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CHAP3B.

VERTICAL PRICE FIXING CONTINUED

Should Vertical Price Fixing be a "Rule-of-Reason" Offense?

The 1911 extension of the evolving per se ban on horizontal price-fixing to vertical price fixing in Dr. Miles¹ has always rested on tenuous grounds. Still, for much of the period after Dr. Miles there was really no serious opposition to this extension of the per se rule by academic economists, Justice Holmes' brilliant dissent in Dr. Miles notwithstanding.

Commercial interests of course sought relief from Dr. Miles throughout the inter-war period, but these efforts were always seen as self-serving, and were generally opposed by economists. However, after World War II, opposition to a per se ban came to be more and more respectable in the academy. In particular, the influential voices of Ward Bowman and Lester Telser in economics and Robert Bork, Richard Posner and William Baxter in law began to have a significant impact on both academic and legal opinion. As a result, many commentators now argue that there is no sound basis for assuming, as the courts have done since Dr. Miles, that retail price maintenance is so invariably anti-competitive as to justify per se condemnation. They hold that resale price maintenance has essentially the same effect as the non-price measures that Sylvania removed from the category of per se offenses in 1977. Like these vertical non-price restrictions, resale price maintenance, on balance, is seen as potentially pro-competitive in that it can often stimulate interbrand rivalry to a greater extent than it reduces intrabrand competition.*

You will remember that in Sylvania, which held most non-price vertical restrictions to be rule of

¹ Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

reason offenses, the Court recognized that many products require considerable pre-sale promotion and post-sale assistance in order to enhance consumer acceptance and demand.² The Court also noted that frequently these services could not be "sold" separately and that they are typically offered without separate charge to the consumer; the additional cost being included in the retail price of the product.

It follows from this observation that in order to persuade his dealers to offer such services, a manufacturer must either compensate the dealers directly or somehow enable them to earn the higher gross margins necessary to defray the extra costs attributable to providing such services. Otherwise, dealers offering these "free" auxiliary services will have their prices undercut by, and lose sales to, dealers who have lower costs because they choose not to offer such services. And, of course, even the prospect of "free-riding" by some dealers on the additional services of other dealers diminishes the incentives of all dealers to offer the services necessary to ensure the most effective distribution. As a result, fewer of the manufacturer's products find their way into the market--to the detriment of consumers as well as the manufacturer. Consequently, any time a manufacturer attempts to ensure that its goods receive a more costly type of treatment at the point of sale, he must invariably cope with potential "free riders" who would undersell these dealers that comply with the manufacturer's marketing program.³ And of course resale price maintenance, along with other vertical restrictions is an effective way for doing this.

Moreover, price-related vertical restrictions in general, and resale price maintenance in particular, directly accomplish what non-price vertical restraints accomplish only indirectly. Professor (now Judge Posner) even holds that resale price maintenance is more flexible than non-price vertical restraints as a method of limiting intrabrand price competition among dealers, and that often it may be the only

² Continental T.V., Inc v. GTE Sylvania Inc. 433 U.S. 36 (1977). See discussion at page_____.

³Baxter, p. 17.

feasible method of regulating free riders where effective retail distribution requires that dealers be located close to one another. He holds that any free-rider or other arguments that are available to justify exclusive territories are equally available to justify resale price maintenance.⁴ It thus follows that it makes no sense to treat them differently. Both practices are designed to increase price and sales volume, and thus both are held to be pro-competitive.

Those who argue for a reconsideration of the per se rule note that even though RPM and other vertical restrictions increase both dealer costs and price, such restrictions would be unprofitable for the manufacturer unless the induced sales support also increases the quantities of product sold. Otherwise, the practice makes no sense from the manufacturer's perspective. This is the critical, pro-competitive respect in which such vertical restrictions differ from a mere widening of dealer margins, which would merely increase price but reduce the quantities of product sold, and hence the manufacturer's profit.⁵

Obviously, resale price maintenance is not likely to be used by manufacturers merely as a way to raise resale prices since there are better ways to do that. (For example, the manufacturer could simply raise the wholesale price and keep the higher revenues himself). Rather, a manufacturer who employs resale price maintenance usually will be trying to provide his distributors with an incentive to handle his product in a way that will increase interbrand competition.⁶ This is why they feel per se treatment is unwarranted.

