, supra note 6, at 308–09.


161. Id. at 38. For a definition of location clauses, see text accompanying note 9 supra. In general, location clauses restrict the location from which a distributor or dealer may resell the manufacturer's product. See note 9 supra. They do not explicitly restrict the territory in which the distributor or dealer may sell. See text accompanying note 9 supra. In 1942, the Second Circuit upheld the use of location clauses in General Motors' franchise agreements, finding no unreasonable restraint of trade. Boro Hall Corp. v. General Motors Corp., 124 F.2d 822 (2d Cir. 1942), cert. denied, 317 U.S. 695 (1943). The Second Circuit's decision was followed by every court that considered location clauses after Boro Hall. See, e.g., Salco Corp. v. General Motors Corp., 517 F.2d 567 (10th Cir. 1975); Kaiser v. General Motors Corp., 396 F. Supp. 33 (E.D. Pa. 1975), aff'd 530 F.2d 964 (3d Cir. 1976). Furthermore, in United States v. General Motors Corp., 384 U.S. 127 (1966), the Supreme Court declined to decide the validity of dealer location clauses. Id. at 139–40.

Both lower court decisions that had held location clauses unlawful were subsequently withdrawn. See United States v. Revlon, Inc., 1975–1 TRADE CAS. (CCH) ¶ 60,202 at 65,727 (S.D.N.Y. 1975), opinion withdrawn, 1975–2 TRADE CAS. (CCH) ¶ 60,583 (S.D.N.Y. 1975). The other lower court decision holding location clauses per se illegal was the original panel decision of the Ninth Circuit in Sylvania itself. GTE Sylvania Inc. v. Continental T.V., Inc., 1974–1 TRADE CAS. (CCH) ¶ 75,072 (9th Cir. 1974). This opinion was withdrawn and reversed by the Ninth Circuit sitting en banc.

https://digitalcommons.law.villanova.edu/vlr/vol23/iss3/6
Sylvania used wholesale distributors to market its televisions and had allowed these distributors to resell to any dealer they

GTE Sylvania Inc. v. Continental T.V., Inc., 537 F.2d 980 (9th Cir. 1976) (en banc), aff'd, 433 U.S. 36 (1977). These courts apparently did not find Schwinn a bar to such clauses. This was a reasonable assumption since location clauses were permitted in the final judgment in Schwinn on remand. United States v. Arnold, Schwinn & Co., 291 F. Supp. 564, 565-68 (N.D. Ill. 1968).

The economic debate over the effects of vertical territorial and customer limitations has occasionally extended to the use of location clauses. For example, those commentators who did not support the Schwinn partial per se rule had read that opinion as permitting the use of less restrictive vertical restraints, including location clauses. See, e.g., Pollock, supra note 54, at 603-05; Zimmerman, supra note 54, at 1187-88. Other economists and antitrust scholars have argued that location clauses may be as anticompetitive as actual territorial restrictions and are therefore within Schwinn's prohibition. See Louis, supra note 6, at 290-91. Although only the geographic location of the outlet is controlled, rather than the freedom of the dealer to solicit and make sales in any territory, it should be noted that the location clause does prevent the dealer from making a large part of these sales in distant territories. Id. As the distance from the authorized location increases, costs of solicitation and shipment also increase until it is impossible for the dealer to make the distant sale at the high price he is forced to charge. Id.

Furthermore, it has been argued that a per se rule of unlawfulness for location clauses would not deny the manufacturer all control over dealer selection. Id. at 288-90. For example, suppose a manufacturer has authorized a particular location and granted an exclusive dealership there. If the dealer opens an unauthorized outlet in another dealer's exclusive territory, he

will suffer increasing transportation costs unless the manufacturer is willing to ship directly to the dealer's customers or to any location it establishes there. Such direct shipments into the territory would, however, arguably violate the manufacturer's promise of exclusivity and justify its refusal to deal;... if it is lawfully implied in the grant of the exclusive franchise... a distributor's ability to operate anywhere at wholesale or retail is significantly limited by the cost of transshipping merchandise from its nearest authorized location. Id. at 288-89. Nevertheless, even those who oppose a rule of reason approach to location clauses have recognized that a possible exception should be made for new retail dealers. Id. at 292-93. The temporary use of location clauses by such dealers is justifiable in their view because without such protection, the new dealer might fail under the pressure of invading the market of established dealers selling the same product. Id.

