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A Rule of Reason for Vertical Restraints: Continental v. Sylvania

CASE COMMENTS

A RULE OF REASON FOR VERTICAL RESTRAINTS

*Continental v. Sylvania**

The American judiciary's enforcement of regulation of economic agreements in restraint of trade, within a historically *laissez faire* politico-socio-economic system,[1] is analogous to Lucifer urging Gideon to blow the final trumpet. The mandates of the federal antitrust statutes[2] to control such undesirable economic activity stem in part from the traditional American notion that non-interference by government is the life blood of free enterprise and open competition, even though all business agreements restrain trade in one fashion or another.[3] Today, governmental antitrust lawyers find themselves in the awkward position of patrolling business to keep competition free of agreements which unduly restrain trade.

It is this very fundamental issue: how much should the government regulate to adequately foster "workable competition," which has perplexed antitrust experts and compounded the judiciary's interpretation function.[4] Beginning with the inception of federal antitrust legislation in 1890, the courts have struggled to resolve basic

*537 F.2d 980 (9th Cir. 1976), *aff'd*, ___ U.S. ___, 97 S.Ct. 2549 (1977).

1. This antithesis, government regulation to preserve a semblance of a *laissez-faire* economy, is fundamental to American antitrust jurisprudence. *See* notes 28-29 *infra* and accompanying test; H. THORELLI, THE FEDERAL ATITRUST POLICY 1-5, 112-113, 115 n.26 *passim* (1955) (hereinafter cited as THORELLI); *See also* BELLOC, *The Modern Man*, in WHO OWNS AMERICA? 340 (H. Agar ed. 1970).

2. The basic antitrust legislation is the Sherman Antitrust Act of 1890. Act of July 2, 1890 c. 647. 26 Stat. 209, 15 U.S.C. §§ 1-7 (1976), as most recently amended by Act of December 12, 1975, Public Law 94-145, effective March 11, 1976 [hereinafter cited as Sherman]. Power to define anticompetitive conduct rests in the judiciary by virtue of U.S. Const. art. III, § 2, cl. 1.

3. Standard Oil Co. of N.J. v. United States, 221 U.S. 1, 10 (1911).

4. Competition operates to keep private markets working in socially acceptable ways. Functioning ideally, private markets should: achieve efficient resource allocations, stimulate the use of efficient methods of production and distribution of quality goods and services at reasonable prices, conserve irreplaceable resources and encourage high productivity through a progressive technology. Theoretically, the combination of these elements contributes to a stable market. *See* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 22-27 (1970).

antitrust questions. Thus, the validity of a restraint's business purpose has been held to determine the degree of judicial scrutiny which that particular restraint receives.[5] While some agreements are now inherently more restrictive of trade,[6] sometimes a company must accept smaller market share simply because Congress prohibited the business restraints necessary to reverse the declining trend in its market.[7] Considering these and similar issues represents the substance of antitrust law on which a court focuses when determining the validity of economic agreements in restraint of trade.

The prohibition of vertical territorial arrangements[8] of a manufacturer (vertical restraints) illustrates the Supreme Court's attempt to resolve antitrust issues where seemingly contradictory economic interests deserve protection. Without agreements defining the parameters of the participants' responsibilities throughout the distribution process, the ability to deliver goods to the marketplace would be impaired and public confidence in the economic system shaken.[9] Therefore, market efficiency "dictates" that restrictions running from the manufacturer to the wholesaler/distributor form an integral part of any efficient distribution system. A problem

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5. Board of Trade of City of Chicago v. United States, 246 U.S. 231, 238 (1918).

6. United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) (price-fixing among competitors as a per se violation of Sherman § 1); United States v. Joint Traffic Ass'n, 171 U.S. 505 (1898); United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897).

7. Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933) (arrangements between competitors reasonable in light of deplorable economic conditions in the bituminous coal mining industry).

8. Vertical agreements exist between persons at different levels of market structure, *i.e.*, among a manufacturer and its distributors—in contradistinction to horizontal agreements among competitors at the same level of the market structure, *i.e.*, among manufacturers or among distributors. United States v. Arnold, Schwinn & Co., 388 U.S. 365, 378-79 (1967); United States v. Sealy, Inc., 388 U.S. 253, 267 (1963) (Brennan, J., concurring). For a more detailed discussion of the horizontal-vertical distinction, see Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 75 YALE L.J. 373, 424-29 (1966).

9. Four possible reasons why a manufacturer/supplier would prefer to use vertical territorial arrangements are:

a. to increase the monopoly power of a supplier's dealers so that the supplier can extract profits from them;

b. to increase the monopoly power of the supplier;

c. to increase the profits of the supplier and his dealers by providing dealers with the means to engage in price discrimination.

d. to increase the supplier's efficiency as well as the efficiency of his dealers.

R. WARREN, ANTITRUST IN THEORY AND PRACTICE, 132 (1975) [hereinafter cited as WARREN].

arises, however, as these restrictions approach an unreasonable limitation on the business opportunities of the participants.