While those opposing per se treatment concede that vertical price fixing may in certain cases net out to be anti-competitive, they argue that abandonment of the per se standard would not necessarily require the courts to engage in protracted proceedings to identify such situations.

⁴48 U.Chi. L. Rev. at 9.

⁵Baxter. p. 17.

⁶See generally Telser 3 J.L. Econ 86 (1960).

They feel there are readily ascertainable objective criteria for determining whether, in a particular market, resale price maintenance is likely to have any adverse effects. Consequently, in those few situations where the objective criteria indicate adverse effects may exist, the practice would still be illegal under a rule of reason analysis without the need for extended inquiry. In the majority of cases, where these criteria signal that the practice increases output as well as increasing price, they feel that there is no justification for automatic condemnation.⁷ Virtually all of the adverse competitive effects of resale price maintenance are seen to occur:

1. where a group of manufacturers attempt to use the practice to police and strengthen a cartel among themselves;
2. where one or more of the manufacturer's distributors coerces the manufacturer (and perhaps other suppliers) to institute an inefficient resale price maintenance system--one that reduces the quantities sold--for the benefit of the coercing distributors.

Furthermore, the first instance cannot arise unless the market structure indicates a good chance of collusion and the second situation likewise requires that the manufacturer have market power, for without it the manufacturer cannot succeed in sustaining a higher price for the benefit of its dealers without a disproportionate loss of volume. Thus it is argued that there can be no adverse competitive effects in situations where the manufacturer lacks market power, and that the presence of market power can be easily detected by "objective economic criteria."⁸

Hence, there is no need to treat vertical price-fixing as a per se offense.

In both amicus briefs that were filed, but not considered, in the Monsanto case it was argued that:

...The overbroad rule that prohibits all resale price maintenance, without regard for its actual impact in the marketplace, is unwarranted; it disserves consumers by precluding

⁷Baxter pp.6-7.

⁸Baxter, p. 23.

beneficial practices along with those that are pernicious.⁹

The amicus briefs further argued that normally, the unreasonableness of a restraint of trade should be established by either evidence that the restraint is demonstrably anti-competitive in the circumstances of the case (the rule of reason), or by a conclusive presumption of unreasonableness based on the general character of the challenged conduct (the per se rule).¹⁰

Unfortunately, this has not been the case in applying the per se rule to vertical price fixing. The fact is that the Court has never really seriously analyzed resale price maintenance in terms of its actual economic effects, much less has it ever found that these effects are so necessarily anti-competitive as to justify a per se ban. When the Court first applied the evolving per se horizontal price fixing ban to vertical price fixing in Dr. Miles, it was done more by characterization and analogy than by analysis.

...the complainant [Dr. Miles] can fare no better with its plan of identical [resale price maintenance] contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other....

But agreements or combinations between dealers, having for their sole purpose the destruction of competition and the fixing of prices, are injurious to the public interest and void. They are not saved by the advantages which the participants expect to derive from the enhanced price to the consumer....

The complainant's plan falls within the principle which condemns contracts of this class....¹¹

While the Court continues to hold the view that resale price maintenance should be held to be illegal per se because it is similar in its effect to horizontal price fixing which has always been illegal per se, there has been a glimmer of reconsideration in several recent cases. This tendency, which was triggered

⁹Baxter, p. 7.

¹⁰See National Society of Professional Engineers v. U.S., 435 U.S. 679, 690 (1978).] [Baxter, p.13.

¹¹Areeda, p. 652.

by the Justice Powell's reasoning in Sylvania, suggests that a shift to a modified per se rule is not completely impossible if the right case comes along.