As one commentator has stated:

Allowing the temporary use of the location clause in nonexclusive new-entry situations would actually be a minor concession. By definition some degree of intrabrand competition would exist. Furthermore, during that period the new entrant would presumably provide the area with sufficient additional capacity or locational convenience to discourage other dealers from locating there anyway, unless they undertook to drive it out of business. Barring such a possibility, the temporary use of location clauses may give the potential new entrant the assurance to undertake the dealership without significantly harming competition. Id. at 292 n.94. However, another commentator has refused to accept this justification, protesting adamantly against any restriction whereby a manufacturer can choose where, when, or for how long intrabrand competition may proceed freely. See Blecher, supra note 54, at 554.

162. GTE Sylvania Inc. v. Continental T.V., Inc., 537 F.2d 980, 982-83 (9th Cir. 1976) (en banc), aff'd, 433 U.S. 36 (1977). Petitioner, Continental T.V., Inc., was a franchised Sylvania dealer operating very successful retail outlets at approved locations. 537 F.2d at 984-85. In 1965, Sylvania franchised another dealer in San Francisco and approved a location for this store only one mile from one of Continental's outlets. Id. Continental objected, but the store was established. Id. Thereafter, Continental cancelled a large order from Sylvania and replaced it with a
chose. However, Sylvania's market share had dropped to one to two percent of national sales by 1962 and the market was dominated by huge companies. In what it saw as a necessary protection against being expelled from the market, Sylvania eliminated its wholesalers, sold directly to only franchised dealers, and employed location clauses. However, Sylvania "made specific efforts to avoid anticompetitive practices." Sylvania did not provide exclusive franchises, no dealer could veto Sylvania's decision to franchise another dealer in a given area, and dealers could sell to any customer visiting the dealer's outlet. The plan achieved moderate success, increasing Sylvania's market share to five percent by the mid-1960's.

In GTE Sylvania Inc. v. Continental T.V., Inc., the United States Court of Appeals for the Ninth Circuit held that Sylvania's contractual restrictions did not foreclose intrabrand competition and were distinguishable from those considered in Schwinn. The court emphasized that the restrictions utilized in Schwinn — territorial restraints — had clearly anticompetitive effects, whereas the location clause employed by Sylvania did not. Stressing the necessary interrelationship between the location clause and the exclusive franchise, as well as the procompetitive interbrand effects of the location clause, the court upheld Sylvania's restrictive practices.

large order from one of Sylvania's competitors. Id. Continental then requested permission to open another outlet in Sacramento, but Sylvania refused its permission. Id. Subsequently, Sylvania severely reduced Continental's credit upon receiving notice from Continental that it was moving Sylvania products to a retail store in Sacramento in violation of the location clause. Id. at 985-86. Continental then withheld payments to John P. Maguire & Co., the finance company responsible for Sylvania's credit transactions with its dealers. Id. Consequently, Sylvania cancelled Continental's franchise and Maguire brought this suit to recover the money due. Id. at 982-87. The issue of the validity of the location clause was raised in a counterclaim by Continental against Maguire Co. Id. at 985.

163. Id. at 982.
164. Id. RCA alone held 60 to 70% of the market. Id.
165. Id. at 983.
166. Id.
167. Id.
168. Id. at 984.
170. 537 F.2d at 989-90. The Ninth Circuit, in its three-part analysis of Sylvania, noted that Schwinn had involved a combination of restraints which, taken together, totally foreclosed intrabrand competition. Id. In contrast, Sylvania allowed its dealers to sell to any customer they chose, and by franchising more than one dealer in each metropolitan marketing area, Sylvania did not foreclose intrabrand competition. Id. at 990. The Ninth Circuit stated: "Thus a critical and very obvious distinction between the restraints in Schwinn and those of Sylvania is that Schwinn involved a restriction on the locations and types of permissible vendees, while Sylvania only imposed restrictions on the permissible locations of vendors." Id. (emphasis in original).
171. Id. at 989-90.
172. Id. at 997. In the second part of its analysis, the court reasoned: If it is legal for a manufacturer to promise one dealer that he will have the exclusive right to sell the manufacturer's products within a designated territory, then obviously it is legal for that manufacturer to keep his promise of exclusivity...
B. The Sylvania Opinion: Has the Supreme Court Decided the Legal Status of Vertical Restrictions?