Continental T. V., Inc. v. GTE Sylvania,[10] the most recent Supreme Court antitrust decision addressing vertical restrictions, establishes a new means of determining whether an unreasonable restraint exists. In *Continental,* a dispute arose when a manufacturer of televisions granted a new distributorship to another business approximately one mile from the manufacturer's then leading distributor. Protesting the manufacturer's action, the leading distributor began selling the manufacturer's televisions from an unapproved location. Selling the television products without the manufacturer's prior approval of the business site was a clear violation of the location restriction contained in the distributorship agreement.[11] The location clause prohibited dealers from opening other outlets, especially in another dealer's territory, without the approval of the manufacturer.[12] Using a per se test established under existing law,[13] the Northern District Court of California found the location restriction to be a vertical agreement in restraint of trade and violative of Section One of the Sherman Act.

Meeting *en banc,* the Ninth Circuit Court of Appeals applied the rule of reason test[14] and reversed. According to the appellate court the application of the rule of reason test was warranted by its finding that the manufacturer's location clause was potentially less harmful than those restrictions prohibited by existing law. The Supreme Court, through Mr. Justice Powell, affirmed the circuit court's decision. Thus, *Sylvania* specifically overruled the application of a per se test to vertical restraints on goods purchased by the distributor.[15]

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10. Continental T.V., Inc. v. GTE Sylvania, Inc., 537 F.2d 980 (9th Cir. 1976), *aff'd,* ___ U.S. ___ , 97 S.Ct. 2549 (1977).

11. *Id.* at 2551.

12. The location clause, clearly a restraint on trade, *limits* the number of distributorships in a given area. Its primary purpose is to maximize manufacturers' sales by increasing the quality of dealer services. Louis, *Vertical Distributional Restraints under Schwinn and Sylvania: An Argument for the Continuing Use of a Partial Per Se Approach,* 75 MICH. L. REV. 275, 282 n.36 (1976) [hereinafter cited as Louis].

13. United States v. Arnold, Schwinn & Co., 388 U.S. 365, 382 (1967). *Schwinn* established a per se test as the correct standard for the evaluation of vertical restrictions on a manufacturer's goods which had been purchased by a distributor.

14. Using the rule of reason test, a court evaluates the restraint under all the particular circumstances, announced initially in *Standard Oil Co. of N.J. v. United States,* see note 3 *supra.*

15. *See* note 13 *supra.*

Understanding the *Sylvania* decision requires familiarity with the antitrust standards—the per se test and the rule of reason test—an understanding of the economic effects which vertical restraints have on intraband and interbrand competition,[16] and some knowledge of the history and development of antitrust law. This comment will thus begin with a general history of antitrust law leading up to the change initiated by *Sylvania*.

GENERAL BACKGROUND

During the twenty-five years between the Civil War and passage of the Sherman Antitrust Act in 1890, the American economic system experienced structural change from an agrarian to an industrial system.[17] Although many political and socio-economic factors contributed to the metamorphosis, this comment focuses on those of special significance to the genesis of antitrust.

Perhaps the most critical feature of this transformation was the trend toward economic concentration.[18] During the "Golden Era of Capitalism," the attainment of monopoly power was generally acknowledged to be the primary avenue to achieve the most efficient cost and distribution of goods.[19] Consequently, the development

16. Interbrand competition occurs among distributors of the same brand, *e.g.*, among different manufacturers (or distributors) of Sealy mattresses—in contradistinction to interbrand competition among distributors of different brands, *e.g.*, among manufacturers for distributors) of Sealy and Simmons mattresses. ABA ANTITRUST SECTION, MONOGRAPH NO. 2, VERTICAL RESTRICTIONS LIMITING INTRABRAND COMPETITION (1977).

17. *See* THORELLI, *supra* note 1, at 62-63. Social struggle between the monopolists (interests of concentrated power) and anti-monopolists (small independent proprietorships) crystallized. "Monopoly exists when a specific individual or enterprise has sufficient control over a particular product or service to determine significantly the terms on which other individuals shall have access to it."

18. This was characterized by the increasing visibility of "loose" and "tight" combinations. Loose combinations did not infringe substantially on their members' sovereignty, *e.g.*, gentleman's agreement and pools. As the trend toward concentration intensified, the tighter forms of combination were adopted of which the trust is the best example. Gentlemen's agreements and pools tended to disintegrate, but in the tight agglomeration of the trust, the relationship was permanent. Thus the trust was recognized as the most sophisticated of these corporate aids to economic concentration.

> Once the holding company became available as an instrument for the conduct of enterprise, its uses began to multiply. Most important of all is its use as the most effective device yet invented for combining under a single control and management the properties of two or more hitherto independent corporations.

E. JONES, THE TRUST PROBLEM IN THE UNITED STATES 30 (1921).

19. The Golden Era of capitalism refers to the period in American history generally between 1870 and 1900. *See* THORELLI, *supra* note 1, at 259.

of sophisticated corporate devices to assist efforts in achieving monopoly status became foremost in the minds of the leading entrepreneurs.[20] The rise of business trust arrangements provides the classic illustration since a shift in popular sentiment against these corporate trust activities gave rise to the countervailing antitrust legislation.[21]

The goal of antitrust legislation was the preservation and fostering of open and free competition. Yet it was this freedom to compete which had resulted in the monopoly and other economic concentrations. With the concentration of economic interests, however, came restrictive contracts used to assure the continuation of achieved market power.

Proponents of trusts asserted that the trend towards monopolization was the natural and inevitable outcome of superior performance in the marketplace.[22] This view was supported by the existence of large economies of scale characteristic of monopolies.[23] Opponents to the trusts perceived the concentration of economic power in the hands of a few individuals as a threat to the century old republic.[24] This fear of an economically-oriented oligopoly (a few producers in a given market) being substituted for the

20. The need for heavy fixed capital investment for efficient use of mass-producing facilities and inconsistent monetary policy were important incentives to concentration. *See* Williamson, *Dominant Firms and the Monopoly Problem: Market Failure Considerations*, 85 HARV. L. REV. 1512 (1972).

