

CHAPTER 6  
TERRITORIAL AND CUSTOMER RESTRICTIONS

Ordinarily, a manufacturer or franchiser will seek to ensure that its dealers/franchisees sell its products or services at as low a price as possible in order to maximize sales.<sup>1</sup> However, as has already been noted, sometimes a manufacturer or franchiser will find it advantageous to limit intrabrand competition (especially intrabrand price competition) among those who resell its products or market its franchised services in order to induce them to undertake certain non-price promotional activities they would otherwise eschew.<sup>2</sup> And, since vertical price restrictions are presently illegal per se, manufacturers have had to fall back on various non-price restraints such as territorial and customer restrictions.

By facilitating such non-price promotional efforts on the part of their resellers, these territorial and customer restrictions tend to increase the sales of the product or service, and like price restrictions, they may do so on balance even when they generate some increase in the price the resellers charge.

These territorial and customer restrictions can take a number of different forms. In the most restrictive case--the exclusive or "airtight" territory--a reseller's marketing activities are completely confined to an carefully defined geographic area. The quid pro quo is that the dealer has an exclusive right to all sales in this territory, except for national accounts.

Under a somewhat less restrictive arrangement, the reseller is assigned an "area of primary

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<sup>1</sup> Red Diamond Supply Inc. v. Liquid Carbonic Corp., 637 F. 2d 1001, 1004 n.4 (5th Cir. 1980), cert. denied, 454 U.S. 827 (1981).

<sup>2</sup> Alexander Hammond, Franchisee Rights: A Self-Defense Manual for Dealers, Distributors, Wholesalers and Other Franchisees, Greenvale, N.Y. :Panel Publishers, 1979) p. 214.

responsibility" (APR), but remains free to market outside this assigned territory if the APR is adequately developed. Much the same result is achieved by specifying the actual location of the retail facility or manufacturing/distribution center, especially if transportation cost is an important factor in the delivered price.

Often, the same limitations on intrabrand competition can be achieved by less direct means. For example, profit pass-over clauses, which require a seller who sells outside his territory to reimburse the invaded competitor for advertising or warranty service, tends to curtail extraterritorial sales if the pass over charges are substantial. Similarly, the feature of a soft drink franchise which requires the bottler only to make store-door, as opposed to warehouse, deliveries tends to make long distance extraterritorial excursions uneconomical. They would not be so if the delivery could be made to the retail chain's central warehouse.

The creativity displayed in limiting intrabrand competition is truly amazing. For example, when Sealy, Inc., the joint venture mattress company which was owned and controlled by its stockholder-licensees, and which only licensed the right to make and sell Sealy products in a defined territory, was found to be a horizontal combination of potential competitors, and therefore illegal per se,<sup>3</sup> the final decree entered by the court enjoined Sealy and its licensees from any arrangement "to limit or restrict any manufacturer in any substantial way to sales of Sealy products within a prescribed territory."<sup>4</sup> Notwithstanding its conviction and the resulting decree, Sealy immediately developed a "new" license agreement which retained the same territories that had been used before, and with Sealy still promising not to license anyone else to manufacture Sealy products in a licensee's territory.<sup>5</sup> The one change was

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<sup>3</sup> United States v. Sealy, Inc., 388 U.S. 350 (1967).

<sup>4</sup> United States v. Sealy, Inc., 1967 Trade Cases ¶ 72,327 at 84,855 (N.D. Ill. Dec 26, 1967)

<sup>5</sup> This description is taken from Ohio-Sealy Mattress Co. v. Sealy, Inc., 585 F. 2d 821 (7th Cir. 1978), cert denied, 440 U.S. 930 (1979).

that the old territories, were no longer to be exclusive as to sales. They thus became APR's.

While each Sealy licensee had the primary responsibility to promote Sealy sales in his area, each also had the right to sell Sealy products in the territories of other licensees. But, since licensees were only authorized to manufacture Sealy products at the locations specified in their agreements, or at additional locations approved by Sealy, and since the majority of mattress sales are made within 200-300 miles of a manufacturing plant because of their bulk, this manufacturing location provision amounted to a formidable territorial restraint .

Also, in addition to normal royalties, if a licensee sold Sealy products outside its area of primary responsibility, the exporting licensee was required to pay the invaded licensee a pass-over payment based on the invaded licensee's prior year advertising and promotion expense. The actual payments ranged from 2.2% to 11% of the sale. Also, an additional charge was levied for "product service repairs" amounting to another 1% of out-of-APR sales. These provisions all but blocked extraterritorial sales.

The Sealy license agreements also contained another interesting provision giving Sealy the right of first refusal" before a licensee could sell its business to someone else. This provision was used to perpetuate enclaves relatively free of intrabrand competition. The final result of all of these new provisions, taken as a whole, was a system of territorial restraints only slightly weaker than those that had been held illegal in the first place.

Sony of America was also quite clever in developing an indirect method for confining its dealers to their assigned territories. Whenever an authorized Sony dealer sold dictating machines outside its territory--usually to an unauthorized dealer--Sony automatically charged the selling Sony dealer a scheduled "warranty fee" which was then automatically credited to the account of the invaded Sony dealer, whether any warranty service was actually provided or not. Moreover, the size of the warranty fee

was designed to eliminate any profit from resale to unauthorized out-of-territory dealers.<sup>6</sup> Many other examples of equally clever arrangements designed to curb intrabrand competition could be cited. The point to be noted is that territorial restrictions come in many different guises, but they all have the same purpose, though some are more effective than others.

By design, then, territorial restrictions diminish intrabrand competition. Under such an arrangement, each reseller, in effect, is guaranteed that his "assigned" territory will be free of competition from any other reseller representing the same supplier. This is especially true at the wholesale distribution level, where a franchisee's customers are usually retailers whose known business address clearly places them either inside or outside the "assigned" territory.<sup>7</sup> However, if customers are highly mobile, territorial restrictions are a less effective method of curbing intrabrand competition.<sup>8</sup> Cross-selling can be controlled, but cross-buying is almost impossible to police.

Intrabrand competition can also be controlled through resort to customer restrictions. Often, specific customers or types of customers will be assigned or excluded in the formal distribution or licensing agreement. For example, a distributor of livestock chemicals and drugs may be designated to serve only major feed manufacturers while another serves drug stores, and manufacturing feed retailers and mills and still another is designated to serve licensed veterinarians. Or one hair care distributor may be restricted to selling to beauty salons while another may be assigned to cover regular retail outlets. Also, certain substantial or multiple location accounts are frequently reserved by the manufacturer as national or house accounts.

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<sup>6</sup> Eiberger v. Sony Corp. of America, 622 F. 2d 1068 (2nd Cir. 1980).

<sup>7</sup> Alexander Hammond, Franchisee Rights: A Self-Defense Manual for Dealers, Distributors, Wholesalers and Other Franchisees, Greenvale, N.Y. :Panel Publishers, 1979) p.84.

<sup>8</sup> Posner 75 Colum. L. Rev., "Antitrust Policy and the Supreme Court: An Analysis if Restricted Distribution, Horizontal Mergers, and Potential Competition Decisions," 282327. (1975).

Thus, by partitioning the market among his dealers, either with respect to territories or class of customer to be served, a manufacturer can protect his reseller's markups from the eroding effects of free-riders and intrabrand price competition. These restraints on customers and territories place an artificial limit on intrabrand competition because they restrict the number of sellers at the wholesale and retail levels.<sup>9</sup> Whether or not this leads to an improvement in welfare as compared to the competitive solution depends upon a number of factors including the nature of the product and the market power of the manufacturer.

