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THE "COMPETITIVE ADVANTAGES" EXPLANATION FOR INTRABRAND RESTRAINTS: AN ANTITRUST ANALYSIS

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Four years ago, the Supreme Court fundamentally altered antitrust jurisprudence when it decided, in *Continental T.V., Inc. v. GTE Sylvania, Inc.*,[1] that nonprice vertical restrictions[2] should be judged

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1. 433 U.S. 36 (1977). The *Sylvania* opinion is the leading case among those of the Burger Court that signal a pragmatic, economics-oriented antitrust policy. *See also* Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1 (1979); United States Steel Corp. v. Fortner Enterprises, Inc., 429 U.S. 610 (1977); United States v. General Dynamics Corp., 415 U.S. 486 (1974).

2. A vertical restriction is one imposed from one level of trade to another, typically by a manufacturer on his retail dealers. A nonprice vertical restriction imposes some restraint on dealers other than on their ability to set retail prices. Nonprice restrictions include requirements that dealers sell only in certain territories ("territorial restrictions"), or to certain customers ("customer restrictions"), or for only certain uses ("use restrictions"), or from specified locations ("location restrictions"). *Sylvania* was a case of location restrictions imposed by a manufacturer on his dealers, restrictions held to be lawful except when shown to have an anticompetitive effect. 433 U.S. at 59. A manufacturer might also assign a dealer an "area of primary responsibility," outside of which the dealer could sell only when the sales within the primary area were adequate. Profit pass-over contracts are similar, but require a dealer selling outside his assigned area to pay some portion of his profits to the dealer in whose area he has sold. Restrictions can also be imposed on a manufacturer by contract with his dealers. *See generally* ABA ANTITRUST SECTION, MONOGRAPH NO. 2: VERTICAL RESTRICTIONS LIMITING INTRABRAND COMPETITION 3-5 (1977). Because all such restraints affect competition between sellers of the same brand of product, they are termed "intrabrand restraints" or "intraband restrictions." Intrabrand restraints may also be imposed "horizontally"—for example, when competing dealers agree to fix the price of a particular product, or when competitors form a joint venture to establish and sell a brand with restrictions on the number of sellers in a given territory. See note 15 *infra*.

The characterization of a restraint as vertical or horizontal is less important than an understanding of whether the restraint affects only competition between sellers of a single brand—intrabrand competition—or also affects competition in the sale of different brands—interbrand competition. The discussion in this article is therefore applicable not only to vertical restraints but under the rule of reason rather than under the per se rule.[3]

The *Sylvania* opinion is noteworthy for its candor; the decision to overrule *United States v. Arnold, Schwinn & Co.*[4] explicitly, rather than distinguish it artificially,[5] was a refreshing change in an antitrust analysis that has too long supported spurious distinctions.[6] Overruling

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also to cases in which dealers agree among themselves to restrict competition in the sale of a single brand, cases that are typically treated as horizontal restraints. For a typical case of this type, see United States v. Topco Assocs., 405 U.S. 596 (1972).

3. The classic definition of the "rule of reason" analysis of antitrust case law was given by Justice Brandeis in Board of Trade v. United States, 246 U.S. 231 (1918):

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

Id. at 238.

In contrast, the per se rule requires no consideration of effect; it applies instead to "agreements whose nature and necessary effect are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality—they are 'illegal *per se*.'" National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 692 (1978).

4. 388 U.S. 365 (1967), *overruled in part*, Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

5. The Court rejected an argument made both in Justice White's concurrence, 433 U.S. at 59, and in the Court of Appeals for the Ninth Circuit's en banc opinion in *Sylvania*, 537 F.2d 980, 989-90 (9th Cir. 1976), *aff'd on other grounds*, 433 U.S. 36 (1977), that *Schwinn* was distinguishable. Justice White contended that location clauses present "less potential for restraint of intrabrand competition and more potential for stimulating interbrand competition," 433 U.S. at 59 (White, J., concurring), than do the territorial and customer restrictions held per se unlawful in *Schwinn*. Because the dealer-services rationale, see text accompanying notes 40-45 *infra*, supports location clauses and territorial and customer restrictions, determining their net effect centers on common analysis, and the majority in *Sylvania* was therefore correct in tearing down the *Schwinn* per se barrier so that each type of restraint can be analyzed in terms of its net effect in the context in which it is employed. This leaves open the possibility that the rule of reason, as applied, will treat various forms of restrictions differently. *See* Pitofsky, *The* Sylvania *Case: Antitrust Analysis of Non-Price Vertical Restrictions*, 78 COLUM. L. REV. 1 (1978) (suggesting per se rules, or rules of presumptive illegality, for some forms of intrabrand restrictions). Indeed, in *Sylvania* the Court did "not foreclose the possibility that particular applications of vertical restrictions might justify *per se* prohibition." 433 U.S. at 58.

6. The *Schwinn* opinion itself created an artificial and widely condemned distinction between vertical restrictions imposed in a sales transaction (illegal per se), 388 U.S. at 376, and vertical restrictions imposed in a consignment arrangement (analyzed under the rule of reason), *id.* at 380. *See, e.g.*, Baker, *Vertical Restraints in Times of Change: From* White *to* Schwinn *to Where?*, 44 ANTITRUST L.J. 537, 537-38 (1975); Handler, *The Twentieth Annual Antitrust Review—1967*, 53 VA. L. REV. 1667, 1682-84 (1967); Pollock, *Alternative Distribution Methods After* Schwinn, 63 NW. U. L. REV. 595, 599-600 (1968). The *Sylvania* Court noted the artificiality of this distinction to support its decision to overrule rather than distinguish *Schwinn*. 433 U.S. at 56-57. Moreover, the inconsistency between the *Schwinn* per se rule for vertical territorial and customer restrictions and the rule of reason applied to other intrabrand restrictions put pressure on courts to

Schwinn's per se rule against vertical restraints on territories and customers properly shed a mischievous precedent.[7] More fundamentally, in *Sylvania* the Court seemed to embrace, for the first time, two postulates long advanced by critics of antitrust policy: that the goal of antitrust policy should be to promote consumer welfare,[8] and that because market efficiencies advance consumer welfare, antitrust policy should foster business practices that increase market efficiency.[9] At the same time, the Court made it clear that the substantial advantages of the per se rule[10]—certainty, ease of application, and deterrence—would not be purchased at the price of arbitrary or inadvisable results.[11]

Despite the significant advances that *Sylvania* initiated in antitrust doctrine generally, the doctrine surrounding intrabrand restrictions[12] remains unsatisfactory.[13] Although the *Sylvania* Court adopted a rule-

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expand the per se rule and, by exposing the potential breadth of the *Schwinn* doctrine, undermined support for it. *See, e.g.*, GTE Sylvania, Inc. v. Continental T.V., Inc., 537 F.2d 980, 997-1000 (9th Cir. 1976), *aff'd on other grounds*, 433 U.S. 36 (1977).

7. As the Supreme Court noted in *Sylvania*, "*Schwinn* has been the subject of continuing controversy and confusion, both in the scholarly journals and in the federal courts. The great weight of scholarly opinion has been critical of the decision, and a number of the federal courts confronted with analogous vertical restrictions have sought to limit its reach." 433 U.S. 47-48 (footnotes omitted). *See id.* at 48 nn. 13 & 14.

8. Although the Court was not explicit on this point, the following footnote appears to assume that position: "Competitive economies have social and political as well as economic advantages . . . but an antitrust policy divorced from market considerations would lack any objective benchmarks." 433 U.S. at 53 n.21. The Court seemed to reject the view that, without regard to competitive effects, "the Sherman Act was intended to prohibit restrictions on the autonomy of independent businessmen." *Id.* The Court endorsed the economic orientation of antitrust analysis again in Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1 (1979), and National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 690-91 n.16 (1978). For the view that *Sylvania* should not be read to preclude an antitrust doctrine based on non-economic goals, see Bohling, *A Simplified Rule of Reason for Vertical Restraints: Integrating Social Goals, Economic Analysis, and* Sylvania, 64 IOWA L. REV. 461 (1979).

9. *See* 433 U.S. at 54-56.

10. On the virtues of per se rules in the context of vertical restraints, see Louis, *Vertical Distribution Restraints after* Sylvania: *A Postscript and Comment*, 76 MICH. L. REV. 265 (1977); Louis, *Vertical Distributional Restraints Under* Schwinn *and* Sylvania: *An Argument for the Continuing Use of a Partial Per Se Approach*, 75 MICH. L. REV. 275, 277-79 (1976); Pitofsky, *supra* note 5, at 12-14, 33-34.

11. "*Per se* rules of illegality are appropriate only when they relate to conduct that is manifestly anticompetitive." 433 U.S. at 49-50. "[D]eparture from the rule-of-reason standard must be based upon demonstrable economic effect rather than—as in *Schwinn*—upon formalistic line drawing." *Id.* at 58-59. The advantages of per se rules "are not sufficient in themselves to justify the creation of *per se* rules. If it were otherwise, all of antitrust law would be reduced to *per se* rules, thus introducing an unintended and undesirable rigidity in the law." *Id.* at 50 n.16. The Supreme Court further delineated the scope and role of per se rules in Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643 (1980) (per curiam); Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1 (1979); National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679 (1978).

12. See a discussion of the doctrine at note 2 *supra*.

13. The antitrust analysis of intrabrand restrictions has had a disorderly development. Contractual restrictions on resale prices were held unlawful in 1911, Dr. Miles Medical Co. v. John D.

of-reason analysis for nonprice vertical restraints, it reaffirmed, without adequate explanation, both the per se rule prohibiting resale price maintenance[14] and the per se rule prohibiting potential competitors who create a new brand through lawful integration[15] from restricting competition in the sale of that brand.[16] Moreover, the rule-of-reason standard the Court established to deal with nonprice vertical restraints is unworkable: to say, as the Court did, that "the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition"[17] offers no guidance unless the relevant circumstances and the weight to be given them are identified. They were not.[18] Although rec-

Park & Sons Co., 220 U.S. 373 (1911), but Congress granted an exemption to state-sanctioned fair trade programs in 1937 (the Miller-Tydings Act, ch. 690, tit. VIII, 50 Stat. 693 (1937) (codified at 15 U.S.C. § 1 (1952))) and 1952 (the McGuire Act, Pub. L. No. 542, 66 Stat. 631 (1952) (codified at 15 U.S.C. § 45 (1952))), only to withdraw the exemption and restore full per se treatment in 1976 (Consumer Goods Pricing Act of 1975, Pub. L. No. 94-145, 89 Stat. 801 (1975) (codified at 15 U.S.C. §§ 1, 45(a) (1976))). California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97 (1980). Restrictions on territories and customers, however, were not dealt with by the Supreme Court (or, with any frequency, by lower courts) until 1964 when, in White Motors v. United States, 372 U.S. 253, 263 (1963), the Supreme Court stated that it did not know enough about such restrictions to articulate a governing rule of law before trial. Yet only four years later, without intervening Supreme Court precedent and with little development in the lower courts, the Court, in United States v. Arnold, Schwinn & Co., 388 U.S. 365, 379 (1967), declared that vertical restrictions on customers and territories in sales transactions are per se unlawful, a rule that was extended to intrabrand restrictions imposed by horizontal agreement in United States v. Topco Assocs., 405 U.S. 596, 608 (1972). Other intrabrand restrictions have been dealt with under a rule of reason and are upheld unless proven to be unlawfully restrictive. *See generally* ABA ANTITRUST SECTION, *supra* note 2, at 20-25.