21. *Contra*, J. CLARK, THE FEDERAL TRUST POLICY (1931); *But see* Destler, *Wealth Against Commonwealth*, 50 AM. HIST. REV. 49 (Oct. 1944).

22. United States v. Grinell Corp., 384 U.S. 563, 570-71 (1966); A. CARNEGIE, THE GOSPEL OF WEALTH 81, 82 (ed. 1933) (Social Darwinism expresses the belief that monopoly is the logical outcome of a struggle where the strong emerge supreme.).

23. One traditional common belief now discarded, was that in the cases of temporary overexpansion of particular industries (repression exhibited by underconsumption of goods), fixed costs prevented rapid transfer of capital. Given the necessity for existing facilities to be functional to defray overhead costs, many businesses were run at a loss. This result was a byproduct of an economy adjusting itself to radically changed fixed income and variable cost relationships, while the long-term price generally receded. With the economic environment thus altered, unless a business could compete at monopoly level, it faced extinction. These economic realities spurred the belief in monopolies' economies of scale (the larger the company, the lower the cost of doing business). *See* WARREN, *supra* note 9.

24.

> A plutocracy is a political form in which the real controlling force is wealth. This is the thing which seems to me to be really new and really threatening; there have been states with wealth and power, but none in which wealth seemed to have such absorbing and controlling power as it threatens us.

W. SUMMER, ESSAYS OF WILLIAM SUMNER 404-409 (1934).

constitutionally based democracy grew as numerous instances of political graft by various trusts were disclosed.[25] Concomitant with the fear of oligopolistic control was the notion that the small independent proprietor's opportunity for successful business diminished as the trusts/monopolies invaded both old and emerging industries.[26]

It is important to remember that the trend toward economic concentration and the resulting demand for its social control are both premised historically on the notion of freedom. It becomes logically impossible therefore to support both interests simultaneously; in antitrust litigation, they are diametrically opposed.[27] In a market place where freedom to compete exists, both interests may be entitled to governmental protection. The following hypothetical example will illustrate the difficulty. Company *A* with 49% of the market purchases Company *B* whose 10% decline in market share was reflected as growth by *A* over a three year period. Company *B* or the government claims Company *A* engaged in anticompetitive practices. Is *A* being singled out because of *A*'s success and *B*'s inability to compete or has *A* exceeded the bounds of competition and infringed upon *B*'s right to compete? Each has an interest; both deserve protection.

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25. The following reinforced the popular notion that trusts were fast becoming invincible. One legislator was first bought by Vanderbilt for $75,000; he next sold out to Vanderbilt's competitor Gould for $100,000. F. SHANNON, THE ECONOMIC HISTORY OF THE PEOPLE OF THE UNITED STATES 492 (1934).

26. Farmers, small businesses, and labor unions individually during different stages of society's economic transformation had confrontations with trusts, tending to restrict their individual liberty. *See* THORELLI, *supra* note 1, at 149. *See also* Twelfth Census Reports, Vol. 7 (1902) (percentage of industries moving toward large scale concentration unmistakable).

27.

> A general application of the Act to all combinations of business and capital organized to suppress commercial competition is in harmony with the spirit and impulses which gave it birth. "Trusts" and "monopolies" were the terror of the period. Their power to fix prices, to restrict production, to crush small independent traders and to concentrate large power in the few to the detriment of the many were but some of the evils ascribed to them.

United States v. Underwriters' Ass'n, 322 U.S. 553, 554 (1943) (insurance companies held subject to Sherman Act § 1).

This reflects the common law notion, codified by the Sherman Act, that competition is the interest to be served. At the point economic power becomes so concentrated that the opportunity of others in the industry to compete does not exist, the threat of monopoly requires a limitation on the monopolist's "right to compete." Kiefer-Stewart Co. v. Joseph Seagrams and Sons, Inc., 340 U.S. 211 (1951).

The central inquiry of the court conducting any antitrust analysis is whether the economic interest protected or sanctioned by the judicial decision is consistent with the Sherman Act's purpose. To maximize competition[28] courts use two radically different principles, the per se test and rule of reason test, the purpose of each being the evaluation of economic conduct.

THE TWO STANDARDS: PER SE RULE AND RULE OF REASON

Developed early in the history of antitrust law, the per se rule is applied to agreements and practices *directly* restraining competition.[29] For example, an agreement between competitors to fix prices without apparent legitimate business purpose has the effect of stifling competition, therefore the application of the per se rule is appropriate. Whenever the restriction directly restrains trade without sufficiently valid justification the per se test is applicable. If the

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28. The primary objective of the antitrust laws is to make the United States economy competitive. United States v. Underwriters' Ass'n, 322 U.S. 533 (1943).

Modern scholars have adopted a term that permits a progressive approach to some inherent inconsistencies with our historically rooted *laissez faire* economy. A structural approach, "workable competition" has two formal elements and four informal elements. One formal requirement is that a firm has the ability by a decrease in price to attract customers from its competitors. In economic terms, its demand function has a greater elasticity than the other producers. The other formal requirement is that the market be composed of firms able to slightly affect the market individually, hold their own and be encouraged to compete. The informal requirements for workable competition are: 1) consumer competence, 2) ability of firms to protect their competitive position, 3) willingness of firms to compete aggressively, but 4) fairly (offer better quality products closer to costs). *See* note 32 *infra;* M. CLARK, COMPETITION AS A DYNAMIC PROCESS (Washington D.C. The Brookings Institution 1961).