The most significant feature of the Sylvania decision, authored by Justice Powell, was the acknowledgment by the Court that the reasoning by denying other dealers...the power to sell from retail outlets at unauthorized locations within the first dealer's exclusive territory.

Id.

In the opinion of the Ninth Circuit, the exclusive franchise with a location clause was actually a preferable method of distribution. Id. at 996. It ensured efficient market coverage, reduced intrabrand competition instead of foreclosing it, and preserved the role of the small businessman by discouraging vertical integration. Id. at 996 n.27, citing Jentes, Permissible Vertical Restraints in Manufacturer — Distributor Relations, 8 ABA ANTITRUST L. NOTES 97, 102 (1972). The Ninth Circuit argued by analogy that the clearly established legality of exclusive dealerships logically compels the conclusion that location clauses are not per se illegal. 537 F.2d at 997. For cases holding exclusive franchises legal, see note 14 supra. See generally McClaren, supra note 54, at 144-45.

The final section of the Ninth Circuit's analysis of the location clause was grounded in the court's perception of the policy of the Sherman Act. 537 F.2d at 1000. According to the court, this policy would not be served if every slight restraint of competition was considered per se illegal. Id. Rather, the intrabrand anticompetitive effects should be balanced against the procompetitive interbrand effects of the location clause. Id. The court noted that Sylvania remained in the market as a competitor against other brands, because it was able to regulate its distribution system and prevent cut-throat intrabrand competition by employing location clauses. Id. If Sylvania had been eliminated from the market, the result would have been further concentration of an oligopolistic market and a greater likelihood of eventual monopolization. Id.

Interestingly, the court indicated in a footnote that it was aware of the economic controversy generated by vertical restraints and did not espouse either view. Id. at 1003 n.390. The court felt this neutrality could be adequately served only by conducting a rule of reason trial. Id. The court recognized, however, that vertical restrictions and the location clause in particular had some procompetitive effects. Id.

Judge Kilkenny, joined by Judges Browning, Duniway and Wright, dissented in a lengthy opinion, the main thrust of which was the applicability of Schwinn to any post-sale restraint on alienation, regardless of whether the restraint involved vendees or vendors. Id. at 1008-09 (Kilkenny, J., dissenting). Judge Kilkenny asserted that the location clause had the same economic effect as the territorial restraints in Schwinn, for the dealer could not realistically be expected to sell to accounts very distant from his authorized location. Id. at 1009-10 (Kilkenny, J., dissenting). The dissent also noted that the remand decree in Schwinn, while permitting a location designation clause, "means only that a manufacturer can specify the location at which a retailer is the manufacturer's authorized representative and assign areas of primary responsibility, but that a manufacturer cannot impose resale restrictions forbidding retailers from selling the manufacturer's product except where the manufacturer allows." Id. at 1011 (Kilkenny, J., dissenting).

Judge Kilkenny also disputed the majority's formulation of the relationship between exclusive franchises and location clauses. Id. at 1013-14 (Kilkenny, J., dissenting). Finding the two practices entirely independent of each other, Judge Kilkenny opined that the manufacturer could adequately ensure effective marketing solely through use of the exclusive franchise. Id.

Finally, Judge Kilkenny disagreed strongly with the majority's willingness to balance procompetitive effects in one sector against anticompetitive effects in another. Id. at 1015 (Kilkenny, J., dissenting). The dissent stated that free enterprise meant that no single manufacturer or group of individuals should be permitted to choose where competition will be encouraged or discouraged. Id.

underlying the _Schwinn_ decision was unacceptable.\(^{174}\) Unable to distinguish _Schwinn_ from the case before it,\(^{175}\) the Supreme Court reconsidered _Schwinn_ in light of the controversy and criticism that decision generated in the ten years preceding _Sylvania_.\(^{176}\) Reviewing the two standard modes of antitrust analysis, the Court stressed the infrequency with which a per se rule should be applied and noted that _Schwinn_ represented an unexplained departure from the rule of reason enunciated in _White Motor_, decided only four years before.\(^{177}\)

Noting that _Schwinn_ did not distinguish between vertical restrictions which merely limited intrabrand competition and those which foreclosed it, the Court viewed _Schwinn_’s sale-nonsale distinction as an attempt to balance the intrabrand harm and interbrand benefit which often result from vertical restrictions.\(^{178}\) The _Sylvania_ Court found no analytical support for this distinction,\(^{179}\) and proceeded to reject the _Schwinn_ Court’s sale-nonsale distinction as unrelated to the actual market impact of vertical restrictions.\(^{180}\)