14. 433 U.S. at 51 n.18.

15. Integration generally comes in one of two forms, exemplified by two major cases. United States v. Topco Assocs., 405 U.S. 596 (1972), involved a group of relatively small grocery store chains in various parts of the country that formed a joint buying agency to achieve the cost economies and promotional benefits of having their own private brand. The territorial restrictions they placed on their resale of the brand were deemed to be horizontal restraints and were therefore per se unlawful. In United States v. Sealy, Inc., 388 U.S. 350 (1967), a group of mattress manufacturers in different regions of the country were licensed to produce and sell mattresses under a national brand name, with attendant standards and quality control. Their agreements to maintain resale prices and divide territories were also held unlawful per se.

16. 433 U.S. at 58 n.28. These inconsistencies are discussed in Bork, *Vertical Restraints:* Schwinn *Overruled*, 1977 SUP. CT. REV. 171, 189-92, and Posner, *The Rule of Reason and the Economic Approach: Reflections on the* Sylvania *Decision*, 45 U. CHI. L. REV. 1, 6-9 (1977). The author's view on the difference between price and nonprice restraints is outlined in the text accompanying notes 61-93 *infra*.

17. 433 U.S. at 49.

18. The Court's citation, *id.* at 49 & n.15, to the famous but amorphous quotation from Board of Trade v. United States, 246 U.S. 231, 238 (1918) ("The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied . . .") provides little elaboration of the rule-of-reason standard. The difficulty of formulating

ognizing that nonprice intrabrand restrictions might promote distributional efficiency, and hence presumably further competition, the Court completed only half of the rule-of-reason analysis because it was unable to say in what ways intrabrand restrictions are anticompetitive.[19] *Sylvania* simply turned the clock back to 1963, when the Court originally rejected a per se rule against vertical restraints.[20] As was true then, the Court still does "not know enough of the economic and business stuff out of which these arrangements emerge"[21] to fashion a workable doctrine.

This article argues that antitrust doctrine concerning intrabrand restrictions is unsatisfactory because the economic theory of intrabrand restrictions has been only partially developed and articulated. An unfilled and largely unacknowledged analytical gap exists between the view that intrabrand restraints are generally anticompetitive[22] and the view that intrabrand restraints are generally efficiency-producing.[23]

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meaningful jury instructions under this standard is apparent in First Beverages, Inc. v. Royal Crown Cola Co., 612 F.2d 1164, 1170-71 (9th Cir.), *cert. denied*, 447 U.S. 924 (1980).

19. After noting that "[t]he market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition," 433 U.S. at 51-52, the Court summarized "[the] substantial scholarly and judicial authority supporting [the] economic utility" of vertical restrictions, noting, also, the "relatively little authority to the contrary." *Id.* at 57-58. The Court acknowledged the view of some theorists that manufacturer-imposed intrabrand restrictions are always pro-competitive but, without explanation or citation, dismissed that view as one "not universally shared." *Id.* at 56. Rather than discussing the anticompetitive implications of nonprice intrabrand restrictions, however, the Court moved on to justify its decision to overrule *Schwinn* on the ground that the *Schwinn* distinction between sale and consignment transactions was untenable.

20. White Motor Co. v. United States, 372 U.S. 253 (1963).

21. *Id.* at 263.

22. *See, e.g.*, Bohling, *supra* note 8, at 505-07; Carstensen, *Vertical Restraints and the* Schwinn *Doctrine: Rules for the Creation and Dissipation of Economic Power*, 26 CASE W. RES. L. REV. 771 (1976); Pitofsky, *supra* note 5, at 28-31; Strasser, *Vertical Territorial Restraints After* Sylvania: *A Policy Analysis and Proposed New Rule*, 1977 DUKE L.J. 775, 801-02. Several commentators have advanced the view that intrabrand restraints are anticompetitive because they induce dealers to engage in promotional product differentiation that insulates the manufacturer from price competition. *See, e.g.*, Comanor, *Vertical Territorial and Customer Restrictions:* White Motor *and Its Aftermath*, 81 HARV. L. REV. 1419, 1422-25 (1968); Louis, *Vertical Distributional Restraints Under* Schwinn *and* Sylvania, *supra* note 10, at 281. That view, however, is "flawed by its necessary assumption that a large part of the promotional efforts resulting from vertical restrictions will not convey socially desirable information about product availability, price, quality, and services." 433 U.S. at 56 n.25.

23. *See, e.g.*, R. BORK, THE ANTITRUST PARADOX, 288-98 (1978); R. POSNER, ANTITRUST LAW 147-67 (1976); Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 75 YALE L.J. 373, 403 (1966); Goldberg, *The Law and Economics of Vertical Restrictions: A Relational Perspective*, 58 TEX. L. REV. 91, 92, 129 (1979); Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L. REV. 282, 293-94 (1975); Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards*, 30 LAW & CONTEMP. PROB. 506, 511-12 (1965); Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960); William-

That gap is the failure to explore how a manufacturer benefits from intrabrand restraints other than by increasing the profitability of his dealers. This article attempts to fill that gap by drawing on the theory of imperfect competition[24] to explain why manufacturers find it profitable to restrict intrabrand competition in an anticompetitive way. Using this analysis, the article explains why price restraints should indeed be treated differently from nonprice restraints[25] and formulates an analytical approach under the rule of reason for addressing nonprice vertical restraints.[26] Non-economic analyses are possible,[27] but are not treated here. The approach of this article rests on economic theory.

I. INTRABRAND RESTRAINTS

A. *Traditional Explanations.*

For years, economists have attempted to explain why a manufacturer would restrict competition between his dealers[28] and thus give up the additional sales that such competition would presumably bring.[29]

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son, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PA. L. REV. 953 (1979).

24. The theory of imperfect competition posits that actual or perceived differences between goods may give particular brands market power by insulating them somewhat from competition. *See generally* E. CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION (8th ed. 1962); J. ROBINSON, THE ECONOMICS OF IMPERFECT COMPETITION (2d ed. 1969).

The central thesis of the article—that reduced intrabrand competition decreases consumer welfare by denying important choices to consumers without providing better services—has been mentioned, but not fully developed, by others. *See* L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 379 (1977); Strasser, *supra* note 22, at 794. *See also* P. AREEDA, ANTITRUST ANALYSIS 504 (2d ed. 1974) ("resale price maintenance eliminates dealer price competition that might possibly generate dealer resistance to existing wholesale prices"); Gould & Yamey, *Professor Bork on Vertical Price Fixing: A Rejoinder*, 77 YALE L.J. 936, 941 (1968); Gould & Yamey, *Professor Bork on Vertical Price Fixing*, 76 YALE L.J. 722, 725-26 (1967).

25. This article addresses only agreements fixing minimum prices. For a good argument that *Sylvania* can and should be read to overrule the per se rule against maximum price-fixing, see Halligan, GTE Sylvania: *The Case for Overruling* Albrecht v. Herald Co., 39 OHIO ST. L.J. 496 (1978).

26. *See also* Bohling, *supra* note 8; Denger, *Vertical Restrictions: The Impact of* Sylvania, 46 ANTITRUST L.J. 908 (1978); Stewart & Roberts, *Viability of the Antitrust Per Se Illegality Rule:* Schwinn *Down, How Many To Go?*, 58 WASH. U. L.Q. 727 (1980); Strasser, *supra* note 22; Zelek, Stern, & Dunfee, *A Rule of Reason Decision Model After* Sylvania, 68 CALIF. L. REV. 13 (1980).

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28. For simplicity, the discussion in the text is presented in the context of direct distribution—the sale by a manufacturer directly to retail dealers for resale to consumers. Distribution through wholesalers, distributors, or jobbers to retail dealers for resale to consumers has special ramifications, see text accompanying notes 89-93 *infra*, but does not change the basic analysis. "Dealers" in the text means dealers in one or more, but not all, brands of a given product. Thus, a consumer electronics dealer might sell several brands (such as Sony, Zenith, Pioneer) of one product (such as stereo amplifiers).

29. *See, e.g.*, P. AREEDA, *supra* note 24, at 500-01; Telser, *supra* note 23, at 86-87.

One explanation—the "manufacturer's cartel" theory—states that competing manufacturers may find that intrabrand restrictions facilitate collusive or interdependent pricing at the manufacturing level by removing the uncertainty caused by shifting dealer prices, thus allowing larger manufacturer profits.[30] Intrabrand restraints imposed under the manufacturer's cartel theory do not produce efficiencies, and are undoubtedly unlawful.[31] These restraints are, however, apparently uncommon and are of little concern as long as they can be distinguished from intrabrand restrictions with other purposes and effects.[32]

In the absence of a manufacturer's cartel, intrabrand restrictions are generally considered a means of increasing the dealer's margin (the difference between the price a dealer pays for the goods and the price at which he sells them);[33] most commentators have therefore focused their analysis of such restrictions by asking why a manufacturer would allow larger dealer margins than would occur with unrestrained dealer competition.[34] Two theories have been advanced.[35] The "dealer cartel"

30. For slightly differing perspectives on the manufacturer's-cartel rationale, compare R. BORK, THE ANTITRUST PARADOX, *supra* note 23, at 293-95, and Bork, *The Rule of Reason*, *supra* note 23, at 411-15 with Posner, *Antitrust Policy and the Supreme Court*, *supra* note 23, at 294, and Williamson, *supra* note 23, at 967.