#### Intrabrand vs Interbrand Competition

In assessing the competitive impact of territorial and customer restrictions, the question is not whether intrabrand competition is diminished by territorial and customer restrictions; it is. This is their purpose. Rather, the question is whether this diminution of intrabrand competition is somehow offset by gains in interbrand competition, or if the intrabrand restrictions promote other values which enhance consumer welfare. The answers to these latter questions are unclear.

As noted in earlier chapters, on balance, not all restrictions on intrabrand competition are seen to be anti-competitive. Certain reductions of intrabrand competition seem to have the potential, at least, for increasing the effectiveness of interbrand competition, and/or enhancing consumer welfare. For example, while territorial restrictions, reduce intrabrand competition, they may be necessary to induce competent and aggressive resellers to invest capital and labor in developing the distribution of new products in new markets. Or they may be needed to induce the resellers of established products to spend sufficient money on those promotional and servicing activities necessary to market the goods efficiently. In both cases, the

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<sup>9</sup> Alexander Hammond, Franchisee Rights: A Self-Defense Manual for Dealers, Distributors, Wholesalers and Other Franchisees, Greenvale, N.Y. :Panel Publishers, 1979) p. 214.

reseller might not commit these resources and efforts if other resellers could take a "free ride" and enjoy the benefits of the providing reseller's efforts.<sup>10</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 97 S.Ct. 2549 (1977) at 2560. 433 U.S. 38 at ??(1977). Also, location restrictions can be used to ensure product quality and safety in accordance with products liability and consumer warranty law.<sup>11</sup> It is also claimed that location restrictions facilitate more concentrated and intense market coverage<sup>12</sup>; and that they promote efficiency by allowing scale economies to be realized. In each instance interbrand competition supposedly is enhanced by the reduction in intrabrand competition.

Territorial restrictions thus give each dealer the incentive to cultivate his exclusive territory as intensively as is worthwhile. Similarly, "primary responsibility" clauses permit the manufacturer to demand of the dealer that amount of local sales effort which the manufacturer considers optimum. However, "area of primary responsibility clauses" (APR's) are not as potent as exclusive territorial restrictions which give each dealer the incentive to cultivate his exclusive territory as intensively as is worthwhile both from his point of view as well as that of the manufacturer. Likewise, location restrictions encourage dealers to carry and promote the manufacturer's product, thus strengthening that brand's competitive position against other brands.<sup>13</sup>

It is also argued that customer restrictions are often necessary to facilitate price discrimination between customers, and that only by charging lower prices to certain classes customers, can interbrand competition for these customers exist at all.<sup>14</sup> This is especially true when the manufacturer reserves

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<sup>11</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 97 S.Ct. 2549 (1977) at 2560 n. 23, 433 U.S. 38 at ?? (1977).Id.

<sup>12</sup> Lee Preston, "Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards," 30 Law & Contemp. Prob. 506 (1965).

<sup>13</sup> 88 Harvard Law Review 636 at 641 (1975)

<sup>14</sup> Comanor, "Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath,"

certain key customers as house accounts.

The problem for analysis is that in those cases where these territorial and customer restrictions are enforced primarily to limit free-riding, or to achieve resale price stability and to facilitate price discrimination, they have essentially the same economic consequences as those fashioned more directly through illegal resale price maintenance (RPM), and must overcome the same objections that confront resale price maintenance.<sup>15</sup> In a sense, vertical territorial and customer restrictions may be seen as a weaker alternative to illegal RPM.<sup>16</sup> If vertical price-fixing were legal, many other vertical restrictions- including territorial and customer restrictions- would soon disappear.

#### Territorial and Customer Restrictions and the Law

The question of whether a vertical territorial or customer limitation is a violation of the Sherman Act, that is, whether it amounts to an illegal contract, combination or conspiracy in restraint of trade, depends on the actual impact of the agreement on competition.<sup>17</sup> Moreover, this competitive impact is often complex and hard to assess.

Professor Comanor argues that since customer and territorial restrictions are ways of achieving product differentiation, and since they are likely to promote differentiation and contribute to the

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81 Harv. L. Rev. 1419 at 1433 (1968).

<sup>15</sup> Comanor, "Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath," 81 Harv. L. Rev. 1419,1427 (1968).

<sup>16</sup> Posner 75 Colum. L. Rev., "Antitrust Policy and the Supreme Court: An Analysis if Restricted Distribution, Horizontal Mergers, and Potential Competition Decisions," 282327. (1975).

<sup>17</sup> White Motor Co. v. United States, 372 U.S. 253 (1963) in Areeda, Antitrust Analysis: Problems, Text, Cases, 2nd (Boston: Little Brown, 1974), p. 740

achievement of market power, they should all be seen as violations of Section 1 of the Sherman Act.<sup>18</sup>

But this is not any longer the position of the court.

For a short time between 1967-1977, when the Schwinn<sup>19</sup> decision was controlling, a "bright line" rule of per se illegality for all vertical restrictions, like that advocated by Comanor, was followed:

Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it.<sup>20</sup>

However, since the 1977 Sylvania decision, this per se rule no longer holds.<sup>21</sup> In Sylvania, the Supreme Court held that "reasonable" territorial and customer restraints imposed by a franchiser were not automatically illegal as they had been under the Schwinn rule, and that henceforth they should be judged under the traditional "rule of reason" interpretation of Section 1 of the Sherman Act. This is now the law.

In taking this approach, the Supreme Court was merely reverting to its pre-Schwinn standard (articulated in 1963 in White Motor) for determining whether or not vertical restrictions must be "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."<sup>22</sup>

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<sup>18</sup> Comanor, "Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath," 81 Harv. L. Rev. 1419 at 1424 (1968).

<sup>19</sup> United States v. Arnold, Schwinn & Co., 388 U.S. 365, 87 S.Ct. 1856, 18 L. Ed. 2d 1249 (1967).

<sup>20</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 97 S.Ct. 2549 (1977) at 2554. 433 U.S. 38 at 44. (1977).

<sup>21</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 97 S.Ct. 2549 (1977), 433 U.S. 38 (1977).

<sup>22</sup> Northern Pac. Ry Co. v United States, 356 U.S.1 at 5 (1958).

Noting that there had been no showing in the record that Sylvania's vertical restrictions have, or are likely to have, a "pernicious effect on competition, or that they "lack...any redeeming virtue." the Supreme Court concluded that the per se rule stated in Schwinn must be overruled.<sup>23</sup>

In so holding, the Court did not rule out the possibility that particular (unspecified) applications of vertical restrictions might still justify per se prohibitions under Northern Pac. R. Co. But they did make it 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.<sup>24</sup>

Thus, while some applications of territorial and customer restrictions were still to be treated as per se violations--including all horizontally imposed territorial or customer restrictions, most vertical territorial and customer restrictions now are to be judged under the rule-of-reason standard. Sylvania, thus placed the competitive effects of particular vertical restraints at the center of their antitrust analysis under the rule of reason.<sup>25</sup>

#### The Rule of Reason Analysis

Actually, in Sylvania, the Supreme Court was not called upon to apply the rule of reason to the facts of the case, and thus did not specifically address the legality of the agreement between Continental TV and GTE Sylvania that prohibited the sale of Sylvania products by Continental "from other than specified locations." In fact, the Supreme Court has yet to give plenary consideration to the question of

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<sup>23</sup> Northern Pac. Ry Co. v United States, 356 U.S.1 at 5 (1958).

<sup>24</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 97 S.Ct. 2549 at 2562 (1977).