The _Sylvania_ Court’s economic analysis of vertical restraints was based on the recognition of the pragmatically similar effects of location clauses and outright territorial and customer limitations.\(^{181}\) Vertical restrictions in general were viewed as reducing intrabrand competition\(^ {182}\) in order to improve distributional efficiency by encouraging dealer investment and servicing, and by protecting product quality.\(^{183}\) Consequently, the Court concluded that vertical restrictions may have “economic utility” and thus could not be readily disposed of by a per se rule of illegality.\(^ {184}\) Accordingly, the Court concluded that the _Schwinn_ per se rule should be overruled:

---

174. 433 U.S. at 57-59.
175.  Id. at 45-47. Since title had passed from _Sylvania_ to the dealers upon whom the location restriction was imposed, the _Schwinn_ partial per se rule was applicable unless the location clause did not restrict the freedom of those dealers.  Id. at 45-46. However, the dealers’ freedom was clearly restricted since they could not sell from wherever they wished and therefore could not practically sell to many customers and in many territories distant from their authorized outlet.  Id. The location clause, according to the Court, was indistinguishable from the retail customer limitations condemned in _Schwinn_, despite slight differences in their effectiveness in foreclosing intrabrand competition.  Id.
176.  Id. at 47-49.
177.  Id. at 51.
178.  Id. at 52.
179.  Id. at 54. The majority summarily dismissed the restraint on alienation rationale advanced in support of the _Schwinn_ partial per se rule.  Id. at 53 n.21. See text accompanying note 77 supra.
180.  433 U.S. at 54-56.
181.  Id. at 54.
182.  Id. The Court recognized that location clauses severely restrict the ability of dealers to exploit the available market due to the practical inability of many consumers to reach a dealer’s location.  Id. at 52 n.19.
183.  Id. at 54-56.
184.  Id. at 57-58. It is important to note that the court refrained from engaging in a sophisticated economic analysis. However, the Court did evidence a generally positive attitude toward vertical restraints throughout its brief effect analysis.  Id. at 56 n.25. For example, the majority expressed a lack of concern over the product differentiation which might result from use of these restrictions.  Id. Moreover, the
In so holding we do not foreclose the possibility that particular applications of vertical restrictions might justify per se prohibition. But we do make clear that departure from the rule of reason standard must be based upon demonstrable economic effect rather than — as in Schwinn — upon formalistic line drawing.

In sum, we conclude that the appropriate decision is to return to the rule of reason that governed vertical restrictions prior to Schwinn.185

C. The State of the Law after Sylvania

The Sylvania Court laid to rest the controversial Schwinn partial per se rule and replaced it with the rule of reason applicable to all vertical restrictions.186 However, the impact Sylvania will have on lower courts in their analysis of vertical restrictions or on businessmen in their utilization of them is unclear. The Court was careful to expressly indicate that some methods of employing vertical restraints could be so anticompetitive as to be deemed per se illegal.187 The Court, however, provided no guidance for determining which restrictions might be so anticompetitive, nor did the opinion explain whether such a per se rule could ever be applied to single vertical restraint in isolation from others.

It should be noted that the validity of a location clause was the only issue presented to the Sylvania Court on appeal, and therefore the majority's broad rule of reason holding is technically dicta as to all other vertical restrictions.188 Moreover, the Court refused to distinguish among the economic effects of the various restraints.189 It is submitted that this lack of careful analysis led the Court to generalize unjustifiably, since it ignored the clearly less restrictive impact such vertical restraints as primary responsibility clauses have compared to the use of exclusive territories that are firmly enforced by the manufacturer.190

---

185. Id. at 59. In his concurring opinion in Sylvania, Justice White objected to the majority's decision to overrule Schwinn in the context of a case where only a location clause was involved. 433 U.S. at 59-60 (White, J., concurring). Justice White asserted that the only holding necessary for the just resolution of this case was a recognition of the significantly less anticompetitive effects of location clauses as compared to the Schwinn restraints. Id.