31. *Cf.* United States v. Masonite Corp., 316 U.S. 265, 277-79 (1942) (the use of patent and marketing restrictions by a cartel are unlawful); United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) (per se rule applied to horizontal agreement to remove excess supply from the market). Similarly, the fair trade exemption was applicable only to commodities in "free and open competition with commodities of the same general class . . . ." 15 U.S.C. § 45(a)(2) (1970) (repealed 1975).

32. The Supreme Court, however, appears to base the per se rule against resale price maintenance in part on the manufacturer's-cartel theory. See text accompanying notes 62-65 *infra*.

33. *See, e.g.*, M. PORTER, INTERBRAND CHOICE, STRATEGY, AND BILATERAL MARKET POWER 63 (1976) (resale price maintenance must profit either the dealers or the manufacturer; the former is said to be the usual presumption); RESALE PRICE MAINTENANCE 3 (B. Yamey ed. 1966).

34. Several reasons for intrabrand restrictions are unrelated to either a manufacturer's cartel or to increasing the dealer's margin, but they do not appear to have significant policy implications. A manufacturer may want to improve the image or prestige of his product by maintaining high resale prices as a connotation of quality. L. SULLIVAN, *supra* note 24, at 384. Whether this is in fact a motivation for imposing resale price maintenance, and why a manufacturer could not achieve the same effect directly by charging high prices to dealers, are unclear. In any event, society has no economic interest in protecting resale price maintenance or other intrabrand restrictions that are so motivated.

Intrabrand restrictions have also been viewed as decreasing the risk dealers face and thus decreasing capital costs, but this is generally not considered any greater justification for intrabrand restrictions than it would be for interbrand restrictions. *See* Comanor, *supra* note 22 at 1428-29. Professor Louis, however, argues that vertical restraints might be justified on this ground for new entrants and failing firms because of the long-run benefit of their presence in the market as an interbrand competitor. Louis, *Vertical Distributional Restraints Under* Schwinn *and* Sylvania, *supra* note 10, at 297.

Finally, by separating customers with different demand elasticities, some forms of intrabrand restrictions—particularly territorial and customer restrictions—may facilitate discrimination between customers. This appears to be a possibility without policy implications in any direction.

That gap is the failure to explore how a manufacturer benefits from intrabrand restraints other than by increasing the profitability of his dealers. This article attempts to fill that gap by drawing on the theory of imperfect competition[24] to explain why manufacturers find it profitable to restrict intrabrand competition in an anticompetitive way. Using this analysis, the article explains why price restraints should indeed be treated differently from nonprice restraints[25] and formulates an analytical approach under the rule of reason for addressing nonprice vertical restraints.[26] Non-economic analyses are possible,[27] but are not treated here. The approach of this article rests on economic theory.

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31. *Cf.* United States v. Masonite Corp., 316 U.S. 265, 277-79 (1942) (the use of patent and marketing restrictions by a cartel are unlawful); United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) (per se rule applied to horizontal agreement to remove excess supply from the market). Similarly, the fair trade exemption was applicable only to commodities in "free and open competition with commodities of the same general class . . . ." 15 U.S.C. § 45(a)(2) (1970) (repealed 1975).

32. The Supreme Court, however, appears to base the per se rule against resale price maintenance in part on the manufacturer's-cartel theory. See text accompanying notes 62-65 *infra*.

33. *See, e.g.*, M. PORTER, INTERBRAND CHOICE, STRATEGY, AND BILATERAL MARKET POWER 63 (1976) (resale price maintenance must profit either the dealers or the manufacturer; the former is said to be the usual presumption); RESALE PRICE MAINTENANCE 3 (B. Yamey ed. 1966).

34. Several reasons for intrabrand restrictions are unrelated to either a manufacturer's cartel or to increasing the dealer's margin, but they do not appear to have significant policy implications. A manufacturer may want to improve the image or prestige of his product by maintaining high resale prices as a connotation of quality. L. SULLIVAN, *supra* note 24, at 384. Whether this is in fact a motivation for imposing resale price maintenance, and why a manufacturer could not achieve the same effect directly by charging high prices to dealers, are unclear. In any event, society has no economic interest in protecting resale price maintenance or other intrabrand restrictions that are so motivated.

Intrabrand restrictions have also been viewed as decreasing the risk dealers face and thus decreasing capital costs, but this is generally not considered any greater justification for intrabrand restrictions than it would be for interbrand restrictions. *See* Comanor, *supra* note 22 at 1428-29. Professor Louis, however, argues that vertical restraints might be justified on this ground for new entrants and failing firms because of the long-run benefit of their presence in the market as an interbrand competitor. Louis, *Vertical Distributional Restraints Under* Schwinn *and* Sylvania, *supra* note 10, at 297.

Finally, by separating customers with different demand elasticities, some forms of intrabrand restrictions—particularly territorial and customer restrictions—may facilitate discrimination between customers. This appears to be a possibility without policy implications in any direction.

theory holds that a manufacturer may be forced to impose distribution restrictions by a dealer cartel.[36] If dealers refuse to distribute a manufacturer's goods unless he guarantees them freedom from intrabrand competition, the manufacturer may relinquish some of his profit to the dealers as the price for getting his product distributed. In such cases, the manufacturer is merely the "cat's paw" of the dealer cartel.[37] Difficulties of identification and proof complicate any analysis of the dealer-cartel problem,[38] but once identified, such cartels are readily held to be unlawful.[39]

The "dealer services" explanation for intrabrand restrictions holds that a manufacturer restricts intrabrand competition to induce his dealers to undertake greater nonprice competition by using, for example, advertising, showrooms, product demonstrations, and warranty and repair services.[40] Under this view, such activities increase consumer wel-

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See, e.g., R. BORK, THE ANTITRUST PARADOX, *supra* note 23, at 295, 394-401; Bowman, *Resale Price Maintenance*, 22 U. CHI. L. REV. 825, 839-40 (1955). *But see* Pitofsky, *supra* note 5, at 31-32 (suggesting that a manufacturer's prohibition of sales by dealers to the manufacturer's customers, which may facilitate discrimination, is per se unlawful).

35. The two categories come from R. POSNER, *supra* note 23, at 148. Other possibilities cannot be discounted. Intrabrand restrictions may be used to compensate dealers for agreeing not to sell competing brands, in which event the legality of the intrabrand restraint may turn on the legality of the resulting exclusive dealing arrangement. M. PORTER, *supra* note 33, at 59. Professor Caves, in an analysis that in some respects parallels the analysis in this article, argues that intrabrand restrictions may reflect the market power of dealers and arise from joint profit-maximizing through bargaining. Caves, *Vertical Restraints as Integration by Contract: Evidence and Policy Implications*, forthcoming in The Journal of Industrial Economics (on file with the author).

36. R. BORK, THE ANTITRUST PARADOX, *supra* note 23, at 292; R. POSNER, *supra* note 23, at 148; Pitofsky, *supra* note 5, at 28-30.

37. R. POSNER, *supra* note 23, at 148.

38. As Professor Posner has argued, because dealers are in a good position to evaluate consumer demand, they have a legitimate need to communicate with the manufacturer concerning the free-rider problem and dealer delivery of services. R. POSNER, *supra* note 23, at 165. If a manufacturer imposes intrabrand restraints in response to such communication the situation may look like a dealer cartel even though the manufacturer is acting only to increase dealer services, see text accompanying notes 41-42 *infra*, not dealer profits. *See, e.g.*, Borger v. Yamaha Int'l Corp., 625 F.2d 390 (2d Cir. 1980) (discussions between manufacturer and dealer prior to restraints are not themselves proof of unlawful dealers' agreements). On the other hand, true dealer cartels—those that attempt to increase dealer profits without increasing dealer services—may be imperceptible. *See* Pitofsky, *supra* note 5, at 31. The approach advocated in this article would avoid these problems by sustaining any intrabrand restriction designed to increase dealer services and invalidating any restrictions designed to increase either manufacturer or dealer profits without inducing services.

39. *See, e.g.*, United States v. General Motors Corp., 384 U.S. 127 (1966); Eastern States Retail Lumber Dealers' Ass'n v. United States, 234 U.S. 600 (1917). *Cf.* United States v. Topco Assocs., Inc., 405 U.S. 596 (1972) (horizontal division of intrabrand markets is per se unlawful); United States v. Sealy, 388 U.S. 350, 357 (1967) (territorial restraints imposed by a dealer cartel were held unlawful, but because of their role as part of a series of price restraints).

40. The dealer-services rationale covers many types of efficiencies associated with intrabrand restrictions. The inapplicability of the theory to resale price maintenance is discussed in the text

fare and interbrand competition.[41] Furthermore, the dealer-services theory states that intrabrand restrictions are necessary to achieve those purposes: no dealer would increase advertising and other customer services if he thought that other dealers could cut prices and make sales—take a "free ride"—on the basis of *his* promotional expenditures.[42]

The dealer-services theory offers one reason why, even in the absence of a dealer cartel, a manufacturer would impose intrabrand restrictions, and why restrictions imposed for that reason enhance competition.[43] Writers of the so-called "Chicago school"[44] have argued that absent a dealer cartel both price and nonprice intrabrand restrictions must increase dealer services and promote competition, because a manufacturer would never impose the restrictions unless they induced demand-promoting, consumer-satisfying activities by his dealers. These writers acknowledge the possibility of a dealer or a manufacturer cartel, but assume that such cartels are infrequent and that they can be separately identified and dealt with, or ignored.[45] The Court, however, has never fully endorsed the position taken by the Chicago school. Although the Supreme Court adopted the dealer-services theory in *Sylvania* to justify applying the rule-of-reason standard to nonprice

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accompanying notes 72-86 *infra*; its applicability to nonprice restraints is discussed in the text accompanying notes 118-29 *infra*. For informative descriptions of the theory, see Goldberg, *supra* note 23, at 106-11; Williamson, *supra* note 23, at 975-80. One writer argues, however, that no policy implications should be drawn from the dealer-services rationale. *See* L. SULLIVAN, *supra* note 24, at 412-16.

41. *See, e.g.*, R. BORK, THE ANTITRUST PARADOX, *supra* note 23, at 290-91 (1978); R. POSNER, *supra* note 23, at 148-50; Bork, *The Rule of Reason*, *supra* note 23, at 429-65.