<sup>25</sup> Graphic Products Distributors, Inc. v. Itek Corp. 1983-2 Trade Cases ¶ 65,670, 69,421 (11th Cir.).

the proper antitrust analysis of location restrictions.<sup>26</sup> As noted, even in Sylvania, the Court was only concerned with the jury instructions which had barred the jury from considering the reasonableness of the territorial restraint, if they found that Sylvania had parted with dominion over the products in accordance with the Schwinn per se rule.<sup>27</sup> Not called upon to apply the rule of reason to the facts at hand, the Supreme Court merely recited Justice Brandeis' classical articulation of the rule of reason in Chicago Board of Trade v. United States.<sup>28</sup> Thus guidance has had to come from the lower courts.

Comment [1]: Has the Court done an antitrust analysis of locations since 1977?

For example, on remand, the original trial judge did find Sylvania's location clause to be reasonable, and hence legal. In reaching this conclusion, he emphasized Sylvania's "faltering status, the presence of more than 100 competing manufacturers, Sylvania's improved effectiveness as an interbrand competitor, and the "less restrictive' character of location restrictions vis a vis closed territories.<sup>29</sup> Whether he would have found the territorial restrictions legal under the facts in Schwinn where each distributor had a defined geographic area in which each had the exclusive right to supply franchised retailers, and where sales to the public could only be made through franchised retailers who were authorized to sell Schwinn bicycles only from specified locations is unclear. Also Schwinn was the leading bicycle producer in the nation at the time, with a market share of 22.5%.<sup>30</sup>

Noting this lack of guidance as to how the rule of reason should be applied, In the Itek case, the 11th Circuit sought to narrow the broad-ranging inquiry called for by outlining a more detailed approach. To start with, they held that the market power of the offender must be established.<sup>31</sup> Their reasoning was

<sup>26</sup> Continental T.V. v. GTE Sylvania Inc., 97 S.Ct. 2553, note 11.

<sup>27</sup> Continental T.V. v. GTE Sylvania inc., 97 S.Ct.2549, 2552.

<sup>28</sup> Chicago Board of Trade v. United States 246 U.S. 231, 238 (1918)

<sup>29</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 699. 461 F. Supp. 1046 (N.D. Cal. 1978).

<sup>30</sup> United States v. Arnold, Schwinn & Co., 388 U.S. at 368

<sup>31</sup> Graphic Products Distributors, Inc v. Itek Corp. 1983-2 Trade Cases, ¶ 65,670, 69,421 (11th Cir. 1983).

that absent market power, the effect of vertical restraints imposed on dealers could not be to raise the price consumers paid for the product.<sup>32</sup>

The absence of market power in the interbrand market implies that the defendant is in competition with firms that sell products regarded by the consumer as close substitutes for the defendant's. The defendant will therefore lose most or all of its sales if its retail price exceeds its competitors' retail price for any reason, including a lack of intrabrand competition...<sup>33</sup>

In order to establish the defendant's market power, the Circuit Court stated that one must first define "the relevant market upon which the challenged anticompetitive actions would have had a substantial impact." The relevant product and geographic market is, of course, a question of fact. But once the relevant market has been defined, then market power in the relevant market can be considered.<sup>34</sup>

Traditionally, market power has been defined as the ability to raise prices significantly above the competitive level without losing all of one's business.<sup>35</sup> However, since market power is conceptually difficult to define in any given case, market share is frequently used as its surrogate. Moreover, market share is seen as an especially good surrogate in this instance because it directly relates to the effectiveness of interbrand competition in minimizing the anticompetitive effects of a restraint of intrabrand competition.<sup>36</sup> ABA Antitrust Section Monograph No. 2 (1977).

Another important index of market power is the degree of product differentiation. Product

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<sup>32</sup> See Muenster Butane, Inc. v. Stewart Co., 651 F. 2d 292 at 298 (5th Cir. 1981).

<sup>33</sup> Posner, "The Next Step in Antitrust Treatment of Restricted Distribution: Per se Legality," 48 U. Chi L. Rev. 6 at 16 (1981).

<sup>34</sup> Graphic Products Distributors, Inc. v. Itek Corp 1983-2 Trade Cases ¶65,670, at 69,422.

<sup>35</sup> Valley Liquors, Inc. v. Renfield Importers, Ltd. 1982-2 Trade Cases ¶ 64,744, 678 F. 2d 742, 745 (7th Cir. 1982).

<sup>36</sup> "Vertical Restrictions Limiting Intrabrand Competition,"

differentiation can be based on styling packaging, advertising, service, brand image, reputation, product quality, functional features, and other product and promotion policies. To the extent that product differentiation has been effectively created, a company will have additional freedom to raise the price of its product above that of competing brands while still retaining a substantial portion of its business.<sup>37</sup> Product differentiation moves the demand curve up and to the right.

Once having established market power on the basis of share of market and/or product differentiation, one must next show an anti-competitive effect, either in the intrabrand or interbrand markets. Moreover, demonstration of the anti-competitive effect was to be but the first step in the systematic comparison of the negative effects of the restraint on intrabrand competition and interbrand competition, if any, with the alleged positive effects on interbrand competition stemming from the restraints.<sup>38</sup>

This is the nature of the antitrust analysis now understood to be required by Sylvania. Just because an arrangement is no longer illegal per se, does not mean that it is automatically legal per se. It might still be illegal because it is an unreasonable restraint of trade.

In addition, the 11th Circuit noted that a mere abstract lessening of intrabrand competition is not enough to establish a cause of action for a violation of the antitrust laws.<sup>39</sup> They held that the effects of a restraint on intrabrand competition on consumer welfare could not be viewed in isolation from the interbrand market structure. Consumers are only injured by a restraint if, without obtaining more services, they are denied intrabrand choices that are the sources of consumer welfare. They are benefited if,

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<sup>37</sup> ABA Monograph, supra, at 64.

<sup>38</sup> Graphic Products Distributors, Inc v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,423 (11th Cir.).

<sup>39</sup> Aladdin Oil Co. v. Texaco, Inc., 603 F. 2d 1107, 1116 (5th Cir. 1979).

notwithstanding the restraint, desired dealer services increase. Only when enhanced dealer services to the consumer result from the restraint, is interbrand competition sharpened.<sup>40</sup>

To summarize the 11th Circuit's reasoning so far, a seller with considerable market power in the interbrand market--whether stemming from a dominant position in the market structure, or from successful differentiation of its products-- will necessarily have some power over price. If so, intrabrand competition will be a significant source of consumer welfare because only intrabrand competition can exert downward pressure on the retail price at which the good is sold. Dealers, by competing against each other and bidding retail price down, will in turn exert downward pressure on the seller's wholesale price in order to maintain their profit margins. Thus, in situations of manufacturer market power, intrabrand restrictions on distributor competition can have a substantial adverse effect on consumer welfare by eliminating an important source of competitive pressure on price, even if additional services result. Rather than promoting non-price competition, vertical restraints in this context may enable a manufacturer to retain monopoly profits arising from interbrand market power. Thus where a manufacturer has discretion to raise prices over interbrand competitors, elimination of intrabrand competition can be injurious to consumer welfare because it eliminates a source of downward pressure on price.<sup>41</sup>

But, even if there is a negative impact on consumer welfare and on competition that follows from a restriction on intrabrand competition, this is not enough by itself. The Court holds that one must still determine if they are outweighed by possible pro-competitive effects in the interbrand market stemming from the intrabrand restriction.<sup>42</sup> According to the 11th Circuit, competitive analysis thus becomes a

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<sup>40</sup> Graphic Products Distributors, Inc. v. Itek Corp., 69,424.

<sup>41</sup> Gerhart, "The Competitive Advantages" Explanation For Intrabrand Restraints: An Antitrust Analysis, 1981 Duke L. J. 417, 426-429. See also Coleman Motor Co. v. Chrysler Corp., 525 F.2d 1338, 1347 (3rd Cir. 1975).