For example, in the recent Broadcast Music case,¹² the Court refused to apply the per se rule to blanket copyright licenses issued by Broadcast Music, Inc., even though those licenses eliminated competition between individual copyrighted works and necessarily fixed price. The Court said:

...As generally used in the antitrust field, "price fixing" is a shorthand way of describing certain categories of business behavior to which the per se rule has been held applicable. The Court of Appeals' literal approach does not alone establish that this particular practice is one of those types or that it is "plainly anti-competitive" and very likely without "redeeming virtue." Literalness is overly simplistic and often overbroad. When two partners set the price of their goods or services they are literally "price fixing," but they are not per se in violation of the Sherman Act....Thus it is necessary to characterize the challenged conduct as falling within or without that category of behavior to which we apply the label "per se price fixing." That will often not be a simple matter.¹³

Moreover, in establishing a standard by which to "characterize the challenged conduct as falling within or without the category of behavior to which it applies the label 'per se price fixing'" the Court wrote:

More generally, in characterizing this conduct under the per se rule, our inquiry must focus on whether the effect, and here because it tends to show the effect...the purpose of the practice to threaten the proper operation of our predominantly free market economy--that is, whether the practice facially appears to be one that would always or

¹²Broadcast Music, Inc., v. Columbia Broadcasting System, 441 U.S. 1 (1979).

¹³Broadcast Music, Inc., v. Columbia Broadcasting System, 441 U.S. 1 (1979) at 8-9.

almost always tend to restrict competition and decrease output, and in what portion of the market , or instead one designed to "increase economic efficiency and render markets more rather than less competitive."...The blanket license, as we see it, is not a naked restraint of trade with no purpose except stifling of competition."...but rather accompanies integration of sales, monitoring, and enforcement against unauthorized copyright use.¹⁴

As already noted, the Court was urged by Amicus Curiae to consider this approach in Monsanto, but did not for narrow technical reasons related to the limited scope of the appeal. Still, this approach seems to be catching hold as evidenced by Justice Powell's dissent in Maricopa¹⁵ where he continued this new train of thought.

It is settled law that once an arrangement has been labeled as "price fixing" it is to be condemned per se. But it is equally well settled that this characterization is not to be applied as a talisman to every arrangement that involves a literal fixing of prices. Many lawful contracts, mergers, and partnerships fix prices. But our cases require a more discerning approach. The inquiry in an antitrust case is not simply one of "determining whether two or more potential competitors have literally 'fixed' a 'price'..." [Rather], it is necessary to characterize the challenged conduct as falling within or without that category of behavior to which we apply the label "per se price fixing." That will often but not always, be a simple matter.¹⁶

Before characterizing an arrangement as a per se price fixing agreement meriting condemnation, a court should determine whether it is a "naked restrain[t] of trade with no purpose except stifling competition." U.S. v. Topco Associates, Inc., 405 U.S. 596, 608 (1972), quoting White Motor Co. v. United States, 372 U.S. 253, 263 (1963). See also Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 49-50 (1977). Such

¹⁴Id. 441 U.S. at 19-20.

¹⁵Arizona v. Maricopa Medical Society, 102 S. Ct. 2466 (1982).

¹⁶ Broadcast Music, Inc. v. Columbia Broadcasting System, Inc., supra, at 9.

determination is necessary because "departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than ... upon formalistic line drawing." *Id.*, at 58-59 As part of this inquiry, a court must determine whether the pro competitive economies that the arrangement purportedly makes possible are substantial and not realizable in the absence of such an agreement.¹⁷

Also in a very interesting case dealing with a claim that certain restrictions on admission to a realtor's multiple listing service were per se illegal, Judge Goldberg of the Fifth Circuit wrote:

In light of the potency of the per se rule,... the Supreme Court has recently reemphasized that the invocation of this conversation stopper must be limited to those situations which fairly fall within its rationale.¹⁸

After citing and discussing Broadcast Music and Sylvania,

Judge Goldberg concluded:

These and other recent cases make it clear that the legal characterization of a class of restraints requires "a judgement about [its] competitive significance" and that, in formulating that judgement, courts must pay heed to relevant "economic conceptions."¹⁹

The Court has always regarded the rule of reason as the normal test of the legality of an alleged restraint; per se rules are invoked only where economic and judicial experience have shown that certain practices invariably have a "pernicious effect on competition" and lack "any redeeming [competitive] virtue."²⁰

¹⁷Arizona v. Maricopa Medical Society, 102 S. Ct. 2466 at 2482 (1982), (emphasis added).

¹⁸United States v. Realty Multi-List, Inc., 629 F. 2d 1351 (5th Cir. 1980).