42. Usually free riding occurs because consumers can get a service without having to buy the product from the dealer who provides the service. For example, some high-fidelity equipment dealers provide a listening room where customers can compare different stereo components. Once he decides which brand to buy, a customer can then make the purchase from a discount dealer. *See* R. POSNER, *supra* note 23, at 149.

43. If some consumers will purchase the product with or without dealer services, while other consumers will purchase the product only with the services, a manufacturer imposing intrabrand restraints to improve dealer services could conceivably increase his profits without increasing consumer welfare; the welfare gain to those consumers who want services could be offset by the welfare loss to those consumers who continue to buy the product but do not consider the services valuable. Abbott, *Paradox Regained: Toward a "New Economic Approach" to Vertical Restraints Policy* 8-9 (FTC Staff Paper on file with the *Duke Law Journal*). *See also* Spence, *Product Differentiation and Welfare*, 66 AM. ECON. REV. 407 (1976) (product differentiation that is profitable for the manufacturer may not increase consumer welfare). No one has offered, however, a practical way to identify such situations.

44. *See* Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925 (1975).

45. *See, e.g.*, R. BORK, THE ANTITRUST PARADOX, *supra* note 23, at 292-95; Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 23-25 (1981).

restraints,[46] it failed to apply the same standard to price restraints.[47] Moreover, the Court apparently refused to accept the dealer-services rationale as a complete explanation for nonprice restraints.[48] Although the Court's explanations are not persuasive,[49] it reached the correct result. Resale price maintenance cannot be explained by the dealer-services rationale;[50] a separate rationale—the competitive-advantages rationale—explains both the per se treatment of resale price maintenance and the anticompetitive effects of nonprice restraints.

B. *The Competitive-Advantages Explanation.*

Although the cartel theories and the dealer-services theory undoubtedly fit some sets of facts, they ignore circumstances in which manufacturers impose intrabrand restrictions to gain increased profits by keeping their prices to dealers higher than otherwise would be possible, without expecting that dealers' margins or dealers' services will increase. A manufacturer who, because of either product differentiation or a cost advantage, enjoys a competitive advantage over rivals has the potential to earn greater profits than he otherwise would.[51] Without intrabrand restraints, however, the profits resulting from a competitive advantage could be lost through intrabrand competition.

If intrabrand competition is possible, the elasticity of demand[52] for a brand from a particular dealer usually exceeds the elasticity of demand for the brand collectively because consumers can readily obtain the identical brand from any dealer; a price decrease by any one dealer should bring a substantial increase in sales by diverting customers from rival dealers—a result that benefits the price-cutting dealer[53] but not

46. 433 U.S. 36, 54-55.

47. *Id.* at 51 n.18.

48. *Id.* at 56 ("the view that the manufacturer's interest necessarily corresponds with that of the public is not universally shared"); *id.* at 58 ("we do not foreclose the possibility that particular applications of vertical restrictions might justify per se prohibitions . . .").

49. See text accompanying notes 61-69 *infra*.

50. See text accompanying notes 72-84 *infra*.

51. The idea that differentiation among competing brands should make a difference in economic analysis derives from the theory of imperfect competition. See note 24 *supra*. The recent literature on product differentiation and market structure is reviewed in F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE ch. 14 (2d ed. 1980).

52. Price elasticity of demand is the ratio of the change in the quantity of a product demanded resulting from a change in the product's price. Landes & Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 940 n.8 (1981).

53. A dealer will want to increase his sales whenever the marginal cost of additional sales is less than the marginal revenue to be derived from additional sales. Under conditions of elastic demand the dealer's price need be decreased only slightly to add additional sales; when his cost of goods (the major portion of his marginal cost) is constant, the dealer is likely to view additional sales as profitable ones. The profitability of additional sales is even greater if, as may often be the

the manufacturer. Moreover, because dealers have different cost and demand characteristics,[54] competition between dealers of the same brand is likely;[55] when it occurs, dealer margins will diminish. As margins shrink, dealers on the edge of profitability will either go out of business, stop carrying the cut-price brand, or press the manufacturer to reduce wholesale prices.

A manufacturer with a competitive advantage can cut his wholesale price and still earn a competitive profit; he is therefore especially susceptible to pressure for lower prices if dealers can credibly threaten to drop his brand otherwise. Because dealers are generally indifferent to the brands of products they sell except to the extent that some brands promise greater profit than others, they can indeed switch, or threaten to switch, from selling one manufacturer's product to selling another's, depending on which product offers the greatest potential profit. In effect, manufacturers buy distribution outlets, and they bid against each other for the best outlets by offering the dealer profit potential.[56] If a manufacturer cannot offer his existing dealers as much profit as rival manufacturers, the dealers will switch suppliers.[57] Intrabrand competition thus results in downward pressure on the manufacturer's wholesale prices.[58]

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case, his marginal cost of selling (shelf space, employees, etc.) decreases with increasing output, or if the manufacturer gives quantity discounts.

54. Some dealers will inevitably be more efficient or more aggressive than others; some will have lower maintenance costs, or more attractive locations. In addition, the same brand is often sold through different types of retailers, whose costs and sales strategies are likely to differ markedly. *See generally* M. PORTER, *supra* note 33, at 38-42.

55. *See* RESALE PRICE MAINTENANCE, *supra* note 33, at 4-5. *See also* Comanor, *supra* note 22, at 1426. Manufacturers cannot selectively raise their wholesale prices to dealers to stop intrabrand competition, both because such refined price determinations are impractical, and because they might be unlawful under the Robinson-Patman Act, 15 U.S.C. § 13 (1976). *See* Mueller Co. v. FTC, 323 F.2d 44 (7th Cir. 1963), *cert. denied*, 377 U.S. 923 (1964). *Cf.* Interstate Cigar Co. v. Sterling Drug, Inc., 1980-2 Trade Cas. ¶ 63,430 (S.D.N.Y. 1980) (a large discount to new dealers does not adversely affect competition).

56. *See, e.g.*, R. BORK, THE ANTITRUST PARADOX, *supra* note 23, at 293; Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795, 805-06 (1962).

Recent scholarship has emphasized that dealers derive bargaining power from the structure of retailing markets and from the fact that dealer services are an important influence on consumer demand. M. PORTER, *supra* note 33, at ch. 2. Whatever the relative bargaining strengths of retailers and manufacturers, the competitive-advantages rationale explains that imposing intrabrand restrictions maximizes the manufacturer's use of his bargaining power. Acknowledging the bargaining power of dealers merely confirms the difficulty a manufacturer has in restricting intrabrand competition by charging high prices to his dealers.

57. But see note 92 *infra*.

58. Nor can a manufacturer easily replace a dealer threatening to drop his brand. A replacement dealer will demand an adequate return just as the original dealer did. Losing a dealer's outlet altogether would leave the manufacturer worse off, or else he would not have sold to that dealer in the first place.

No doubt dealers and manufacturers bluff to a degree about who will switch away from whom, but in the aggregate dealers and manufacturers bargain toward an equilibrium at which the dealers' profitability will be roughly equal for all the brands. If this equality were not attained, dealers would make more money on some brands than others; they would then have an incentive to drop a lower-profit brand and to increase their volume of a higher-profit one or to press the manufacturer to lower his prices, and the cycle would start over. The cycle ends—and equilibrium is reached—when no manufacturer can reduce his wholesale price without selling below his own cost (including a competitive profit). Manufacturer competition for dealers ends and no dealer can credibly threaten to switch to a rival manufacturer. At this equilibrium point, however, a manufacturer with a competitive advantage cannot profit from that advantage.

Suppose, for example, that when a market is in equilibrium a manufacturer introduces a new, more attractive brand. If the attractiveness results from quality differences that increase the manufacturer's production costs above those of his rivals, the manufacturer should be able to charge proportionally higher wholesale prices; dealers will charge higher retail prices but will earn the same profit as on the lower-quality, lower-priced brands. Dealer pressure for lower wholesale prices will be ineffective and will eventually abate because no manufacturer will have the ability or incentive to lower prices.

Suppose, on the other hand, that the attractiveness of the new brand does not result from higher costs to the manufacturer but results from, for example, strong brand-name recognition by consumers. If the manufacturer can still charge the higher wholesale price, he will earn a more-than-competitive profit. As dealers seek the equilibrium retail price for the brand, however, they will compete with one another and bargain for lower wholesale prices from the manufacturer. Two circumstances put the dealers in a good bargaining position: first, the manufacturer, by hypothesis, is earning unusually high profits and can therefore afford to reduce his prices, and second, the dealers can forcefully threaten to drop the brand or refuse to carry it initially. The likelihood that dealer pressure will succeed is thus much greater in these circumstances than when the market is at equilibrium, and ultimately a new equilibrium will be reached at which the manufacturer earns less than he would if his dealers were not engaging in intrabrand competition. The manufacturer can avoid these pressures if he restricts competition among dealers.

Intrabrand restraints imposed by a manufacturer thus may be neither a response to a dealer cartel nor an implementation of a legitimate desire to promote dealer services. Instead, they may be imposed to enable the manufacturer to capture the profit arising from an advantage that his product has over a rival's product, and to do so by eliminating the possibility that his dealers will compete such profits away through intrabrand competition. This is called the competitive-advantages rationale.[59] Restrictions imposed under the competitive-advantages rationale are unjustifiable because they remove market forces that would otherwise lower prices to consumers, without inducing greater dealer services. Moreover, such restrictions are unnecessary to spur the manufacturer to improve his product's quality or his efficiency; that incentive comes from interbrand, not intrabrand, competition.[60] Most important, the competitive-advantages rationale for intrabrand restraints explains the Supreme Court's distinction between price and nonprice restraints.

II. Price and Nonprice Restraints

The *Sylvania* Court's rationale for distinguishing price from nonprice restraints was Justice Brennan's concurring statement in *White Motor Co. v. United States*[61] that "[r]esale price maintenance is not only designed to, but almost invariably does in fact, reduce price competition not only *among* sellers of the affected product, but quite as

59. The competitive-advantages rationale demonstrates that dealers need not form a cartel to exercise their bargaining power over manufacturers. Instead, dealer pressure for lower wholesale prices or intrabrand restraints results from individual reactions by dealers to the erosion of profits from intrabrand competition. When the manufacturer imposes intrabrand restraints to forestall such pressure the result is the same as that produced by a formal dealer cartel—except the manufacturer, not the dealers, gets the extra profit. Recent cases provide an accurate depiction of dealer pressure that is unrelated to either formal dealer cartels or the free-rider problem. *See, e.g.*, Eiberger v. Sony Corp. of America, 622 F.2d 1068 (2d Cir. 1980). *See also* H.L. Moore Drug Exchange v. Eli Lilly & Co., 1979-1 Trade Cas. ¶ 62,674 (S.D.N.Y. 1979) (relying on dealer communication to deny the defendant's motion for summary judgment, but not considering whether the communications related to a free-rider problem).