<sup>42</sup> Graphic Products Distributors, Inc. v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,425 (11th Cir.).

matter of determining whether, on balance, the nature and effect of the restraints are procompetitive when viewed as a whole, or whether they are substantially adverse to market competition.<sup>43</sup>

Note that this systematic comparison need not necessarily involve a specific weighing or balancing of the effects of a restraint on intrabrand competition with its effect on interbrand competition. The Supreme Court had previously cautioned about the difficulty inherent in such a weighing process.<sup>44</sup> Under the rule of reason, the interbrand market context in which intrabrand restraints are imposed will often allow one to determine the effects on overall competition without recourse to a specific balancing analysis.<sup>45</sup>

Thus, some of the facts that one must consider in assessing the legality of a franchiser's vertical territorial or customer restraints are:

- 1) The manufacturer's share of market: is it large or dominant as in Schwinn?
- 2) The number of competitive products on the market: are there over 100 as in Sylvania, or relatively few?
- 3) The type of restraint imposed. Was it, as in Schwinn, a rigid system that all but eliminated competition among dealers, or was it, as in Sylvania, a loose restraint that did not prohibit dealers from selling in particular areas but only limited their ability to expand into new areas?<sup>46</sup>

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<sup>43</sup> Graphic Products Distributors, Inc v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,425 (11th Cir.).

<sup>44</sup> United States v. Topco Associates, Inc. (Slip Opinion March 29, 1972) p.13.

<sup>45</sup> Graphic Products Distributors, Inc v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,423 n. 18 (11th Cir.).

<sup>46</sup> Alexander Hammond, Franchisee Rights: A Self-Defense Manual for Dealers, Distributors.

### The Emerging Pattern

The answers to the above questions seem to be guiding the courts in determining the reasonableness of vertical territorial restraints since the Sylvania decision. For example, a locations clause adopted by a small competitor like GTE Sylvania will be less destructive to interbrand and intrabrand competition than rigid restrictions adopted by a dominant firm like Arnold, Schwinn & Co.. On the other hand, if there are many manufacturers in the market, the potential impact on competition in both these cases will probably be less pronounced than in a highly concentrated industry.<sup>47</sup>

Thus the legality of a vertical territorial or customer restriction is still a matter of speculation, judgement and complex analysis. Nevertheless, there are a number of arrangements that have passed muster under the rule-of-reason analysis and the list is still being developed. So far the list of vertical restraints regarded as legal includes:

Selective distribution

Areas of Primary Responsibility (APR's)

Location clauses

Profit passover clauses if related to cost

Other restrictions are still in limbo, but are not necessarily illegal.

#### Exclusive Territories:

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Wholesalers and Other Franchisees, Greenvale, N.Y. :Panel Publishers, 1979) p.221.

<sup>47</sup> See Snap-on Tools Corp. v. F.T.C., 321 F. 2d 825 (7th Cir. 1963).

Clearly, exclusive territories have a considerably more severe impact on intrabrand competition than do location restrictions, even though as a practical matter, a location restriction becomes an absolute territorial restriction at some radius from the assigned location.<sup>48</sup> This means that closed territories are often suspect if less restrictive means can be found to achieve essentially the same end.

In fact, many would support the view that exclusive territorial limitations--in light of their obvious susceptibility to anti-competitive misuse--are always more restrictive than necessary to achieve legitimate goals, in light of such less restrictive alternatives such as a clause assigning each dealer a territory of primary responsibility which he agrees to use his best efforts to develop.<sup>49</sup>

In the Itek case quoted above, a network of absolute territorial restraints on company-owned and independent distributors was found to constitute an unreasonable restraint of trade because of its adverse effect on intrabrand competition and because of the lack of any offsetting pro-competitive effect on interbrand competition.<sup>50</sup> The arrangement completely eliminated intrabrand competition, which was seen as the critical source of competitive pressure on price and consumer welfare in a market which was 70% controlled by the manufacturer of a product which was not readily interchangeable with competitive products.<sup>51</sup>

On the other hand, in Adolph Coors Co. v. FTC, it was recognized that some form of territorial

**Comment [2]:** See ABA Antitrust Section, Monograph No. 2, Vertical restrictions Limiting Intrabrand Competition (1977).

<sup>48</sup> 88 Harv. L. Rev. 636, 643 (1975).

<sup>49</sup> 75 Harv. L. Rev. 699. See Pitofsky, 78 Col. L. Rev. at 4, n. 10 and Stewart and Roberts, "Viability of the Antitrust Per Se Rule: Schwinn Down, How Many to Go?" 58 Wash U. L. Q. 724, 728 (1980).

<sup>50</sup> Graphic Products Distributors, Inc v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670 (11th Cir. 1983).

<sup>51</sup> Graphic Products Distributors, Inc v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,416 (11th Cir. 1983).

restriction might be justified to protect a product (unpasteurized beer) unusually susceptible to damage in distribution.<sup>52</sup>

As an aside, the core facts of the Coors case point up the need for caution in uncritically accepting a manufacturer's unsupported assertion that a marketing restriction with demonstrable anti-competitive effects is necessary to its "survival." Even if the restrictions are not tainted by pricefixing as they were here, the manufacturer must still demonstrate the absence of alternative means less restrictive of competition to achieve the same end. And, it was not clear in Coors that a less restrictive means could not be found to assure quality control. The mere invocation of a possible pro-competitive purpose will not suffice to legalize a restraint under the rule of reason.

This raises an interesting complication. Nothing in the Sylvania decision indicates that an inquiry into whether or not a restraint must be "reasonably necessary" to accomplish the manufacturer's legitimate business purposes, or that it is the least restrictive means of doing so, was to be an integral part of a rule of reason analysis. This question of "reasonable necessity" was first raised, but not answered, in White Motor Co.<sup>53</sup> Even though the "reasonably necessary" test is not explicitly mandated in Sylvania, the test does speak to the manufacturer's motive in imposing the restrictions and thus to the effects of the restrictions overall.<sup>54</sup> Consequently, numerous lower courts have explicitly endorsed this "reasonably

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<sup>52</sup> Adolph Coors Co. v. FTC, 497 F. 2d 1178 (10th Cir.), cert. denied, 419 U.S. 1105(1974). In this particular instance the territorial restraints were also seen to be ancillary to an illegal price fixing scheme, and thus were held to be illegal for that reason.

whatever may be said of the efficacy of the territorial restrictions here in maintaining quality control, the restrictions also play a vital role in Coor's maintaining control over the wholesale and retail price of its beer.

<sup>53</sup> White Motor Co. v. United States, 372 U.S. 253,270 (1963).

<sup>54</sup> Graphic Products Distributors, Inc v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,429, n. 31. (11th Cir. 1983).

necessary" test.<sup>55</sup>

Neither did the Sylvania Court require an inquiry into whether or not a restraint was the least restrictive means available for achieving the desired end, or that its reasonableness should depend on it being the least restrictive limitation available. Professor Areeda convincingly argues that the Court's failure to make this requirement explicit does not imply that they were indifferent to the relative severity of related restraints. Rather he feels that the Court merely decided that "relative restrictiveness" was an insufficient basis for a per se condemnation of one restraint while allowing the other.<sup>56</sup> In any event, this "relative severity" test has also come to be included in the evaluation of territorial and customer restraints.