¹⁹*Ibid.* at 1363.

²⁰Northern Pacific Railway Co. v. United States, 356 U.S. 1 (1958).

While the Sylvania Court continued the per se treatment of retail price maintenance on the possibility that industry wide resale price maintenance might facilitate cartelization--shades of Dr. Miles--many commentators now believe that this concern can easily be addressed on a case-by-case basis. They see little justification for an absolute ban. In those cases where market and product characteristics negate the possibility that resale price maintenance can result in anti-competitive effects, per se condemnation of the practice unjustifiably deprives consumers of the benefit of intensified interbrand competition.

On the basis of these arguments, those opposed to the per se treatment of vertical price fixing conclude that the Court should only determine whether a per se rule should be applicable to resale price maintenance after a careful analysis of the "predictable competitive effects of the practice."²¹ They hold that both the economic evidence and the adverse consequences of the opposite course demonstrate that resale price maintenance should not be treated differently from all other vertical arrangements between manufacturers and their distributors.

Only when the market characteristics allow the possibility of anti-competitive effects, and no free-rider problem is apparent, and even then, only after the defendant has failed to demonstrate that the particular resale price maintenance system promotes competition, would these commentators be willing to declare vertical price fixing to be unlawful.²²

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Not everyone, however, agrees with the proposition that resale price maintenance is identical in its effect to other vertical restrictions, and that it should thus be treated as a rule of reason offense. In general, this contrary view holds that there is no way to determine when rigged prices are reasonable, and thus that a rule of reason approach would be unworkable. Moreover, they also note that whatever the

²¹Baxter, p.29.

²²Baxter, p.24.

true reasons, hardly any group has ever undertaken to fix prices without insisting that it is serving the public interest by preventing cutthroat competition, preserving firms and employment, reducing uncertainty, financing desirable activities, protecting quality or otherwise increasing efficiency.²³ Consequently, they hold that the reasoning of Trenton Potteries and Socony appropriately applies to vertical as well as horizontal price fixing, and that the Court has properly held this practice to be illegal per se.

Apart from ease of enforcement, this group also holds that the per se rule against vertical price fixing protects the central price mechanism, so essential to efficient resource allocation, from the distortions introduced by those who would tamper with prices. Thus the per se rule performs the important function of insuring that the information conveyed by prices can reasonably be believed to be accurate and to correctly reflect the value of the alternatives foregone at the margin.²⁴

They hold that those who would have the courts depart from the per se rule show a surprising mistrust of free markets and of the underlying forces of competition for compelling efficient resource use. Moreover, they feel that the arguments for a rule of reason approach which rely on the proposition that intrabrand competition is somehow inferior to intrabrand competition, and that to increase the latter, public policy must allow the restriction of the former is mistaken.²⁵ (This argument is developed more fully in the chapter on Vertical and Territorial Restrictions).

Most importantly, however, Those who would continue the per se treatment of vertical price fixing feel that the principal justification advanced by the opposition--free-riding-is grossly exaggerated.

²³Areeda, p. 489.

²⁴David O. Stewart National Law Journal.

²⁵Stewart ,National Law Journal.

Indeed, they feel that those who would sanction vertical price fixing seem to assume that manufacturers are incapable of ingenious or resourceful actions to manage channel behavior short of direct or indirect price fixing, and that this is obviously counter to the evidence.

Consider the retailing of appliances and consumer electronics. This has been one of the most frequently cited example of the need to legalize resale price maintenance in order to induce desirable point of sale support. And yet it is in these very markets that evidence from the "real world" contradicts the assumption that point of purchase support and the successful retailing of such complex products can only be achieved with rigged prices. Consider the following remarks from a special report on consumer electronics marketing in a recent edition of Advertising Age:

Gone are the days when consumer electronics retailing was dominated by specialized boutiques, intimidating salesmen and high-tech junkies.

In a growing number of markets, superstores--the market place's newest innovation--and discounters have put out the welcome mat of low prices and wide selection for the casual consumer. In addition to changing the way electronics are sold, these stores have had a profound impact on how these products are priced and advertised.

....