29. The current statement of the per se rule seems to establish a much higher standard than when first utilized in *United States v. Joint Traffic Ass'n, supra* note 6. Today the party alleging a per se violation must show the practices or agreement has a pernicious effect or that it lacks *any redeeming social value.* Northern Pacific Ry. v. United States, 356 U.S. 1 (1958) (emphasis added). The family of restraints routinely classified by courts as per se violations has increased since *Trans-Missouri* to include agreements to: fix prices, Simpson v. Union Oil Co., 377 U.S. 13, 17 (1964); boycott, Radiant Burners, Inc., v. People's Gas, Light and Coke Co., 364 U.S. 656 (1961), *per curium reversing,* 273 F.2d 196 (7th Cir. 1959); Klor's, Inc., v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959); Fashion Guild v. F.T.C., 312 U.S. 457, 467 (1941); *horizontal* division of market, Timken Roller Bearing Co. v. United States, 341 U.S. 593, 599 (1951); make tying arrangements (conditional sale of needed product tied to another product for no valid reason), United States v. Loew's, Inc., 371 U.S. 38, 44-45 (1962); Northern Pac. Ry. v. United States, 356 U.S. 1, 5-8 (1958); International Salt Co. v. United States, 332 U.S. 392, 396 (1947); foreclose the market through monopolistic conduct, United States v. Griffin, 334 U.S. 100, 105-06 (1948), American Tobacco Co. v. United States, 328 U.S. 781, 808-15 (1946), Swift and Co. v. United States, 196 U.S. 395-96 (1905).

practice is once found per se illegal, courts will not inquire into the business purpose for the questioned practice, nor entertain any defenses.[30] Because of its potential severity, courts limit the per se rule to that class of restraints clearly offensive to competition and historically without any valid business purpose in a free-enterprise system.[31]

The rule of reason test functions by distinguishing those restraints unduly limiting competition from those which may be reasonable.[32] In applying this test, a court should carefully examine the nature of the restraint, its purported purpose, the effect on competition and whether the restraint exceeds its purpose.[33] In essence, the rule of reason is a balancing test measuring the competitive effect and the reasonableness of the restriction by weighing the catalogue of business factors against the potential harm to competition.[34] Under this standard a business practice may adversely affect competition yet still be lawful.[35]

The necessity of applying the rule of reason to such varying circumstances oftentimes seems to dictate a loose application by the judiciary, subjecting the courts to the criticism that they make decisions under a per se rule while dressing the opinion in rule of reason terminology. To the extent that this is true, the semblance of logical development of each rule becomes blurred. To avoid confusion some contemporary antitrust scholars suggest viewing the per se doctrine as a special application of the rule of reason, while others contend that the rule of reason is an outgrowth of the per se test.[36] Regardless of which position is correct, when judicial experience finally concludes certain conduct is either harmful to competition,

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> Since the purpose and effect of this combination, its tendency to monopoly . . . brought it within the policy declared by Sherman . . . it was not error to refuse to hear the evidence . . . the reasonableness of the methods to accomplish unlawful object is no more material than would be the reasonableness of prices fixed by unlawful competition.

Fashion Guild v. Trade Comm'n, 312 U.S. 457, 468 (1941).

31. United States v. Underwriters' Ass'n, 322 U.S. 553 (1943).

32. Standard Oil Co. of N.J. v. United States, 221 U.S. 1 (1911) (all cases rest on premise that reason was guide by which the provision was interpreted). *See* note 3 *supra* at 65.

33. L. SULLIVAN, ANTITRUST 187, 188 (1977) (analysis is necessary to determine whether a particular practice will restrain or aid competition).

34. *Id.* at 189.

35. Chicago Board of Trade v. United States, 246 U.S. 231, 241 (1918).

36. For commentary in support of a structural or "truncated" approach for vertical restraint cases, see Comment, *Franchising Restrictions*, 49 N.Y.U. L. REV. 957, 964 (1974).

void of economic justification or without benefit to society, judicial economy dictates application of the per se doctrine.[37] Under the rule of reason test, the court evaluates the restriction in question in light of business factors appropriate under the circumstances to determine the reasonableness of the restraint in question.

White Motor Co. and Arnold Schwinn: Background to Sylvania

Prior to *White Motor Co. v. United States*,[38] a vertical restraint case, horizontal arrangements dividing market territories between distributors were determined to be illegal per se.[39] In *White Motor Co.*, the manufacturer in restricting its distributors to specific customers and territories[40] contended that the distribution system was necessary to compete with other major truck manufacturers.[41] The majority of the Court concluded there was too little information on vertical restraints to apply the per se test.[42] Concurring, Mr. Justice Brennan noted the importance of determining whether: (a) interbrand competition was more significant than intrabrand competition; (b) the arrangement was induced by the dealers; and (c) such arrangements were a prerequisite for survival and effective competition for independent truck manufacturers. The necessity of considering these factors suggested applying a rule of reason to vertical restraints.[43]

In his dissenting opinion, Justice Clark emphasized that under these vertical contracts, a customer was compelled to deal with one seller who had sole power to set terms.[44] Relying on precedent,[45] he observed that the existence of interbrand competition had been

37. United States v. Topco Associates, Inc., 405 U.S. 596 (1972).

38. 372 U.S. 253 (1962).

39. Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951).

40. Manufacturer prohibited distributors from selling outside territory and reserved major municipal, state, and federal accounts to itself. *See* note 39 *supra*.

41. Competition with other manufacturers in the industry equals interbrand competition. *See* note 16 *supra*.

42. "We do not know enough of the economic and business stuff out of which these arrangements emerge to be certain [about applying a per se rule to vertical restraints] .... We need to know more than we do about the actual impact of these arrangements." *See* note 39 *supra*.

43. Except when "the dealer who cross-sells runs the risk under the agreement of losing his franchise altogether, intrabrand competition across territorial boundaries involves serious hazards which might deter any effort to compete." *Id.* at 273 (Brennan, J., concurring). Assuming a rule of reason approach, the language suggests an exception where the franchise is vulnerable to retaliatory action by a manufacturer.

44. *Id.* at 275.

45. United States v. McKesson and Robbins, Inc., 351 U.S. 305 (1956).

traditionally insufficient to support an explicit agreement to eliminate intrabrand competition.[46] Notwithstanding disagreement among the Justices, *White Motor Co.* left unanswered the question of which of these standards should be applied to vertical restraints.

Four years after the *White Motor Co.* decision, the Supreme Court applied the harsh per se test to some of the vertical restraints imposed by Schwinn on its distributors. An elaborate set of restrictions prompted the Court to draw a distinction between purchased goods and goods handled by the distributor on a consignment basis.[47] Relying on the ancient rule against restraints on alienation,[48] the Court held any vertical restrictions on those goods which the distributor had purchased were subject to the per se prohibition. Where the manufacturer retained title, dominion and risk of loss, however, the vertical restrictions were to be evaluated by the rule of reason test.[49]

Schwinn received almost universal condemnation from antitrust lawyers and economists.[50] This criticism focused mainly on use of the ancient rule against alienation as the basis for invalidating some vertical restrictions and not others.[51] The distinction appeared empty and useless.[52] From the economic standpoint the effect vertical restraints had on intrabrand and interbrand competition was not altered by the passage of title to the goods.[53]

Reflecting the overall disenchantment with this distinction, lower courts narrowly construed *Schwinn*, and refused to apply the per se test even though the vertical restrictions clearly fell within the categories prohibited by the *Schwinn* decision. This extensive rejection of *Schwinn* by the lower courts underscored the wholesale

46. The late Justice Clark adamantly held that the restraint's vertical nature did not make it less an offense to the purpose behind the Sherman Act.

47. 372 U.S. 253, 275 (1962). United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

48. Dr. Miles Medical Co. v. John D. Park and Sons, 220 U.S. 373 (1911), held resale price maintenance arrangements invalid once manufacturer's goods merged into stream of trade (after purchase by another).

49. United States v. Arnold, Schwinn Co., 388 U.S. 365 (1967).

50. "[A]lmost all commentators deplore the opinion as unforgiveably bad." *See* note 12 *supra* at 275, 276 (1976).

51. *Id.* at 276 n.6.

52. "It is particularly disappointing to see the Court balk at the label 'sale' and turn from a reasoned response to a wooden and irrelevant formula." 388 U.S. at 394 (Stewart, J., dissenting).

53. The *Schwinn* Court gave two reasons for its decision *neither of which had anything to do with economics.* See WARREN, *supra* note 9, at 149.

dissatisfaction with the *Schwinn* doctrine.[54] Thus, of the few cases invalidating vertical restrictions purportedly under *Schwinn*, most involved vertical price-fixing in addition to territorial restraints.[55]

Schwinn answered the question left open in *White Motor Co.* as to which test applied to vertical restraints. Yet the sea was far from calm. The Ninth Circuit case, *Continental v. Sylvania*[56] provided the Supreme Court an opportunity to significantly clarify antitrust law on the important issue of vertical restraints.

Continental v. Sylvania

In 1962 GTE Sylvania, dissatisfied with its one to two per cent national sales of televisions terminated the saturation method of distribution in favor of the more modern selective distributional system.[57] Sylvania abandoned distribution through wholesalers and decided to sell only to selected retailers who would promote the Sylvania brand. It is undisputed that title to the television sets passed to these retailers. This plan, by limiting the number of franchises in a given area, would reduce intrabrand competition among retailers and serve as an incentive to carry and promote its products.[58] Under this new program sales were made directly to a limited number of franchised dealers. A provision in the distributorship agreement specifically prohibited the franchisee from opening additional retail outlets at different locations without the manufacturer's approval.[59] This law suit resulted from the manufacturer's en-

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54. *See* Colorado Pump and Supply Co. v. Febco, Inc., 472 F.2d 637 (10th Cir. 19), *cert. denied*, 411 U.S. 987 (1973) (primary responsibility clause); Joseph E. Seagram and Sons, Inc. v. Hawaiian Oke and Liquors, Ltd., 416 F.2d 71, 76 (9th Cir. 1969), *cert. denied*, 396 U.S. 1062 (1970) (exclusive dealership); Supeira Bedding Co. v. Serta Associates, Inc., 353 F. Supp. 1143 (N.D. Ill. 1972) (primary responsibility and profit pass-over clauses). A primary responsibility clause is an agreement obligating a distributor to concentrate his sole efforts in a specified geographical area for which he is primarily responsible. These clauses were endorsed in *White Auto Co. v. United States* similarly to the location clause in *Arnold*, *Schwinn* via the consent decree.