#### Location Clauses:

The Ninth Circuit's consideration of the Sylvania case on its way to the Supreme Court is instructive in providing an understanding of those factors that should enter into an antitrust analysis of the legality of location agreements. The Ninth Circuit had held that location agreements imposed by manufacturers which had only a small percentage of the total market in which many other brands are available, which gave its dealers no veto power against franchising of additional dealers in a given area, which permitted its dealers to carry competing brands, which had no demonstrable effect on prices, volume of products available, quality or consumer choice, and which did not foreclose any consumer from substantial choice among several dealers, should be judged legal under the rule of reason.<sup>57</sup> This still leaves open the question of whether the use of location restrictions in a different situation--say the

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<sup>55</sup> See, e.g. Donald B. Rice Tire Co. v. Michelin Tire Corp., 483 F. Supp. 750, 758 (D. Md. 1980)(citing cases). Also American Motor Inns, Inc. v Holiday Inns, Inc. 521 F. 2d. 1230, 1248-48 (3rd Cir. 1975) (citing cases).

<sup>56</sup> Areeda, The Rule of Reason in Antitrust Analysis: General Issues, 9 (Federal Judicial Center Monograph 1981)

<sup>57</sup> GTE Sylvania, Inc v. Continental T.V., Inc., 537 F2d 980 (1977).

situation in the Schwinn case described earlier- would be judged acceptable under such a rule-of-reason test.

In any event, location clauses which restrict the freedom of a dealer to choose the place from which he may distribute have now been upheld in several cases.<sup>58</sup> But, a location clause was also invalidated in U.S. v. Revlon.<sup>59</sup>

Comment [3]: Why was it invalidated...explain

#### Primary Responsibility Clauses:

The use of a primary responsibility clause has been upheld by the 10th Circuit in Colorado Pump and Supply Co. v. Febco, Inc.<sup>60</sup>. In that case the court held that a mere designation in a contract of an area of primary responsibility without more is not a per se violation of §1 of the Sherman Act.

Comment [4]: Need to see if this was upheld, or if it was just a RofR decision

#### Profit Pass-Over Clauses:

Primary responsibility as well as profit pass-over clauses were allowed in Superior Bedding Co. v. Serta Associates, Inc.<sup>61</sup> However in Ohio-Sealy Mattress Mfg. Co. v. Sealey, Inc., a finding that a required payover of one percent of revenues on out-of-territory sales to reimburse the "invaded" firm for the cost of servicing goods "had no purpose except to discourage such sales."<sup>62</sup>

<sup>58</sup> 793 ATRR A-2 Denger, Continental T.V., Inc. v. GTE Sylvania, 461 F. Supp. 1046 (N.D. Cal. 1978); Salco Corp v. G.M. Corp 517 F.2d 567 (CA 10 1975); Kaiser v. G.M. Corp 396 F. Supp. 33 (E.D. Pa. 1975); Sheldon Pontiac v. Pontiac Motor Div. 782 ATRR A-21 D NJ (1976).

<sup>59</sup> United States v. Revlon, 706 ATRR A-25 (S.D.NY 1975)

<sup>60</sup> Colorado Pump and Supply Co. v. Febco, Inc. 472 F. 2d 637(10th Cir. 1973).

<sup>61</sup> Superior Bedding Co. v. Serta Associates, Inc. 353 F. Supp 1143 (1972)

<sup>62</sup> Ohio-Sealy Mattress Mfg. Co. v. Sealy, Inc., 585 F. 2d 821 (7th Cir. 1978), cert. denied, 440

### Sole Outlet Clauses:

Sole outlet agreements have also be allowed in several cases.<sup>63</sup> Generally, the rule is that absent evidence of monopolization, a manufacturer may legally grant such an exclusive franchise even if this entails the elimination of another distributor.<sup>64</sup> GTE Sylvania, Inc v. Continental T.V., Inc, 537 F2d 980, 997 (1977).

**Comment [5]:** Put in a citation about selectivity

### Horizontal Implications of vertical Restraints:

One must also be sensitive to the horizontal implications of vertical restrictions. Occasionally, there may be problems in differentiating vertical restrictions from horizontal restrictions originating in agreements among a firm's retailers. If the restriction can be shown to be horizontal in origin, it is illegal per se.<sup>65</sup> The questions arise over defining the behavior that signifies that the restriction in horizontal in origin. If the franchiser consults with nearby existing franchisees before approving a new franchise competing with them, or if he responds to dealer complaints about extra territorial sales, is this evidence of a "restriction horizontal in origin"<sup>66</sup> In the American Motor Inn case, the consultation with potentially

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U.S. 930 (1979).

<sup>63</sup> See Jos. E. Seagram & Sons, Inc v. Hawaiian Oke & Liquors, Ltd., 416 F 2d 71 (1969) which allows sole outlet agreement. Also see Packard Motor Car Co. v. Webster Moror Car Co., 243 F.2d 418 (D.C. Cir), cert denied, 355 U.S. 822 (1957).

<sup>64</sup>

<sup>65</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 97 S. Ct. 2561

<sup>66</sup> See American Motor Inns v. Holiday inns, 521 F. 2d 1230 (3rd Cir. 1975). See also United States v. Wohl Shoe Co., 369 F. Supp. 386 (D.N.M. 1974), where a conspiracy was found among dealers working with each other and the manufacturer to police the market.

competitive franchisees amounted to horizontal market allocation.

Dual Distribution:

The horizontal implications of territorial restrictions imposed by a manufacturer who also acts as a dealer, competing with his own dealers also poses a problem. Obviously, not all of the usual interbrand competitive advantages apply with the same force in a system of dual distribution. The manufacturer may no longer have the exclusive interest in a low margin, high volume distribution system that is normally attributed to him.<sup>67</sup>

Those normal market factors encouraging a supplier to let its distributors compete are less effective to the extent that [the defendant manufacturer] also competed as a distributor.<sup>68</sup>

For example, in Hobart Bros. v. Malcom T. Gilliland, Inc.,<sup>69</sup> the Court found:

...the Hobart distribution agreement, while appearing to allocate territory vertically, in fact, resulted in a horizontal territorial allocation between Hobart and its distributors. Such an arrangement must be treated as it operated in practice rather than as arranged by skillful drafting.<sup>70</sup>

This same approach was taken in Pitchford Scientific Instruments Corp. v. Pepi.<sup>71</sup> In fact, some

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<sup>67</sup> Graphic Products Distributors, Inc. v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,428 (11th Cir. 1983).

<sup>68</sup> Abadir & Co. v. First Mississippi Corp. 651 F. 2d 422 at 427 (5th Cir. 1981)

<sup>69</sup> Hobart Bros. v. Malcom T. Gilliland, Inc., 471 F. 2d 894 (5th Cir. 1973)

<sup>70</sup> Alexander Hammond, Franchisee Rights: A Self-Defense Manual for Dealers, Distributors, Wholesalers and Other Franchisees, Greenvale, N.Y. :Panel Publishers, 1979) p. 241.

<sup>71</sup> Pitchford Scientific Instruments Corp. v. Pepi, 531 F. 2d (3rd Cir.), cert denied, 426 U.S. 935 (1970)

would even go so far as to argue that an entity occupying such a dual role should be forbidden per se from imposing territorial market restraints on its distributors. Even Judge Posner, who usually advocates complete license with respect to vertical restrictions, noted a difference when dual distribution is involved. However, in Krehl v. Baskin-Robbins Ice Cream Co.,<sup>72</sup> the Court specifically rejected Krehl's contention that the territorial restrictions imposed upon him were horizontal because both he and the defendant were in the business of granting local franchises. The Court held that since the defendant was "controlling the system from the top," the relationship was that of central director and not competitor.<sup>73</sup>

**Comment [6]:** Get Posner citation re: dual dist.

Likewise in Graphic Products Distributors, Inc. v. Itek Corp., the 11th Circuit held that even though the case involved a dual distribution system, the restraints on intrabrand competition were vertical. Nevertheless, they noted that though they treated Itek's restraints as vertical, Itek's motivations to restrict competition from its independent distributors was a factor in their analysis of its pro-competitive purposes.<sup>74</sup>

**Comment [7]:** Expand on this dual distribution point. See Areeda note on p. 702 and look up s. Altschuler, "Sylvania, Vertical Restraints and Dual Distribution," 25 Antitrust Bull. 1 (1980)

#### Price-Fixing Implications:

**Comment [8]:** May want to cover issues in Areeda footnotes 702...

It is very clear that, regardless of the business reason that may have originally prompted the vertical restraint, customer or territorial restrictions that are part of an illegal pricing scheme cannot claim the protection of the rule of reason. In applying the rule of reason, the courts have consistently rejected the notion that "naked restraints of trade" are to be tolerated because they are well intentioned, or because they were allegedly developed to increase competition. Such restraints are still per se violations, however they are disguised.