60. It cannot be argued convincingly that competitive advantages are too insignificant a phenomenon to warrant attention. *Compare* Posner, *Oligopolistic Pricing Suits, the Sherman Act, and Economic Welfare: A Reply to Professor Markovits*, 28 Stan. L. Rev. 903, 912 (1976) *with* Markovits, *A Response to Professor Posner*, 28 Stan. L. Rev. 919, 937-38 (1976). Even the dealer-services theory assumes that individual brands have, or can obtain, some competitive advantage; without market power derived from a competitive advantage, intrabrand restrictions would be profitable for neither the manufacturer nor the dealer. *See, e.g.*, R. Posner, *supra* note 23, at 149-50; Bowman, *supra* note 34, at 848-49; Holahan, *Resale Price Maintenance*, 21 J. Econ. Theory 411 (1979) (a competitive manufacturer does not benefit from resale price maintenance); Preston, *supra* note 23, at 518. Given the competitive-advantages rationale, it is not surprising to observe that many of the products on which resale prices have been fixed are highly differentiated, widely recognized brand names on which no dealer services are required. *See, e.g.*, Eastman Kodak Co. v. FTC, 158 F.2d 592 (2d Cir. 1946), *cert. denied*, 330 U.S. 828 (1947). *Compare* Resale Price Maintenance, *supra* note 33, at 67 *with* M. Porter, *supra* note 33, at 23-30.

61. 372 U.S. 253 (1963).

much *between* that product and competing brands."[62] This assertion is unsupported,[63] ambiguous,[64] and, at best, an argument supporting per se treatment only in concentrated industries where the significant firms engage in resale price-fixing through separate dealers.[65] The Court's additional assertion[66] that Congress endorsed the per se rule as applicable to resale price maintenance when it repealed the fair trade laws[67] also fails to support disparate treatment for price and nonprice restraints.[68] Thus, the Court provided no adequate answer for critics who pointed out the apparent inconsistency of treating nonprice restraints, which may prohibit both price and nonprice competition, less harshly than price restraints, which prohibit only price competition.[69]

When examined closely, however, differences in the effects of price and nonprice restraints fully justify their disparate treatment. Briefly stated, price restraints are almost always likely to be explained by the competitive-advantages rationale and never by the dealer-services rationale. Price restraints are therefore appropriately treated under a per se rule. Nonprice restraints, however, may be explained by the dealer-services rationale and should therefore be treated under a rule-of-reason analysis that seeks to measure the effect of the restraint.

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62. *Id.* at 268 (Brennan, J., concurring) (emphasis in original).

63. The sole support for Justice Brennan's statement was United States v. Parke, Davis & Co., 362 U.S. 29, 45-47 (1960), which is distinguishable because it analogized resale price maintenance to a dealer cartel and concerned only decreased intrabrand competition.

64. If the statement by Justice Brennan means that resale price maintenance diverts intrabrand competition from price competition to service competition, it does not serve to distinguish price from nonprice restraints, and is inconsistent with the Court's simultaneous rejection of the argument that product differentiation is necessarily contrary to consumer welfare. 433 U.S. at 56 n.25. If the statement means that resale price maintenance may support manufacturer cartelization, it is subject to severe limitations. *See* Bork, *supra* note 16, at 190-91; Posner, *supra* note 16, at 7-8. *But see* Pitofsky, *supra* note 5, at 15-16.

65. *See* Posner, *The Rule of Reason*, *supra* note 16, at 7-8.

66. 433 U.S. at 51 n.18.

67. Congress repealed the fair trade laws in the Consumer Goods Pricing Act of 1975, Pub. L. No. 94-145, 89 Stat. 801, *codified at* 15 U.S.C. §§ 1, 45(a) (1976) (amending 15 U.S.C. §§ 1, 45(a) (1970)).

68. *See* Bork, *supra* note 16, at 191-92; Posner, *supra* note 16, at 8-9. If Congress did legislate a per se rule for vertical price fixing when it repealed the fair trade laws, the inference could be drawn that it was bringing the law relating to price restraints into line with that relating to nonprice restraints, which at the time was governed in part by the per se rule of United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967). If so, the overruling of *Schwinn* would be inconsistent with Congress's intentions.

69. R. BORK, THE ANTITRUST PARADOX, *supra* note 23, at 288-91; Posner, *supra* note 45, at 9.

A. *Resale Price Maintenance.*

The defect in the theory supporting the legality of resale price maintenance is the assumption that by diminishing price competition the manufacturer stops free riding and induces competition in services that is in his and the consumer's interests.[70] In fact, resale price maintenance does not overcome the free-rider problem; nor does it induce any nonprice competition that benefits consumers. Minimum price restraints can be explained only by the competitive-advantages rationale.

1. *Nonprice Competition and Resale Price Maintenance.* Resale price maintenance cuts off price competition, the most effective means of intrabrand rivalry and the form of rivalry that is most likely to reduce the manufacturer's profits from a competitive advantage. By contrast, the nonprice competition permitted under resale price maintenance is often ineffectual; beyond some level of dealer services, consumers will cease to respond to additional investment in services, even if they would have responded to price decreases.[71] Indeed, when resale prices are fixed and the manufacturer gives the dealers a margin that is both competitive with that given by other manufacturers and sufficient to provide the amount of dealer services the manufacturer desires, the dealer's incentive to engage in intrabrand competition through additional nonprice rivalry would appear to be small; if consumer demand were responsive to dealer services, the manufacturer would want them to be provided. Under these circumstances, resale price maintenance reduces all pressure for lower wholesale prices.

2. *Dealer Services and Resale Price Maintenance.* Moreover, con-

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70. *See, e.g.*, R. POSNER, *supra* note 23, at 148:

> If the manufacturer fixes a minimum resale price that exceeds the cost of reselling his product without . . . services, but non-price (*i.e.*, service) competition among the dealers is not constrained, the dealers will step up such competition among themselves—*i.e.*, increase the provision of services . . . . They will continue to increase their outlays on service competition until the marginal cost of distribution has risen to meet the resale price. When that point is reached the dealers will not be receiving any monopoly profits but will instead be furnishing the level of services desired by the manufacturer.

Id. Professor Posner thus makes it clear that the assumption of "effective non-price competition among the dealers," *id.*, is a prerequisite to the dealer-services rationale.

71. A dealer with a showroom, for example, is unlikely to attract customers from a rival dealer by making the showroom even more lavish, but is able to attract customers from rival dealers by continuing to reduce his prices. The relative ineffectiveness of nonprice competition as a form of intrabrand competition is implicit in much of the analysis of intrabrand restraints. Bowman, *supra* note 34, at 825, 830 n.29 (dealer cartels are content to fix only prices, without significant concern that nonprice competition will subvert the profitability of cartels); Comanor, *supra* note 22, at 1426 (a manufacturer cannot finance service competition by reducing prices to dealers because dealers will instead engage in price competition); Gould & Yamey, *Professor Bork on Vertical Price Fixing: A Rejoinder*, *supra* note 24, at 941.

trary to the Chicago school analysis,[72] a manufacturer is unable, by fixing resale prices, to overcome any free-riding competition that undermines desirable dealer services. Even after prices are fixed, a dealer may take a free ride by offering an inexpensive increment of service or value to take customers away from dealers who offer more expensive services.

Suppose, for example, that one dealer offers a large showroom with helpful, knowledgeable sales clerks. Even if resale prices are fixed, another dealer can still take a free ride on those services by offering free gifts on each sale, free home delivery, or advantageous credit terms, without ever investing in a showroom or sales-clerk training.[73] Consumers can examine and try out the product with the first dealer and then buy from the second. As long as the second dealer's bonus has some attraction to consumers but costs less than the first dealer's showroom and sales training, the second dealer can take a free ride at the expense of the first. This free riding discourages the first dealer from investing in the showroom—precisely the type of free-rider problem that price restrictions purportedly overcome.

Of course, if rivals are induced to increase services of some kind, even if not showrooms, the suppression of price competition appears to meet its objective of inducing dealer services. But this is hardly the effective nonprice competition that supports the dealer-services rationale. First, dealer services such as showrooms can be so easily undercut by cheaper, free-riding nonprice competition like free gifts that no dealer would have an incentive to provide the more expensive services. Successive rounds of nonprice competition undercutting the expensive dealer services of rivals would, in all probability, uniformly reduce dealer services to those that could be provided at low cost.[74] Second, because services on which a free ride can be taken can be undercut by services—like gifts—on which a free ride cannot be taken, the most likely outcome of successive rounds of nonprice competition would be an increase in the amount of dealer services on which free rides could not be taken. Whether these services are valuable to consumers misses the point; the market will generate these services in accordance with

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72. See note 44 *supra*.

73. Such forms of nonprice competition were common when prices were fixed under the fair trade laws. *See, e.g.*, Vornado v. Corning Glass Works, 388 F.2d 117 (3d Cir. 1968) (trading stamps for fair-traded items); Colgate-Palmolive Co. v. Max Dichter & Sons, 142 F. Supp. 545 (D. Mass. 1956) (trading stamps for fair-traded items); *In re* Schwanhausser, 52 F.T.C. 28 (1955) (trade-in allowances given).

74. The fact that nonprice free-riding competition leads to less expensive dealer services is another example of the fact that the nonprice rivalry remaining after resale prices are fixed is an ineffective form of rivalry. See text accompanying note 71 *supra*.

consumer demand even without any special inducements by the manufacturer.[75] Systematic resale price-fixing therefore cannot be explained by the dealer-services rationale.

This is not to say that there is no free-rider problem in the showroom example—there is. And overcoming the problem through a dealer's contractual commitments to supply services, some forms of nonprice vertical restraints,[76] or other means[77] should be permitted. But the fact that dealers whose prices are fixed have showrooms does not prove that the showrooms result from price-fixing.