55. These cases flow more logically from the vertical price-fixing line of cases, arguably, justifying the application of *Schwinn*. *E.g.*, Copper Liquor, Inc. v. Coors Co., 506 F.2d 934 (5th Cir. 1975).

56. *See* note 10 *supra*.

57. The essence of this program is a reduction in personnel with increased attention on franchises selected individually to cultivate a particular market. Selective distribution differs substantially from the post World War II saturation distribution technique which sought to flood the market with products in anticipation of increased sales volume.

58. *See* note 10 *supra* at 2550.

59. A manufacturer or franchisor seeks to maximize the extent of control to insure the market will "support" the products. In reality, the manufacturer

forcement of the location clause when one of its distributors began selling the television products from an unauthorized location.[60] The Supreme Court upheld the location restriction under the rule of reason standard, specifically overruling *Schwinn*.

In overruling *Schwinn*, the Court in *Sylvania* recognized that vertical restraints have the dual characteristics of simultaneously reducing intrabrand competition and stimulating interbrand competition.[61] Since the *Schwinn* court failed to evaluate the challenged restrictions on the basis of their individual potential for intrabrand harm or interbrand benefit,[62] but rather assumed the form of the transaction dictated the competitive impact of the restriction, the *Schwinn* analysis was considered superficial and defective.[63] Without legitimate criteria determining the degree of either intrabrand harm or interbrand benefit, the imposition of a per se standard based on the form of the transaction is itself unreasonable and unfair to the business community. By discounting *Schwinn's* distinction between sale and non-sale transactions[64] and characterizing it as "essentially unrelated to any relevant economic impact,"[65] *Sylvania* overrules *Schwinn* on the ground that vertical restrictions promote interbrand competition.

After eliminating the basis for the *Schwinn* distinction, the *Sylvania* Court examined the question of whether to expand the per se application to all vertical restraints regardless of the form. Finding no compelling reason to so expand the per se rule, the Court concluded the pernicious effect test[66] should determine whether vertical

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manipulates the market artificially by differentiating his product to the consumer. One aspect of this market manipulation is the establishment of a limited number of outlets in a given area. *See* Louis, *supra* note 12, at 284.

60. The notion of free enterprise normally rewards the independent, agressive, small businessman. *See* note 30 *supra* (specifically disallowing agreements to combine for the limited purpose of restricting competition).

61. ___ U.S. ___, 97 S.Ct. 2549, 2551 (1977).

62. *Id.*

63. Since the mobility of consumers neutralizes any artifical stabilizing effect a location clause may have, in the interests of free competition it is unnecessary to permit location clauses at all conceding as the majority does, that a restraint results on competition.

64. *Schwinn* applied a per se standard to a manufacturer's restrictions on goods purchased by a distributor but used the rule of reason for restriction on goods where title remained in the manufacturer.

65. There is no mention of a balancing test, but the court has assumed that a franchisor has the right to control the product after it has been purchased. *Id.*

66. Interbrand competition between manufacturers is not so desperately fragile that the court must require the narrow, "pernicious, without any redeeming value," standard to test a possible antitrust violation. One scholar argues the adoption

restraints should escape per se application. In rather cavalier fashion the Court concluded its decision to overrule *Schwinn* with the following caveat: "[T]he possibility is not foreclosed that particular application of vertical restraints may still justify a per se standard under *Northern Pac. R. Co.*"[67] Such an application should be withheld until a clear negative effect has been demonstrated.[68]

THE LOGIC OF THE SYLVANIA RATIONALE

Mr. Justice White's concurring opinion exposes the weakness in the majority's reasoning, while providing guidelines for lower courts seeking to resolve vertical restraint questions consistent with antitrust principles. Notwithstanding his concurrence in the result, Justice White would *not* have overruled *Schwinn*.

His first observation is the recognition that the restrictions condemned in *Schwinn* and challenged in *Sylvania* differ substantially in their effects on intrabrand competition. The Arnold Schwinn Co. employed a system of interrelated vertical restraints, one of which, a customer restriction, prohibited the bicycle sales by franchised retailers to non-franchised retailers. While the majority in *Sylvania* states the effect of Schwinn's customer restriction and Sylvania's location clause is indistinguishable, Justice White illustrates a major difference between the two.[69] Assume that intrabrand competition is sufficiently weak so that franchised retailers can charge a price substantially above wholesale. Under a location restriction, one franchised retailer may lower its price and sell to discount stores seeking to exploit the potential sales at prices below the prevailing retail level. Under a retail customer restriction, however, the franchised dealers can not sell to discounters and the opportunity for intrabrand competition is eliminated.[70] This difference of effect on competition merits greater consideration than the majority concedes.[71] The majority correctly observes that both

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of a partial per se test could provide a more stable set of criteria for the business community to follow and the courts to apply. *See* Louis, *supra* note 12.

67. Unfortunately there is no example of what combination of vertical restraints will be pernicious enough to justify the application of the *Northern P. Ry.* test. *See* note 30 *supra*. Under a traditional, rule of reason analysis, *Schwinn* had market power and restrictions but yet *Schwinn* was not horrible enough to justify a "pernicious, lack of redeeming value" test since the court overruled *Schwinn*.