<sup>72</sup> Krehl v. Baskin-Robbins Ice Cream Co., 1979 Trade Cases, ¶62806 (C.D. Cal).

<sup>73</sup> Areeda, Antitrust Analysis: Problems, Text, Cases, Boston: Little Brown, 1981, p. 702-703, note 57.

<sup>74</sup> Graphic Products Distributors, Inc. v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,428 11th Cir. 1983)..

For example, in Beech-Nut,<sup>75</sup> which was discussed in Chapter 3, the company had adopted a policy of refusing to sell its products to wholesalers or retailers who did not adhere to a schedule of resale prices. Beech-Nut later implemented this policy by refusing to sell to wholesalers who sold to retailers who would not adhere to the policy--a vertical customer restriction. The company had urged that its conduct was entirely legal under the Sherman Act as interpreted by Colgate. The Court rejected this contention, saying that "the BeechNut system goes far beyond the simple refusal to sell goods to persons who will not sell at stated prices, which in the Colgate Case was held to be within the legal right of the producer." ...[T]he Court held that the securing of the customer's adherence by such methods constituted the creation of an unlawful combination to suppress price competition among the retailers.<sup>76</sup>

#### Customer Restrictions:

Some would go so far as to argue that there are no countervailing benefits at all from customer restrictions. This was the view of the 9th Circuit in the Sylvania case:

While there are no possible pro-competitive benefits to be derived from vendee or customer restrictions, some territorial restrictions on vendors may have pro-competitive effects. ( to make sure that products are adequately advertised, promoted or serviced).<sup>77</sup>

This was also the position of Justice Brennan in the White case who said that:

customer restraints are more dangerous than territorial limitations. White seeks to retain a distribution system for the general run of customers

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<sup>75</sup> FTC v. Beech-Nut Packing Co., 257 U.S. 441 (192?)

<sup>76</sup> FTC v. Beech-Nut Packing Co., 257 U.S. 441 (192?).

<sup>77</sup> GTE Sylvania, Inc v. Continental T.V., Inc., 537 F2d 980, 990 (1977).

while skimming off the cream of the trade for its own direct sales.<sup>78</sup>

However, in Tripoli v. Wella Corp.,<sup>79</sup> the Third Circuit upheld customer restrictions that were reasonably necessary to protect the public.

**Comment [9]:** Say something about what was involved in this case

National account programs also pose special problems for analysis. In many instances a national account program amounts to little more than vertical price fixing.<sup>8</sup> Often, they are but one part of a complex strategy by which franchisers attempt to create a smoke screen for re-instituting price controls by resorting to legal technicalities and definitions affecting the way goods are transferred from manufacturer to dealer to consumer.

Because of this uncertainty, many franchisers do not use the term "national" or "special" account. They simply go after a substantial or multiple account and then demand that the dealer supply and service the account at the pre-set price. Others declare certain accounts to be national accounts, but also require the dealer to service them at the national account price. Nevertheless, the right to negotiate the price, whether it is designated a national account or not, is the dealer's and attempts to make him sell his products at pre-set prices to certain customers are as illegal as attempts to make him follow any other franchiser pricing policy.<sup>80</sup>

The national account pricing system is especially invidious when it is tied in with a territorial restriction because a distributor does not have the right undercut a national account price in another territory. He has no incentive to undercut the national account price in his own territory, but he would

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<sup>78</sup> White Motor Co. v. United States, 372 U.S. 253 (1963) in Areeda, Antitrust Analysis: Problems, Text, Cases, 2nd (Boston: Little Brown, 1974) p. 752.

<sup>79</sup> Tripoli v. Wella Corp., 425 F. 2d 932 (3rd Cir 1970)

<sup>80</sup> Alexander Hammond, Franchisee Rights: A Self-Defense Manual for Dealers, Distributors, Wholesalers and Other Franchisees, Greenvale, N.Y. :Panel Publishers, 1979) p.150.

have lots of reasons to want to undercut it in someone else's territory as long as it exceeded his marginal cost. Thus, the national account system has a very strong horizontal impact in that, if combined with a territorial restriction, it prevents a dealer in one territory from undercutting the price of a dealer in another.

### Conclusion

In the realm of territorial and customer restraints, several issues remain unresolved. First, in the same way that all of the arguments that are used to justify a rule of reason treatment of vertical non-price restrictions can be applied to resale price maintenance,<sup>81</sup> all of the arguments supporting the per se treatment of resale price maintenance can also be applied to vertical and customer restraints.

Second, there is still considerable disagreement over whether interbrand competition is superior to intrabrand competition, as Justice Powell contended in Sylvania.<sup>82</sup> Third, there is growing disagreement over whether the free-ride problem is all that important. And fourth, there is the question of whether or not the distinctions between price and non price and horizontal and vertical restraints make any economic sense. Fifth, and finally, there is the alternative view of distribution restraints, initially advanced by Chicago School economists, that holds that the law should back away completely from the regulation of all vertical distribution restraints, since they are seen as only promoting efficiency.<sup>83</sup> While this latter issue is part of the larger question addressed by this book, the argument as it applies to territorial and customer restrictions needs to be addressed with here.

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<sup>81</sup> Posner, 48 U. Chi L. Rev. at 9.

<sup>82</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 52. n.19).

<sup>83</sup> Peter A. Carstensen, "Legal and Economic Analysis of Distribution Restraints: A Search for Reality or Myth-making?", in Issues After a Century of Federal Competition Policy, R.L. Wills, J.A. Caswell & J.D. Culbertson, eds., Lexington Books, 1987, pp. 79-101, p. 88.

### Importance of Intra-brand Competition:

A key notion that needs to be critically reexamined is the view that a reduction or elimination of intra-brand competition, in and of itself, and without regard for its effect on interbrand competition, is never sufficient to show that a vertical restraint is anticompetitive. At bottom, this position rests on the view that intra-brand competition—regardless of the circumstances—is never a significant source of consumer welfare. But, of course, this is only true if the seller has no power over price. As the 11th Circuit noted in Itek, if the seller has power over price, intra-brand competition alone will be a significant source of consumer welfare because only intra-brand competition can exert downward pressure on the retail price at which the good is sold.<sup>84</sup>

The fact is that if the seller has market power, there is a gain in lower prices and increased marketing efficiency from intra-brand competition as well as from interbrand competition. It cannot be dismissed as a secondary form of competition. Intra-brand competition is not inferior to interbrand competition. It needs to be assessed in its own right.

Moreover, rather than promoting non-price competition, vertical restraints, in a context of power over price, may even enable a manufacturer to retain the monopoly profits arising from an interbrand competitive advantage.<sup>85</sup>

Nor is it true that a reduction in intra-brand competition is not pernicious as long as interbrand competition acts as a check on the exploitation of intra-brand market power.<sup>86</sup> Within broad limits, the

<sup>84</sup> Graphics Distributors, Inc. v. Itek Corp., 1983-2 Trade Cases, ¶65,670, 69,424, n.20 (11th Cir. 1983).