Two further arguments are commonly made to show that resale price maintenance induces dealer services: the uniformity argument and the market coverage argument. With respect to the gasoline retail industry, for example, Professor Bork argues that the oil companies have a legitimate interest in ensuring that their retail outlets provide a uniformly high level of service[78] because a high level of service creates good will, which in turn induces repeat sales. Without price restraints, goes the argument, some dealers may ignore service, taking a free ride on the good will created by the dealers who do give service, degrading the brand's image, and destroying its good will. With price restraints, dealers will engage in service competition.

Concededly, oil companies have an interest in ensuring that dealers do not degrade their products by providing poor service. That is why contractual commitments by the dealer to provide services are enforceable,[79] and why *Sylvania* permits restrictions that keep gasoline

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75. If a free-rider problem does not exist, the value of services to consumers can be appropriated only by sellers who offer the services. In this circumstance, to allow a manufacturer to induce dealer services would misallocate resources by requiring consumers to pay for more services than they desire.

76. See note 87 *infra*.

77. A manufacturer has several ways other than contractual commitments to overcome the free-rider problem, including customer restrictions (which, if lawful, permit a manufacturer to restrict distribution to dealers that provide the services desired by the manufacturer), direct payments to dealers who provide the desired services, and the direct provision of services by manufacturers themselves. Pitofsky, *supra* note 5, at 22-23; Telser, *supra* note 23, at 92-94 (arguing, however, that these alternatives are too costly or ineffective to be meaningful). None of these methods is costless, but in view of the inability of resale price maintenance to overcome the free-rider problem, they are the only means available.

78. Bork, *The Rule of Reason*, *supra* note 23, at 454-56.

79. *See, e.g.*, Frisard v. Texaco, Inc., 460 F. Supp. 1094 (E.D. La. 1979); Malone v. Crown Central Petroleum Corp., 474 F. Supp. 306 (D. Md. 1979); D & M Distribs., Inc. v. Texaco, Inc., 1970 Trade Cas. ¶ 73,099 (C.D. Cal. 1970). Dealer terminators in the petroleum industry are now regulated by the Petroleum Marketing Practices Act, Pub. L. No. 95-297, 92 Stat. 322 (1978) (codified at 15 U.S.C. §§ 2801-2805, 2821-2824, 2841 (Supp. II 1978)), which permits terminations for "failure by the franchisee to comply with any provision of the franchise, which provision is both reasonable and of material significance to the franchise relationship . . . ." 15 U.S.C. § 2802(b)(2)(A) (Supp. II 1978).

out of the hands of low quality dealers.[80] But resale price maintenance does not ensure competition to provide services, much less a uniform level of service; an analysis of the gasoline retail trade shows why.

Consider three types of consumers: first, those who investigate the type of service they will get before they buy; second, repeat customers, who buy from a dealer on the basis of past experience with that dealer; and third, customers who want service but buy from one dealer on the basis of an earlier experience with a different dealer of the same brand. For consumers who shop for gasoline by investigating in advance the services they will get, and for repeat customers, free riding is impossible; consumers will shop and pay for the services they want. The need to impose resale price maintenance to stop free riding arises, therefore, only if customers purchase gasoline on the basis of their past experience with a particular brand, rather than on the basis of their experience with a particular station. Even in this situation, however, dealers can continue to take a free ride after resale prices are fixed: they can provide poor service and simply pocket that portion of the dealer margin that other dealers invest in providing service and generating good will. It is thus irrelevant to say in this example that "any dealer who did not [compete on a service basis] would lose business."[81] The loss of business would come only from careful shoppers and repeat customers—those for whom free riding is impossible, and for whom the market would provide services without resale price maintenance.

An alternate argument for resale price maintenance in the gasoline industry and other industries[82] states that uniform price levels permit a manufacturer to sell to many outlets, including some inefficient ones, and thus achieve a market saturation that puts the product within the convenient reach of consumers.[83] Gasoline, under this view, is a convenience good because consumers want it where and when they need it

80. *See, e.g.*, Reno West Coast Dist. Co. v. The Mead Corp., 613 F.2d 722 (9th Cir.), *cert. denied*, 444 U.S. 927 (1979). *See also* Comment, *Retail Gasoline Franchise Terminations and Nonrenewals Under Title I of the Petroleum Marketing Practices Act*, 1980 DUKE L.J. 522.

81. Bork, *The Rule of Reason*, *supra* note 23, at 455. As Professor Bork recognizes, *id.* 456 n.161, the market itself generally promotes the manufacturer's interest in uniformity: dealers are induced to give services in order to retain the patronage of their many repeat customers, and because they cannot discriminate between repeat and one-time customers, they must give the same services to all. The manufacturer's concern with the free-rider problem arises, therefore, only when the dealer is indifferent to repeat customers or when repeat customers are indifferent to services—both unlikely occurrences.

82. *See, e.g.*, P. AREEDA, *supra* note 24, at 503-04; M. PORTER, *supra* note 33, at 66; L. SULLIVAN, *supra* note 24, at 382-83. The Chicago-school writers do not discuss this argument in the context of resale price maintenance, presumably because they have rejected it.

83. This argument is refuted, in the context of nonprice vertical restraints, in Comanor, *supra* note 22, at 1430.

and are therefore as likely to have their purchasing decisions influenced by availability as by price or services. Resale price maintenance therefore supposedly serves the manufacturer's and the consumer's interest in ensuring availability. Increased convenience makes up for the value consumers lose from the lack of price competition; if it did not, the manufacturer would not fix prices.

This argument misses an important point. If gasoline is really a convenience good, consumers will not shop between stations on the basis of price, so that intrabrand competition will not be strong enough either to drive prices down or to force inefficient gasoline dealers out of business. The manufacturer therefore need not restrain price competition to keep inefficient dealers in the market and ensure adequate market coverage. Consumers who want convenience will pay for it and keep inefficient dealers in business.

To be sure, some consumers value convenience and others value price competition. Those who value price competition might force dealers of the same brand to compete against one another, driving the inefficient dealers out of business and depriving the other consumers of the convenience they value. This possibility does not, however, explain or justify resale price maintenance. First, if the manufacturer set the resale price too high, consumers who value price competition might switch to other brands. If so, the manufacturer would be acting against his interest because the value of convenience to the consumers who liked convenience must have been less than the value of price competition to those consumers who valued price competition. Had it not been less, the market would have supplied more convenience.[84] The second possibility is that after the imposition of resale price maintenance, those consumers who value price competition might continue to buy the same brand, but at the higher, fixed price, permitting the manufacturer to satisfy those consumers who like convenience without diverting price-sensitive consumers to other brands. If consumers value convenience, it makes economic sense for a manufacturer to subsidize otherwise inefficient stations to ensure convenience, but the manufacturer should pay for the subsidy out of his own pocket, rather than that of consumers who value price competition. Intrabrand competition cannot threaten his ability to serve those customers who are willing to pay for convenience; he therefore need not restrain intrabrand competition to provide that convenience. Of course, the gasoline producer may want to impose resale price maintenance to increase his own profits and

84. That is, those "inefficient" dealers who are nonetheless convenient will not compete on the basis of price for sales to consumers who shop primarily by price, but will instead attract consumers who value convenience and are willing to pay higher prices for it.

use those profits to subsidize inefficient dealers, but that would be no more legitimate or pro-competitive than if he fixed prices with his competitors in order to finance more convenient service. Price restraints in this situation ought to be illegal.

In short, because resale price maintenance does not overcome the free-rider problem, it cannot induce dealer services that the free market does not provide. The dealer-services rationale thus fails to explain resale price maintenance. The competitive-advantages rationale, by contrast, does explain resale price maintenance. A manufacturer will permit his dealers to earn a margin that finances the level of services necessary for effective *interbrand* competition; dealers are unlikely to find additional nonprice competition to be an effective form of *intrabrand* rivalry, and it will not occur.[85] Thus, when a manufacturer fixes resale prices he generally need not fear that nonprice competition between his dealers will erode dealer margins and put pressure on him to lower his price to dealers; resale price maintenance eliminates all forms of interdealer competition that threaten a manufacturer's profit. Under any welfare analysis, therefore, the per se rule against resale price maintenance is sound.[86]

B. *Nonprice Restrictions.*

In contrast to price restrictions, nonprice restrictions have two characteristics that justify the more sympathetic treatment they receive under the antitrust laws.

First, because nonprice restrictions stop both price and nonprice competition, they can be used to overcome the free-rider problem.[87] Their imposition may therefore be explained by the dealer-services rationale, and they cannot be presumed to be anticompetitive. Second,

85. See text accompanying note 71 *supra*.

86. The per se rule should not be applied, however, to restraints that are really territorial restrictions, Eastern Scientific Co. v. Wild Heerbrugg Instruments, Inc., 572 F.2d 883 (1st Cir.), *cert. denied*, 439 U.S. 833 (1978) (extra-territorial sales permitted at above list prices), nor when the price restraint is ancillary to beneficial integration. Bork, *The Rule of Reason*, *supra* note 23, at 457-64.

87. The utility of nonprice restrictions in overcoming the free-rider problem is well established. Airtight territorial restrictions, which stop all intrabrand competition, see note 89 *infra*, would, if successfully imposed at the dealer level, stop the kind of nonprice, free-rider effect that occurs when price-fixing is employed and would thus overcome the free-rider problem. Restrictions on dealer locations may also separate dealers enough to avoid the kind of free-rider effect that diminishes important dealer services. Restrictions that permit a manufacturer to sell only to outlets that meet service standards the manufacturer desires are even more likely to facilitate dealer services. *See* Williamson, *supra* note 23, at 975-79. Indeed, when a manufacturer seeks to ensure consumer services through contracts with his dealers, customer restrictions are necessary to keep the merchandise from those who refuse to agree to the contracts.

nonprice restraints differ widely in their types and effects; some place only minimal restraints on intrabrand competition.[88] For nonprice restraints, therefore, a court must base a finding of anticompetitive effect on an appraisal of the circumstances in which the restraints are imposed.