186. Id. at 59.
187. See text accompanying note 185 supra.
188. 433 U.S. at 38.
189. Id. at 46.
190. See notes 10, 100, 108 & 109 and accompanying text supra. In his concurring opinion, Justice White found significant differences between the economic effects of a location clause as opposed to vertical territorial and customer restraints. 433 U.S. at 59-62 (White, J., concurring). The concurrence also noted that Schwinn and Sylvania involved defendants with very disparate amounts of market power. Id. at 63-64 (White, J., concurring). Instead of overruling Schwinn, Justice White preferred to
Furthermore, since the Court chose to subject all of these restrictions to a rule of reason analysis, it may be that territorial and customer restrictions which completely ban intrabrand competition will be declared illegal more frequently than will those restraints which merely discourage intrabrand competitive activity. It is important to note, however, that the Court specifically restored the state of the law to the way it was before Schwinn.\textsuperscript{191} It may also be significant that prior to Schwinn, and subsequent to White Motor, the two courts that considered vertical restraints upheld them, even though they foreclosed intrabrand competition.\textsuperscript{192} In addition, the Supreme Court’s reinstatement of White Motor as the controlling precedent in this area strongly suggests that vertical restrictions will rarely be held to be so anticompetitive as to justify application of a per se rule. Indeed, as Justice Brennan’s frequently cited concurrence to White Motor strongly suggested, vertical restraints were often economically necessary and generally procompetitive practices, even outside of the new entrant or failing company situations.\textsuperscript{193}

Nevertheless, the Sylvania Court explicitly left open the issue of the applicability of a per se rule in some vertical restraint cases,\textsuperscript{194} giving lower courts the freedom to strengthen their experience and familiarity with vertical restraints cases through rule of reason trials and then to determine whether each type of restraint unerringly proved to be severely anticompetitive. Whether lower courts will exercise this option, in light of the clear implications of the Sylvania opinion favoring the rule of reason, is doubtful. It is more likely that the lower courts will be confronted with a flood of vertical restraint cases brought by enforcement agencies and private parties to test the validity of various combinations of vertical restraints. In the course of the protracted litigation that will result, it is submitted that courts will be forced to balance economic theories with which they are incapable of dealing.\textsuperscript{195} Consequently, it appears that few courts will be capable of finding a use of vertical restrictions so unjustifiable, so unsupported by business needs, or so generally anticompetitive on balance as to warrant a per se rule.\textsuperscript{196} While fully consonant with the Supreme Court’s attitude as articulated in Sylvania, it is suggested that this result will be an unfortunate consequence of the Court’s endorsement of the rule of reason. As demonstrated above, vertical restraints in at least the two most restrictive forms — territorial and customer restrictions — may have broad anticompetitive effects, may severely misallocate resources, and may rob independent distributors and dealers of the freedom to regulate their own affairs.\textsuperscript{197)

\textsuperscript{191} See text accompanying note 185 \textit{supra}.
\textsuperscript{192} See notes 42–53 and accompanying text \textit{supra}.
\textsuperscript{193} See notes 34–35 and accompanying text \textit{supra}.
\textsuperscript{194} 433 U.S. at 58–59.
\textsuperscript{195} See notes 147–49 and accompanying text \textit{supra}.
\textsuperscript{196} Id.
\textsuperscript{197} See generally notes 100 & 107–17 and accompanying text \textit{supra}. In his concurring opinion in Sylvania, Justice White was particularly concerned with the
Moreover, similar efficiencies of distribution may usually be achieved through the use of demonstrably less restrictive means.198

V. CONCLUSION

It is submitted that the Supreme Court might have more appropriately limited its holding to a determination of the location clause issue before it. When a case of vertical territorial or customer limitations did ultimately present itself, a preferable resolution would have been to apply a presumption of illegality that might be rebutted by specific defenses.199 This would free the lower courts from an economic battle they are ill-equipped to arbitrate and would lend the law of vertical restrictions some degree of structure, predictability, and ease of enforcement. As the law presently stands, economists will continue to argue the benefits and drawbacks of vertical restraints while businessmen will continue to employ them, pending litigation.

Joanne R. Alfano

fact that vertical restrictions in their most restrictive forms entirely deprive independent businessmen of their freedom. 433 U.S. at 60–61 (White, J., concurring). Therefore, Justice White stated that Schwinn’s emphasis on preventing restraints on alienation was well-founded and should be retained as an expression of antitrust policy. Id. See note 78 supra. Justice White did agree, however, that Schwinn’s sale–resale distinction was insufficient to protect the freedom of these small businessmen and suggested that greater emphasis be placed on an economic effect analysis. Id. at 68–69. (White, J., concurring).

198. See note 100 and accompanying text supra.
199. See notes 150–57 and accompanying text supra.