<sup>85</sup> Gerhart, "The Competitive Advantages" Explanation for Intra-brand Restraints: An Antitrust Analysis, 1981 Duke L. J. 417 Duke L.J. at 426-429 and Graphics Distributors, Inc. v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,424 n. 20 (11th Cir. 1983).

<sup>86</sup> Graphics Distributors, Inc. v. Itek Corp., 1983-2 Trade Cases, ¶ 65,670, 69,424 n. 20 (11th Cir. 1983).

**Comment [10]:** Comment on the difference between retail and mfg competition. Use gasoline example.. In gasoline the competition at retail works its way back up to non-competitive refining level.

ability of consumers to substitute a different brand of the same product is not sufficient to check exploitation in many product categories. In a large number of cases, different brands in a product category are only imperfect substitutes for each other. Even a \$1,000 difference may not make a Chevy S-10 a satisfactory substitute for a Ford "Ranger." In such cases, the consumer has a right to the benefits of intrabrand competition among sellers of the Ranger.

Increasingly, the lower courts have come to accept this proposition that intrabrand competition alone should be a significant concern of antitrust law, notwithstanding the Sylvania Court's observation that interbrand competition is the primary concern of antitrust.<sup>87</sup> In Oreck the 2nd Circuit said:

Unless we are to conclude that an anti-competitive impact on intrabrand competition cannot alone support a finding that §1 of the Sherman Act has been violated...we must conclude that such a violation has been proven here.<sup>88</sup>

The Sixth and Third Circuits, now respectively agree with the Second Circuit on this matter.<sup>89</sup>

**Comment [11]:** Get citation for this statement ...probably in Itek... note 8 in CONCLUDE

#### Exaggeration of Free-Rider Problems:

As was true for resale price maintenance, one of the key arguments justifying territorial restraints is that, given the positive externalities associated with the provision of point-of sale promotion and support by franchised distributors, free-riding by other intrabrand rivals

<sup>87</sup> Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 52 n.19).

<sup>88</sup> Oreck Corp v. Whirlpool Corp. 579 F. 2d 126 (2nd Cir. 1978) cert. denied, 439 U.S. 946 (1978)

<sup>89</sup> Graphic Products Distributors, Inc v. Itek Corp., 1983-2 Trade Cases ¶65,670, 69,425 n.20.

would limit dealer promotion and support to undesirable levels, absent the vertical restraints.<sup>90</sup> Only by shielding the franchised distributor from intrabrand competition can he earn the extra profits necessary to induce him to provide the desired demand enhancing activities.<sup>91</sup>

Obviously, what the franchiser is trying to do by establishing vertical territorial restraints is to give the reseller more pricing power, that is, to raise the reseller's margin in order to induce the reseller to perform more in the way of services.<sup>92</sup>

This free-rider justification which had its origins in Lester Telser's 1960 article,<sup>93</sup> has led those who wish to argue the appropriateness of vertical territorial restraints to seek to identify tangible services provided by resellers. In many cases, the results of this search have been fruitless, and as a consequence have led many to question whether special services can ever explain the incidence and use of vertical restraints.<sup>94</sup>

As a result of this re-thinking, many have now come to realize

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<sup>90</sup> W. John Jordan and Bruce L. Jaffee, "The Use of Exclusive Territories in the Distribution of Beer: Theoretical and Empirical Observations," (Working Paper, Bloomington, IN, 1985)

<sup>91</sup> W. John Jordan and Bruce L. Jaffee, "The Use of Exclusive Territories in the Distribution of Beer: Theoretical and Empirical Observations," (Working Paper, Bloomington, IN, 1985) p. 7.

<sup>92</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 697.

<sup>93</sup> Lester Telser, "Why Should Manufacturers Want Fair Trade?", 3 J. Law & Econ. 86 (1960).

<sup>94</sup> H. Marvel & S. McCafferty, Resale Price Maintenance 4 (October 1982 Ohio State University) (Unpublished Manuscript) cited in F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 694.

that the free-rider theory can only carry very limited weight. While it is valid in some cases, in a large class of cases it just does not fit the real world.<sup>95</sup>

First off, it is important to note that just because there is a protected margin, this does not mean that the reseller will not just pocket the extra margin without undertaking the service. This is an all too familiar outcome for marketing executives who deal with recalcitrant dealers on a day by day basis. Vertical restraints are very blunt instruments of influence.

Second, as noted in the previous chapter, reseller promotion does not always loom large for all kinds of products. Nor are all forms of promotion and service vulnerable to a free ride by intrabrand competitors. For example, for most package goods, point-of-purchase promotion is not very vulnerable to a free ride since its primary purpose is to promote impulse purchases or in-store brand switching. In the Jordan and Jaffee study of beer distribution, they concluded that apart from those activities that could easily be subsidized or otherwise induced or even performed by the brewer, e.g. coop advertising and the provision of outdoor signs, most other activities have little or no significant inter-store spill-over.<sup>96</sup> While it is true that a given Anheuser-Busch wholesaler might not want to provide free cardboard counter cards or build promotional shelf displays or recover stale cases of beer if the beer

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<sup>95</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 694.

<sup>96</sup> W. John Jordan and Bruce L. Jaffee, "The Use of Exclusive Territories in the Distribution of Beer: Theoretical and Empirical Observations," (Working Paper, Bloomington, IN, 1985) p. 12.

in the display is provided by a competing Bud wholesaler, this is insufficient justification for sanctioning the elimination of intrabrand competition at the wholesale level. Since most of these types of promotions do not influence the sales of Bud at competing retail outlets, individual retailers would continue to desire them. And since it is in the brewer's interest to continue to provide all of its retailer with this desired promotional support, the problem of the reluctant wholesaler can easily be overcome by the brewer picking up the tab instead of the wholesaler. In those situations where participation by the local wholesaler is critical, he can be directly compensated for performing the desired marketing services and would not have to indirectly recover his costs of servicing a retail account from a wholesale beer margin inflated by restraints on intrabrand competition. Even the recovery of stale beer could easily be solved by a system of open dating, or charging it back to the brewer. In the case of the outdoor sign, if it were provided to the retailer free or at even at a low subsidized price, this would pose no important free-rider problem for the participating retailer, since the principal promotional effect is site specific.<sup>97</sup>

Perhaps this beer example is an unfair test of the free-rider theory since the market failure rationale for vertical restraints is most believable for complex, expensive, long-lived, infrequently purchased

**Comment [12]:** are there any kinds of marketing activities that cannot be subsidized or performed by manufacturers themselves that previously had been done at the wholesale or retail level

Note difference between wholesale and retail

<sup>97</sup> W. John Jordan and Bruce L. Jaffee, "The Use of Exclusive Territories in the Distribution of Beer: Theoretical and Empirical Observations," (Working Paper, Bloomington, IN, 1985) pp. 12-15.

products.<sup>98</sup> One would expect that free riding is more likely to occur on those items that require some demonstration, explanation, instruction, or advice on the retailer's part. But even here, as was discussed in chapter 3, it is not clear that the free-rider argument applies completely. While it is true that if you buy a complex item, you may want pre-sale demonstration services. But if it is a complex item, you are also probably worried about post purchase service. And if this is the case, you may be inclined to buy from the retailer who provides post-sale service, even if he has a relatively higher margin, in order to increase the probability that if the item goes bad later on, you are going to get quick reliable service. There are probably lots of customers think this way. Rather than getting the pre-sale service and then rushing off to a discount house, they will buy from the higher-price store in order to be sure they are going to get decent service. So even here, it is not clear the freerider problem is all that important.<sup>99</sup>

Free-riding is even less likely to be a problem in the marketing of frequently purchased items or when manufacturers have a strong brand image which is supported by large advertising budgets that pulls the items through the stores rather than requiring a push on the retailer's part.<sup>100</sup> Clearly, it is not a major problem for the typical manufacturer

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<sup>98</sup> Fisher & Sciacca, "An Economic Analysis of Vertical Merger Enforcement Policy," in R.O. Zerbe, Jr. ed. Research in Law and Economics, Vol 6, 1984, Antitrust Regulation: Greenwich CN:JAI Press.