The question arises, however, whether those nonprice restrictions that foreclose *all* intrabrand competition—for example, airtight customer or territorial restrictions[89]—can be presumed to be always anticompetitive. That presumption cannot be made.[90] Airtight restrictions are often imposed on distributors, not on dealers.[91] As long as intrabrand competition among dealers remains unfettered, a dealer's incentive to stop carrying low-profit brands will force distributors to reduce prices to dealers in order to compete for dealer outlets, just as manufacturers do.[92] A restraint on a distributor's territory, without more, will therefore not stop intrabrand competition among dealers

88. For example, area-of-primary-responsibility clauses and profit pass-over provisions, see note 2 *supra*, may be administered so as to overcome free-riding intrabrand competition only, without restraining socially useful forms of intrabrand competition. Similarly, the effect of location restrictions, see note 2 *supra*, on intrabrand competition will depend on how far apart dealers are separated and on the willingness of customers to travel to the dealers. For these nonprice restraints, at least, a finding of anticompetitive effect must be based on an appraisal of the circumstances in which they are imposed. *See generally* ABA ANTITRUST SECTION, *supra* note 2, at 20-25.

89. Restrictions are airtight when potential buyers of a brand have only one source to turn to. Customer restrictions are airtight when only one of a manufacturer's dealers is permitted to trade with each customer; territorial restrictions are airtight when the territorial boundaries are closed and not overlapping; location restrictions are airtight when the dealers are separated by more distance than consumers are able or willing to travel to shop for the merchandise.

90. *But cf.* Pitofsky, *supra* note 5 (arguing that a per se rule should be applicable because airtight restrictions are likely to arise from dealer pressure, and because those that can be explained by the dealer-services rationale are likely to be unidentifiable and unimportant).

91. *See, e.g.*, United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967) (airtight restrictions were imposed only on distributors; the customer and location restrictions on dealers apparently were not airtight), *overruled in part*, Continental T.V., Inc. v. GTE Sylvania, 433 U.S. 36 (1977); Sandura Co. v. FTC, 339 F.2d 847 (6th Cir. 1964) (airtight territories on distributors are lawful only under the rule of reason). *But see* White Motor Co. v. United States, 372 U.S. 253 (1963) (airtight restrictions on both dealers and distributors); Snap-On Tools Corp. v. FTC, 321 F.2d 825 (7th Cir. 1963) (dealers were assigned territories but were permitted to sell to customers coming to them from outside the territory). *See* Note, *supra* note 56, at 803.

92. See text accompanying note 56 *supra*. On the other hand, there may be circumstances in which a dealer is unable, as a matter of marketing realities, to stop selling low-profit brands, in which event intrabrand competition between distributors may be important for dealers and consumers. This may have been the case in *In re* Coca-Cola Co., 91 F.T.C. 517 (1978). For example, a supermarket might carry a low-profit item of frequent purchase, like a particular brand of bread or soft drink, because consumers would not shop there at all otherwise. Congress reversed the *Coca-Cola* decision in legislation authorizing exclusive territories for bottlers if there is "substantial and effective interbrand competition." *See* Soft Drink Interbrand Competition Act, 15 U.S.C.A. §§ 3501-3503 (West Supp. 1981).

and should not be held per se unlawful.[93] Moreover, the dealers' bargaining power over distributors makes it unlikely that a per se rule can be justified by a distributor-cartel theory. In order to deprive dealers of choices, a distributor cartel would have to include virtually all brands and would thus be both rare, because it would be unstable, and easily identifiable.

In sum, nonprice restraints should be analyzed under the rule of reason; section III addresses how that analysis should proceed.

III. Transforming Theory to Practice: The Rule of Reason

Although it is too soon to discern whether a single, coherent rule-of-reason standard is being developed in the post-*Sylvania* cases,[94] many commentators[95] and most courts follow a structural approach: they balance the defendant's market share, a surrogate measure of the vigor of interbrand competition, against an evaluation of whether the restraint promotes dealer services.[96] The lower the market share, the easier it is to justify the restraint. This symmetry, however, is imperfect; courts appear to be influenced by their own *a priori* evaluation of the dealer-services rationale and allocate the burden of proof and the burden of persuasion accordingly. Some easily accept the dealer-services argument and give it overriding weight,[97] while others—such as the

93. When airtight territorial restraints *are* imposed on dealers, the presumption that their effect is anticompetitive becomes greater. Even so, however, the possibility of a legitimate free-rider problem to be overcome by the restraints makes any *a priori* generalization about their competitive effect impossible.

94. Many of the post-*Sylvania* cases merely reversed and remanded decisions made under the *Schwinn* per se rule. *See, e.g.*, General Beverage Sales Co. v. East-Side Winery, 568 F.2d 1147 (7th Cir. 1978); Adolph Coors Co. v. A & S Wholesalers, Inc., 561 F.2d 807 (10th Cir. 1977); Florida Harvestore, Inc. v. A.O. Smith Harvestore Products, Inc., 561 F.2d 631 (5th Cir. 1977). *See also* National Auto Brokers Corp. v. General Motors Corp., 572 F.2d 953 (2d Cir. 1978) (affirming a directed verdict against a plaintiff who had relied on the per se rule), *cert. denied*, 439 U.S. 1072 (1979); Lucas Hoist & Equip. Co. v. Eaton Corp., 76 F.R.D. 661 (W.D. Pa. 1977); United States v. Arnold, Schwinn & Co., 1977-2 Trade Cas. ¶ 61,776, at 73,208 (N.D. Ill. 1977) (vacating the final judgment).

95. See the commentators cited in note 26 *supra*.

96. *See, e.g.*, Donald B. Rice Tire Co. v. Michelin Tire Corp., 483 F. Supp. 750 (D. Md. 1980), *aff'd* 638 F.2d 15 (4th Cir. 1981).

97. *See, e.g.*, Cowley v. Braden Indus., 613 F.2d 751 (9th Cir.), *cert. denied*, 446 U.S. 965 (1980). Two courts have granted summary judgment against plaintiffs challenging intrabrand restraints. *See* Golden Gate Acceptance Corp. v. General Motors Corp., 597 F.2d 676 (9th Cir. 1979) (location clause is lawful where the parties agreed to it and the manufacturer's intent was to provide an effective sales and service network); Continental T.V., Inc. v. GTE Sylvania, Inc., 461 F. Supp. 1046 (N.D. Cal. 1978) (on remand, the court held Sylvania's location clause pro-competitive).

Federal Trade Commission[98]—view the dealer-services argument as suspect.[99] In any event, the rule-of-reason standard generally applied gives the jury wide discretion to arrive at its own assessment of competitive effects.[100]

The focus on market share is basically sound, but the competitive-advantages rationale makes the analysis more accurate. Two preliminary observations must be made. First, because theories explaining intrabrand restraints differ in their assumptions about a manufacturer's motive for imposing restraints, one is tempted to measure the effect of a restraint by asking why the manufacturer imposed it. Focusing on subjective motive, however, is risky and ineffectual: not only can evidence of purpose be manipulated, but the evidence is usually ambiguous. A sounder analysis would identify the most likely effect of the restraint by focusing on objective evidence concerning the nature of intrabrand competition, relying on evidence of subjective intent only to illuminate the objective facts.[101] For example, a relevant question is whether a significant free-rider problem really exists, not only whether the manufacturer believes one to exist.

Second, analyzing the effect of intrabrand restraints does not require the loss of intrabrand competition to be balanced against a gain in interbrand competition.[102] Dealer services may increase the vigor of interbrand competition by making a product more attractive, but that is an incidental benefit: the real issue remains whether the loss of intrabrand competition itself injures or benefits potential consumers of the brand in question. Those consumers are injured by the restraint if, without obtaining more services, they are denied intrabrand choices that are sources of consumer welfare, but are benefited if dealer services increase.

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98. *In re* Coca-Cola Co., 91 F.T.C. 517 (1978); Beltone Elecs. Corp., Administrative Law Judge Decision, [1980] 3 TRADE REG. REP. (CCH) ¶21,726.

99. *See, e.g.*, Eiberger v. Sony Corp. of America, 622 F.2d 1068 (2d Cir. 1980) (analyzing and dismising the free-rider argument for failure of proof).

100. *See* First Beverages, Inc. v. Royal Crown Cola Co., 612 F.2d 1164 (9th Cir.), *cert. denied*, 447 U.S. 924 (1980); Reno-West Coast Distribution Co. v. Mead Corp., 613 F.2d 722 (9th Cir.), *cert. denied*, 444 U.S. 927 (1979); Del Rio Distrib. v. Adolph Coors Co., 589 F.2d 176 (5th Cir.), *cert. denied*, 444 U.S. 840 (1979).

101. "[G]ood intentions will [not] save an otherwise objectionable regulation or the reverse; but knowledge of intent may help the court to interpret facts and to predict consequences." Board of Trade v. United States, 246 U.S. 231, 238 (1918).

102. The Supreme Court's contrary assumption impeded the growth of coherent antitrust doctrine. Balancing interbrand against intrabrand competition was rejected by the Supreme Court in United States v. Topco Assocs., 405 U.S. 596, 610 (1972), but has since become acceptable. See Continental TV, Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 52 n.19 (1977).

In theory, one could analyze the competitive effect of intrabrand restraints by identifying cases of genuine dealer cartels and holding them unlawful, and looking at the remaining cases for changes in the dealers' margins. If restraints increased those margins, the effects would be presumptively pro-competitive: rational manufacturers would not allow their dealers greater gross profits unless those profits were used to increase dealer services. If restraints left dealers' margins unaffected or decreased, the effects would be presumptively anticompetitive because intrabrand competition would have been restrained without the dealers' obtaining any extra money to spend on added services.

Unfortunately, distinguishing dealer cartels from manufacturer-initiated restraints is difficult,[103] and evaluating changes in dealers' margins is nearly impossible,[104] making that approach unworkable. The problem of distinguishing dealer cartels from manufacturer-initiated restraints can be avoided, however, by refining the current approach that focuses on market share. Restraints imposed under the competitive-advantages rationale have the same adverse effects as those imposed under the dealer-cartel rationale; the two differ only with respect to the level—dealer or manufacturer—at which excess profits are earned. Because both are likely to occur only if the product in question has enough market power[105] from differentiation to make the restraints profitable, the two rationales can usefully be treated together. A workable approach would therefore examine the circumstances of the restraint to determine whether a manufacturer's market power or his desire for additional dealer services is the more likely explanation for the restraint.[106] If the former, the restraints should be unlawful; if the latter, they should be lawful.

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103. See note 38 *supra*.

104. Several of the essays in RESALE PRICE MAINTENANCE, *supra* note 33, summarize studies attempting to assess the effect of resale price maintenance on dealer margin and refer to the measurement problems. *Id.* at 55, 99-100. *See also* Schmalensee, *On the Use of Economic Models in Antitrust: The* ReaLemon *Case*, 127 U. PA. L. REV. 994, 1007-08 (1979) (noting the difficulty of measuring and evaluating changes in profitability).