The keys to the superstore are selection and price. "Price is a given," says David Mondrey, chairman of Highland Appliances, a superstore chain based in Taylor Michigan. "No matter what else you offer, if you are not competitively priced you are taking advantage of the consumer."²⁶

Superstore chains like Fretter or Highland Electronics stock virtually every model of every mass-market line, including up to 150 different tv's and 100 video cassette recorders. In addition to price and selection, the superstores are also heavy advertisers. For example in Detroit in 1985, Fretter alone ran

²⁶Alan Redding, "Superstores, Discounters Lead Retail Revolution," Advertising Age, Jan. 9, 1986, p. 15.

60,000 column inches, and since the recent advent of superstores in Boston, the Boston Globe sports section has looked like a consumer electronics shopping directory with pages of competing price promotion ads.²⁷

Mind you, this intense retail marketing effort is all happening without vertical restrictions or manufacturer set prices. Moreover, the discounters are not the only beneficiaries of this intrabrand rivalry. In Boston, for example, even department stores such as Jordan Marsh and Bloomingdales have increased their share of the business by periodically picking up unusually good deals on particular items and capitalizing on the consumer interest generated by the intense competition.²⁸ If resale price maintenance had been legal, none of this could have happened. It would be hard to argue that consumer welfare has not benefited from these changes, and that public policy with respect to vertical price fixing should have been altered to allow manufacturers to freeze the old style retailing strategy of high prices and limited assortments just because the marketing personnel of the major manufacturers could only conceive of one way of retailing consumer electronics.

Actual competition is too complex to be adequately comprehended by a simplistic interbrand-intrabrand characterization. In this case, the real vitality of competition has been between different types of retail institutions and not between different brands as such. Traditionally, it is this intertype competition, rather than interbrand competition that leads to major improvements in the marketing of goods and services. This has clearly been true in the marketing of gasoline.²⁹ It is also true in the marketing of general merchandise where the dominance of the high markup full service department store has been effectively challenged by the self-service discount department store and other mass merchandisers.

²⁷Id. p. 15.

²⁸Id., p.15.

²⁹See F.Allvine and J.M.Patterson, Competition Ltd: The Marketing of Gasoline, Bloomington, IN: Indiana University Press, 1972.

Clearly, certain limited distribution, specialty and fashion items still move best through outlets which emphasize service and point of purchase support over low prices, wide selection and heavy local advertising. The rapid growth of the boutique in recent years is testimony to the fact that many customers still value highly the personalized non-price dimensions of the retail offer in many product categories. For these products, a "push" strategy involving vertical restrictions still makes sense. But because of their limited distribution, this needed "push" can easily be achieved without resale price maintenance through selectivity in franchising outlets.

The obvious lesson from the recent history of retailing in food, drug, hardware and building materials, housewares and even books is that sellers were giving customers more service and point of sale attention than they wanted or were willing to pay for, and that when the option of buying for less with reduced point of purchase support was made available, buyers exercised that option with dispatch. In most cases a wide selection at low price makes up for the loss of a somewhat knowledgeable clerk helping one leaf through a catalogue of one or two manufacturer's items, all for sale at manufacturer's list. It is a misreading of the situation to say that these new retailers, such as the superstores in consumer electronics, are free-riding on the marketing effort of traditional retailers. If anything, it is the other way around. The heavy local advertising and mass displays provide an excitement and interest in a product category that spills over into the traditional outlet.

It was not the traditional outlet that built the mass market for personal computers, and turned them into a common household appliance. Until retailers--some of them mail order retailers-- emphasizing low price, wide selection and heavy advertising entered this business, it was a narrow specialized market. The fact is, that if manufacturers could have effectively regulated intrabrand competition, and set resale prices, these large scale, high volume outlets could not have arisen and both consumers and manufacturers would be less well off. The free-rider problem is exaggerated and is often a red herring. There may be rare occasions where it is truly a problem, but they are the exception, rather than the rule. In a marketplace

characterized by self serve, mass display, large scale retailing, a "pull" strategy is the appropriate strategy. Well designed display racks, extensive advertising, careful point of sale detailing, sales promotions including couponing and trade deals, coop advertising and creative packaging are central to success. Vertical price restrictions have no place here. They would only frustrate the dynamics of retail change which is a principal source of consumer value.