68. ___ U.S. ___, 97 S.Ct. 2549, 2551 (1977).

69. *Id.* at 2552.

70. *Id.*

71. There is a trend towards greater concentration of power by the franchising industry. "The recent phenomenal expansion of franchised business dates back only

restraints restrict the retailer's freedom to dispose of his goods. However, in a location restriction, a retailer remains free to sell to any customer in any area. Such freedom was simply non-existent within Schwinn restrictions.

In light of the primary importance placed on interbrand competition[72] by the majority, it is worthwhile to examine the factors relevant to the majority's final determination. By virtue of its dominant market position and the superior consumer acceptance of its product, the Schwinn bicycle company posed a much greater threat to the achievement of traditional antitrust goals against forms of economic concentration than did Sylvania in the television market.[73] Established economic theories suggest that market share and product differentiation may be used as criteria to measure market power.[74]

If the majority's emphasis on interbrand competition supports its holding in *Sylvania*, it also argues most strongly against overruling *Schwinn*. With its market share and product differentiation, there was little danger of Schwinn suffering extinction from interbrand competition. Without the business justification of a failing company, arguably available in Sylvania,[75] Schwinn's restrictions were totally unwarranted.[76]

Mr. Justice White finds two reasons that provide a "principled basis" for refusing to extend *Schwinn* to location clauses. Ironically,

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to about 1950 . . . [and equal] about 10% of the gross national product or $59.215 billion." D. THOMPSON, FRANCHISE OPERATIONS AND ANTITRUST 26, 27 (1971).

72. Interbrand's importance seems the basis to apply a rule of reason test for location clauses. But given the 22 per cent market share that Schwinn controlled, combined with the substantial number of foreign bicycles in the market, Schwinn would seem to have approached monopoly status relative to other American bicycle companies. If the majority actually wanted to promote interbrand competition, the *Schwinn* restrictions should have been removed since their existence permit a greater market share.

73. *Id.*

74. *See* P. AREEDA, ANTITRUST ANALYSIS 500-04 (2nd ed. 1974) (If both a manufacturer and its dealers believe that the use of distributional restraints will create or preserve promotional differential market power, they will ordinarily concur in their position.).

75. *Sylvania* experienced an increase of three per cent national sales after adoption of its selective distributive program. By being in the market, competition has been protected.

76. Schwinn was not a failing company, nor entering the market for the first time, or marketing a new product. These three situations were enumerated in *United States v. White Motor Co.* as possible circumstances justifying a rule of reason standard being applied to vertical restraints. *See* note 44 *supra.*

both are relied upon by the majority to overrule *Schwinn*. One is the check on the exploitation of intrabrand competition provided by interbrand competition.[77] Since the consumer has the ability to substitute one television brand for another, he has protection from outrageous prices at the retail level. This possibility of consumer choice exists by virtue of multiple manufacturers in the television market. The potential benefits vertical restraints offer to interbrand competition is the second reason. Mr. Justice White would limit *Schwinn's* application.[78]

It is in his misgivings about the overruling of *Schwinn* that the analysis of Mr. Justice White provides illumination for lower courts' future confrontations with vertical restraints. The basis for the *Schwinn* distinction between sale and consignment of goods affirmed the traditional antitrust notion that "independent businessmen should have the freedom to dispose of goods as they see fit."[79] This reasoning, suggests the majority, misinterpreted the purpose behind the *Schwinn* Court's application of both the per se rule and the rule of reason. In other words the *Schwinn* Court merely used the *Schwinn* rule as a convenient description of the most dangerous restraints, which arguably should be per se unlawful anyway, and that therefore it may be less arbitrary than heretofore believed. Irrespective of this criticism, Justice White concedes the majority may be justified in determining that the potential benefit of interbrand competition outweighs the interests of the individual proprietor.[80] This concession presupposes that economic efficiency was the overriding purpose behind the Sherman Act.

Finally, Justice White expresses concern that the majority's reliance on the "relevant economic impact" criteria for determining per se violations of vertical restraints may have ramifications for vertical price restraints.[81] Since the same efficiency arguments for non-price vertical restraints apply equally to vertical price

77. If the dealer only makes sales where marginal cost equals marginal revenue, presumably he will not serve high cost customers. The consumer could benefit from these savings. *See* Zimmerman, *Distribution Restrictions after Sealy and Schwinn*, 12 ANTITRUST BILL 1181, 1188-89 (1967).

78. *See* note 73 *supra* and accompanying text.

79. *See* note 49 *supra*.

80. 97 S.Ct. 2555. The analysis recognizes the overall importance of the manufacturing sector of the economy. In protecting this trend toward concentration of franchises which includes: services, soft drinks, automobiles, fastfoods and computers. The permissive attitude of the present Court parallels that of the country prior to passage of the Sherman Act. *See* notes 20-26 *supra*.

81. 97 S.Ct. 2555.

restraints, this concern may alert the antitrust community. *Sylvania's* longevity may well depend on whether the Supreme Court is willing to adhere to its reliance upon the "relevant economic impact" as the determinative criterion for evaluating vertical restraints under the rule of reason approach.