<sup>99</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 705.

<sup>100</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 705.

who distributes through mass merchandise outlets to the mass market. Free-riding is largely the concern of those marketers who still choose to push their products through the channel to the market. A push strategy may once have been more common than it is today. Now, it is more and more a rarity. And when it exists, the needed push can be easily achieved by selectivity in distribution. It is a mistake to make the law of vertical restraints turn on this phantom issue. Telser, with his free-rider theory, has been the Pied Piper of per se legality. He would have us needlessly give up the positive gains from intrabrand competition.

#### The Misallocation of Resources:

As in the case of resale price maintenance, those who argue that territorial restraints are exclusively pro-efficiency overlook a major problem that was developed in chapter 3. The problem is that the inflated margins induced by territorial restraints may cause the channel of distribution to offer the market more service and information that consumers would be willing to pay for if the product/service package were to be unbundled, and if each component could be purchased separately. If this is true, then the territorial restraints violate consumer sovereignty and are certainly not welfare enhancing.

When public policy relies exclusively on interbrand competition to allocate resources to marketing activities in the channel, situations can arise in which efficiency itself may no longer be enhanced.<sup>101</sup> If one

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<sup>101</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 702.

looks at a single manufacturer imposing vertical restraints upon its distributors in a way that maximizes the distributor's profits, then one can infer from the fact that output has increased and that efficiency is likely to have increased. This is the argument of the "Chicago School."

But on the other hand, when you get a race among numerous rivalrous manufacturers to raise margins and increase the level of non-price competition, then the efficiency results are ambiguous. It may well be that efficiency has increased and that the gain to consumers outweighs the additional cost. But it can go the other way too: the cost of the constraints can exceed the gain to consumers.<sup>102</sup>

Thus, on strictly a priori grounds, it is not possible to determine whether or not the resulting quantity demanded will be increased by these competitive service expenditures. It depends upon the elasticity of demand with respect to service on the one hand, versus the elasticity of demand with respect to price on the other. You cannot tell in a rivalrous situation whether efficiency has been increased or not.<sup>103</sup> Consequently, one must look closely at each situation to determine if the trade-off of intrabrand for interbrand competition is welfare enhancing. It is not automatic as the proponents of per se legality would have us believe. It is quite possible that service spending could not only be excessive from the consumer's perspective, but it could be excessive from the seller's perspective as well.

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<sup>102</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 703.

<sup>103</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 702.

In his paper on vertical restraints which is the basis for the above discussion, Professor Scherer refers a study of airline competition by Miller and Douglas<sup>104</sup> to show how "service competition" can lead to excesses.

...under the cartelized and regulated system of airline ratesetting, prices had been raised too high, especially on the longer-distance routes. These high prices in turn stimulated service competition. That is what we are talking about today. The data were quite imperfect, but Miller and Douglas concluded that with those high prices, so much service competition had been stimulated that the result was inefficient. There was more service competition than could benefit consumers, given plausible values of the time saved...<sup>105</sup>

Scherer goes on to make the point that although vertical territorial restrictions are not regulation of the federal type, they can lead to the same kind of result. That is to say, they can lead to too much raising of prices, just as there was too much elevation of airline rates on the longer-distance flights. Consequently, such a clumsy instrument can produce an equally inefficient result. The extra margins can be dissipated by the provision of costly additional services.<sup>106</sup>

#### Horizontal vs. Vertical Restraints:

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<sup>104</sup> Geo. Douglas and James C. Miller III, Quality Competition, Industry Equilibrium, and Efficiency in the price-Constrained Airline Market, 64 American Economic Review, 657 (Sept 1974).

<sup>105</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 703-704.

<sup>106</sup> F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Review 52 (1983): 687-718, 697.

While the law has relaxed its per se rule with respect to vertical non-price restraints, this has not been the case for horizontal restraints, or vertical restraints with horizontal implications.

To a degree this is troublesome since there is growing concern over whether or not there should even be a distinction between vertical and horizontal non-price arrangements, especially when one looks at the demonstrated economic effect? Chief Justice Burger's dissent in the Topco case distills the issue quite well.

It is far from clear to me why such a [per se] rule should cover those division of market agreements which involve no price-fixing and which are concerned only with trademarked products that are not in a monopoly or near monopoly position with respect to competing brands.<sup>107</sup>

The problem was that in every respect, the purpose and effect of the territorial restraints imposed by Topco Associates (an association of 25 small and medium-sized independent regional supermarket chains which had banded together to compete more effectively against the private brands of the large national chains) seemed to be pro-competitive. And yet, by characterizing these mutually agreed upon restraints among members as horizontal, they were automatically held to be per se illegal.<sup>108</sup>

Topco had argued convincingly that it needed this exclusivity to compete with the larger chains, and that the association could not exist if the territorial divisions were anything but exclusive. The trial court had agreed with Topco's argument and ruled:

<sup>107</sup> Burger dissent in United States v. Topco Associates, Inc. (Slip Opinion, March 29, 1972) p. 11.

<sup>108</sup> United States v. Topco Associates, Inc. (Slip Opinion, March 29, 1972)p. 1, 405 US 596 (1972).

...whatever anti-competitive effect these practices may have on competition in the sale of Topco private label brands is far outweighed by the increased ability of Topco members to compete both with the national chains and other supermarkets operating in their respective territories.<sup>109</sup>

In reversing the trial court, the Supreme Court grounded its per se characterization on its "inability to weigh, in any meaningful sense, destruction of competition in one sector of the economy against promotion of competition in another."<sup>110</sup> This rationale seems inadequate, since this "weighing" is precisely what rule of reason analysis with respect to vertical non-price restraints is all about. The courts now "weigh" the anti-competitive against the pro-competitive consequences of a vertical restraint all the time. There is no obvious reason why the same "weighing" cannot be applied to horizontal non-price restraints. As the facts of Topco show, horizontal non-price restraints are not always, and in every case, "naked restraints of trade with no purpose except stifling competition."<sup>111</sup>

Chief Justice Burger was right. Not only did the Court not tell us what "pernicious effect on competition" the outlawed practices are perceived to have, but it did not even attempt to show that those practices "lack...any redeeming virtue."<sup>112</sup>

Moreover the trap that the per se treatment led the Court into was clear. The automatic invalidation of the exclusive horizontal agreements did not increase competition, while there was a chance, under a rule of reason analysis, that the arrangements would have passed muster, and that competition might have been increased.

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<sup>109</sup> United States v. Topco Associates, Inc., 319 F. Supp 1031,1043 (1970)

<sup>110</sup> Unites States v. Topco Associates, Inc. (Slip Opinion, March 29, 1972) p. 12.

<sup>111</sup> Unites States v. Topco Associates, Inc. (Slip Opinion, March 29, 1972) p.11.

<sup>112</sup> Unites States v. Topco Associates, Inc. (Slip Opinion, March 29, 1972) p. 10.

In all likelihood, the number of situations involving horizontal territorial restraints that are not also part of an illegal price-fixing scheme is small. This is their usual purpose. Nevertheless, it seems unwise to rule out the possibility that at least some horizontal territorial restraints should be allowed after a careful rule of reason analysis. In any event, it should at least be possible to make this argument. Arbitrary per se treatment seems unfounded.

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End Notes

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\* See Chapter 3, where they are treated as such.