There are other problems with allowing manufacturers to fix retail prices and otherwise to restrict intrabrand competition in order to induce point of sale support for their products. Primary among these is the problem that comes from the "bundling" of the product, service, and point of sale support into a single transaction. Such a practice is a form of "tying" which forces customers to purchase components of the total offer which they may not want and may not use. Moreover, unless this package of goods and services can somehow be unbundled so that different customers can purchase different combinations, it frustrates the ability of the market to register the level and quality of these services that it desires, and is willing to pay for. Consider the case of gasoline where for decades if one wanted to purchase a major brand of gasoline, one was obliged to pay for the entire package of goods and services whether one wanted them or not, and since one had to pay the same price whether one used the credit card or free road map, it made sense to use them. The result of this emphasis on non price competition was a massive misallocation of human and material resources that resulted in a huge overpopulation of high cost, low volume, labor intense service stations offering full range of services and promotions. Once it became possible, as a result of intertype competition (not interbrand competition) to buy gasoline for less without these extras, the market was able to assign a value to these non-price components of the major brand offer, and their level and quality was quickly adjusted to reflect this revealed market value. Whenever manufacturers are able to inflate the level of point of purchase sales and service by reducing intrabrand competition and by setting resale prices, the chances are great that resources will be wasted and that the will of the consumer will be ignored. It is hard to see how this furthers consumer welfare as the proponents of a relaxed stance toward vertical price fixing would have us believe. It is wasteful and inefficient.

Finally, let us return to a point which was briefly noted earlier in the chapter, and which is often advanced as justification for a more permissive policy with respect to retail price-fixing. On p. 4, n.6, the point was made that unless the quantity demanded increases as a result of the retail price maintenance, that is, unless RPM shifts the demand curve up and out, no manufacturer in his right mind would ever seek to set resale prices, since such a policy would merely reduce his own sales and profits. And, since the manufacturer would only favor RPM when it shifts the demand curve, and by definition, when the demand curve shifts up and out, consumers are better off, it follows that the manufacturer's interest and the consumer's interest are one. Again, by definition, when there is an upward and outward shift, both producer and consumer surplus automatically increases. As a consequence, economic efficiency is increased and society, as a whole, gains in the process. This is the classical welfare argument used by those that would treat RPM like other vertical restraints.

There are at least three problems this analysis:

First, as both Professors Comanor and Scherer show in their recent articles, for this argument to hold, the demand shift must be parallel. And of course this is unlikely ever to be true, since a parallel shift assumes both the informed and the ignorant buyer have the same preference for the demand enhancing promotional activity that RPM induces. And, if the demand shift is not parallel, the price increase can be profitable for the manufacturer even when associated with a decrease in consumer surplus. Thus, unless the demand shift is parallel, the producer's interest and the consumer's interest are not necessarily identical, and the possibility of producer exploitation occurs.

Second, even if the total combined consumer-producer surplus increases, when the consumer surplus actually decreases as a result of a practice, the distributional consequences of the practice may make it unattractive, even in the face of a net gain in economic efficiency. It depends upon whether one is more sympathetic to consumer welfare than to economic efficiency as a social goal.

Finally, RPM raises an equity question. It follows from the fact that RPM "bundles" POS support and

after sale services into a single transaction, and thus prevents the value of these different services from being separately determined by the market. It frustrates consumer sovereignty. This was the major problem in gasoline marketing before 1973. Most would agree that all of us are better off now that the old major brand "package" has been unbundled and that motorists are freer to choose various purchase combinations from competing sellers of the same brand as well as from sellers of different brands or from different types of marketers. Full serve vs. self serve, credit vs. cash, bay service vs. gas-only vs. convenience store tie-in etc. This is much better than the limited pre-1970 option where the choice was mainly a choice between a full service major brand or a self-serve private brand seller.. Now each of these add-on's and combinations can be specifically valued by the market.

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END NOTES

* Intrabrand competition is the competition among the distributors--wholesale or retail--of the products of a particular manufacturer. Interbrand competition is the competition among the

manufacturers of the same generic product Continental T.V., v. GTE Sylvania Inc., 97 S. Ct. at 2558, n.19 (1967).