IMPACT OF SYLVANIA ON DISTRIBUTION SYSTEM

By removing vertical restraints from the reach of the per se application erected in *Schwinn*, the Court has issued a green light to those manufacturers desiring to increase their distributional efficiency through an expanded use of the franchise system.[82] Presumably, manufacturers will court potential franchisees with inviting combinations of vertical restraints supported by a legally enforceable guarantee of minimum intrabrand competition. This may well be the correct contemporary response to a market composed of mobile consumers acclimated to suburbanization and conditioned by mass advertising.[83]

It is questionable, however, whether the consumer will benefit from the net savings of the dealer/retailer who is thus insulated from intrabrand competition. It is entirely possible that an increase in the amount of customer services will artificially increase the differentiation of products.[84] Whether or not the consumer wants these services he will pay for them, since the cost of providing them is included in the over-all cost of the product. On the positive side, this total package may be justified, especially if useful consumer information can be provided by the dealer. *Adolph Coors Co. v. A & S Wholesalers, Inc.*,[85] decided after *Sylvania*, provides some indication of use and treatment vertical restraints will receive in the immediate future.

Adolph Coors (Coors), a Colorado corporation, sought to enjoin A & S Wholesalers, Inc. (A & S), a North Carolina corporation, from purchasing Coors beer from Colorado retailers and transporting it to

82. The trend towards concentration has threatened local or regional producers in some industries with economic destruction. "In many [organizations of independent local businesses] the alternatives facing independent operators have clearly been those of a synthesis with some sort of national group with continued independent operation, or ultimate demise in favor of nationwide chains of manufacturing or service establishments. . . ." D. THOMPSON, FRANCHISE OPERATIONS AND ANTITRUST (1971).

83. *Id.*

84. *See* note 9 *supra.*

85. Adolph Coors Co. v. A & S Wholesalers, Inc., Nos. 76-1227, 1228, slip op. at 13 (10th Cir. July 19, 1977).

North Carolina for resale to retail outlets at a higher price than its retail price in Colorado.[86] Both parties appealed the judgment based on a jury verdict in favor of Coors. The Tenth Circuit Court of Appeals postponed a decision until the *Sylvania* opinion was handed down.

Coors utilizes a unique brewing process designed to preserve its special flavor and is the fourth largest national beer manufacturer. Coors contended it had the absolute right to: (1) determine the area within which its beer products were to be marketed; and (2) impose certain controls over the products following sale, then in the hands of wholesalers and retailers, in order to protect the quality and integrity of the products.

Following *Sylvania*, the Tenth Circuit concluded that the nature of the restriction need no longer be considered. *Sylvania* was properly applied in light of the fact that the Tenth Circuit remanded for a determination of the territorial restriction's reasonableness. However, language in the opinion suggests possible confusion on vertical restraints remains.[87] Contrary to the court's statement, restrictions on goods where title remained in the manufacturer were valid under *Schwinn*.[88] On remand, the lower court must *sua sponte* examine Coor's justification for the restraint. An inquiry, finding little or no value in a territorial restraint for a uniquely processed product, when it appears another restriction adequately protects the essence of the product's integrity, would indicate judicial willingness to follow *Sylvania's* rule of reason mandate. Otherwise, the adoption of the rule of reason becomes as meaningless as the "irrelevant distinction" discarded in *Schwinn*.

CONCLUSION

The purpose of antitrust law is to promote competition towards the goals of preventing economic concentration and achieving a wide choice of quality products or services at *reasonable* prices. The broad public policy undergirding antitrust is that in the long run the courts wish to maintain a "workable competition," that is: sufficient firm rivalry to attain ultimate consumer goals (quality goods at

86. *Id.* at 3.

87. "[E]ven should a manufacturer retain dominion or control with respect to these goods, and if the dealers' positions and functions are indistinguishable from those of an agent or salesman of the manufacturer, then the restrictions are examined via the *rule of reason.*" *Id.* at 12, 13. Assuming the court meant "release" instead of "retain," *Sylvania* received proper interpretation.

88. United States v. Arnold, Schwinn & Co., 388 U.S. 365, 380 (1967).

reasonable prices), but not so much rivalry that smaller firms are destroyed or taken over with resultant overly concentrated economic power. The Court in *Sylvania* approves those vertical restrictions which allow certain manufacturers protection of their market share if there is sufficient competitive rivalry through interbrand competition.

The intent of the Supreme Court in *Sylvania* seems clear. Lower courts are to no longer apply the harsh per se test to all manufacturer imposed restrictions which restrain trade. They are now to examine all the circumstances surrounding the restraint in light of its anti-competitive effects when deciding the fate of manufacturer restrictions under the rule of reason. Greater discretionary power is vested in the lower courts to decide the ultimate question: the impact of the restrictions on interbrand competition under all of the facts and circumstances.

The per se rule permits judicial efficiency because it is easy to apply. In this respect, it forewarns business firms that certain restrictions will be held clearly invalid. The rule of reason invites litigation since parties are never certain how a court will decide a case until it has used the full rule of reason analysis. It is too early to determine the quality of lower courts' analysis under the *Sylvania* rule. The courts may use the rule to approve almost *carte blanche* manufacturers' restrictions. If so, the pendulum will swing far from the condemnation of manufacturer restrictions under *Schwinn* to the protection of manufacturer restrictions. This will substantially reduce intrabrand competition. Finally, it is also too early to predict the specific impact on distributors. However, the manufacturer's freedom to impose vertical restrictions could adversely affect large and small distributors alike. Such a result would hardly satisfy the American concept of free enterprise.