105. In this context, the term "market power" is synonymous with the term "competitive advantages": both denote a situation in which one brand is more attractive or less costly to produce than rival brands, giving that brand's manufacturer at least a short-run opportunity to earn more-than-competitive profits.

106. The applicability of either the competitive-advantages or the dealer-cartel rationale depends also on the degree to which intrabrand competition is eliminated by the restraint. Airtight territorial and customer restrictions, see note 89 *supra*, eliminate all intrabrand competition. Location restrictions should be presumed to be airtight when they separate dealers by more than the average distance consumers are willing to shop for goods; location restrictions separating dealers by a lesser distance should be evaluated to see whether some significant class of consumers shops between the dealers in a way that constrains the dealers' behavior. Area-of-primary-responsibility clauses, see note 88 *supra*, are neutral unless administered in a way that restricts sales outside the areas. *See, e.g.*, Reed Bros. v. Monsanto Co., 525 F.2d 486 (8th Cir. 1975) (enforcement of shipping policies and rebate agreements make it economically impossible to sell outside an area of

A. *Market Power.*

Elasticity of demand directly measures differentiation, and hence market power,[107] but elasticity defies accurate measurement[108] and therefore fails as an analytical tool. Another measure of market power is a comparison of a product's marginal cost with its selling price; a price substantially and persistently above marginal cost suggests a high degree of market power. But marginal costs are also difficult to determine,[109] so this method, too, fails the test of practicality.

Antitrust cases have evolved the concept of "relevant" market to assess market power.[110] Although "market share in a relevant market" and "market power" are not synonymous,[111] in practice the relevant market concept can reasonably, if roughly, measure market power in

primary responsibility), *cert. denied*, 423 U.S. 1055 (1976); Hobart Bros. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir.) (area-of-primary responsibility clauses enforced by "silent understanding" and "course of dealing"), *cert. denied*, 412 U.S. 923 (1973). *Cf.* Response of Carolina, Inc. v. Leasco Response, Inc., 1976-2 Trade Cas. ¶ 61,045 (5th Cir. 1976) (territorial confinement may be inferred from higher royalty payments on sales outside area of primary responsibility); Noble v. McClatchy Newspapers, 533 F.2d 1081 (9th Cir. 1975) (territorial confinement may be inferred from assigned areas and resulting conduct). Profit pass-over provisions, see note 88 *supra*, unduly restrict intrabrand competition to the extent that they more than compensate for the goodwill used by the dealer entering the protected territory. *See, e.g.*, Superior Bedding Co. v. Serta Assocs., 353 F. Supp. 1143, 1150-51 (N.D. Ill. 1972).

107. Landes & Posner, *supra* note 52, at 939-43.

108. Schmalensee, *supra* note 104, at 1007, described the difficulties in the context of the FTC's ReaLemon decision (*In re* Borden, Inc., 92 F.T.C. 669 (1978)):

> If prices have not varied enough, historical data may not contain information from which reliable estimates of [elasticity] can be derived; and in most situations this elasticity may vary with both the level of price charged and the length of time over which buyer response to price changes is measured. . . . [Elasticity], as defined in the textbooks, measures the sensitivity of demand for a firm's product to changes in the firm's own price, assuming that all other prices in the economy remain constant. Changes in ReaLemon's price, however, might have induced changes in the prices of other brands of processed lemon juice, and perhaps even in the price of fresh lemons. If these prices affected the demand for ReaLemon's output, the price elasticity of demand relevant to ReaLemon's decisionmaking must have reflected its expectations about the changes in competitors' prices that ReaLemon's actions would provoke and its assumptions about the effect of those changes on the demand for ReaLemon's product. Expectations of this cost may be a major determinant of the markup over marginal cost actually selected, but they cannot be readily measured by an outside observer.

109. *See* Schmalensee, *supra* note 104, at 1006. *See also* Posner, *Oligopolistic Pricing Suits*, *supra* note 60, at 910.

110. *See, e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294 (1962) (holding a merger violative of the Clayton Act); United States v. E. I. du Pont de Nemours & Co., 351 U.S. 377 (1956) (a monopoly case under the Sherman Act).

111. *See, e.g.*, United States v. United Shoe Mach. Corp., 110 F. Supp. 295 (D. Mass. 1953), (the court gave some, but not conclusive, weight to the market share), *aff'd per curiam*, 347 U.S. 521 (1954). The problems of market definition are helpfully discussed in Schmalensee, *supra* note 104, at 1004-16. Of the many other general discussions of market definition see R. POSNER, *supra* note 35, at 125-34; F. SCHERER, *supra* note 51, at 59-61.

monopolization and merger cases, where market power is of concern only if it is substantial. In measuring the significance of intrabrand competition, however, the relevant market concept is much less satisfactory because it does not identify firms or products that have market power of less than substantial proportions. To the extent that the market definition includes products that are not close substitutes, it underestimates the market power of individual manufacturers in that market and thus fails to disclose market power derived from product differentiation.[112]

To determine whether a merger between the Coca-Cola Company and another soft drink company is lawful, for example, the "soft drink" market may be an appropriate relevant market.[113] It may not, however, make sense to include all soft drinks in the relevant market if the issue is whether the loss of intrabrand competition among Coca-Cola bottlers is significant for consumers. If consumers do not consider the cola alternatives to Coca-Cola to be good substitutes, intrabrand competition among Coca-Cola bottlers may be more significant than interbrand competition in keeping prices low.[114]

In short, a correct evaluation of intrabrand restrictions requires that the relevant product market be defined narrowly. One must determine whether a firm—because of product differentiation or some other advantage over its rivals—has a degree of discretionary power that makes consumer choice between outlets selling that firm's product an important source of consumer welfare.[115] The factors that go into this analysis will be the same as those used for traditional market definition,[116] because the underlying question—the existence of market

112. In most monopoly and merger cases, the efficiencies of firm size and integration mean that is is only worthwhile to attack substantial disparities between price and cost, so that relatively broad market definitions may be acceptable. *Compare* United States v. E. I. du Pont de Nemours & Co., 351 U.S. 377 (1956) (market defined broadly in a monopolization case) *with* United States v. E. I. du Pont de Nemours & Co., 353 U.S. 586 (1957) (minimal integration may have justified the Court's narrow product market definition). By contrast, restrictions on intrabrand competition that produce no efficiencies are worth attacking even when they result in relatively less disparity between price and cost.

113. *See, e.g.*, FTC v. Pepsi Co., 477 F.2d 24 (2d Cir. 1973).

114. This appears to have been the approach taken by the Federal Trade Commission in *In re* Coca-Cola Co., 91 F.T.C. 517 (1978), in which, without defining a relevant market, the Commission found that although Coca-Cola is "not devoid of interbrand competition, nevertheless Coca-Cola and allied product prices have great competitive significance in the marketplace." *Id.* at 619. *See also* Sulmeyer v. Seven-Up Co., 411 F. Supp. 635 (S.D.N.Y. 1976).

115. *See, e.g.*, Sandura Co. v. FTC, 339 F.2d 847, 857 (6th Cir. 1964) ("significant product differentiation increases somewhat the importance of intrabrand competition between distributors and increases correspondingly the required justification for abolishing it").

116. *See, e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294, 325 (1962) (listing "industry or public recognition, . . . the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors" (foot-

power—remains the same. But the issue should be whether other products are close, almost perfect, substitutes for the product on which intrabrand restrictions have been imposed.

Market power may derive from a manufacturer's cost advantage, as well as from his product's differentiation. Thus costs should be an element in the market-power analysis. Furthermore, analysis of the relevant market for a brand may be deceptive if a second brand looks like a good substitute for the first only because the price of the first has risen so far above its cost that consumers are induced to switch brands.[117] Costs should be examined for this reason as well.

B. *Dealer Services.*

After determining that either the competitive-advantages theory or the dealer-cartel theory explains a restraint, one must weigh that determination against the possibility that the restraint increased dealer services. Because it is difficult to determine directly that intrabrand restraints have increased dealer services, the best technique is to determine whether the circumstances that make the dealer-services explanation a valid one are present in a particular case. In the context of nonprice restraints, dealer-service arguments usually fall into four categories—the need to overcome a free-rider problem, to obtain market penetration, to encourage dealer investment, and to ensure product quality and safety. The circumstances that make each of these arguments sound or unsound are examined separately.

1. *Free riding.* The free-rider problem exists only when a dealer provides services with respect to a particular product,[118] the services potentially benefit rival dealers,[119] and other dealers have the incentive and ability to profit from the first dealer's provision of services. If these conditions do not exist, free riding is not a problem and manufacturers should not argue that it is.

note omitted)). A court might also determine the existence of product differentiation by determining whether a brand's share of the relevant market changes when relative prices within the market change. J. BAIN, INDUSTRIAL ORGANIZATION 217 (1959).

117. R. POSNER, *supra* note 23, at 128; Stocking & Mueller, *The Cellophane Case and the New Competition*, 45 AM. ECON. REV. 29, 57-63 (1955); Turner, *Antitrust Policy and the Cellophane Case*, 70 HARV. L. REV. 281, 309 (1956).

118. When the activity promotes a particular dealer—rather than a particular product—other dealers will be unable to take a free ride on the activity and there will thus be no disincentive to engage in it. Telser, *supra* note 23, at 89. Dealer advertising may, of course, be related to both the dealer and the product, in which event some free riding may be possible.

119. *See* Posner, *supra* note 16, at 6. See note 42 *supra*.

Free riding is not a problem, for example, when a dealer confines his services, such as maintenance and repair, to those customers who buy from that dealer. Nor does it exist when dealers do not provide any customer services, nor when a manufacturer undertakes most or all of the activities that satisfy or generate consumer demand, nor when the manufacturer ensures through contract that all his dealers will supply the necessary services. Moreover, dealers have a natural incentive, regardless of the possibility of free riding, to cultivate a high quality image for themselves; this is especially true for dealers in multiple brands, where the amount of services provided for any particular brand is unlikely to be determined by the size of the dealer margin on that product. Finally, consumers may be unresponsive to the free-rider possibility when the cost or time required to identify and patronize free-riding dealers is high.[120]

2. *Market penetration*. One of the common arguments supporting territorial restrictions holds that they increase market penetration.[121] A dealer or distributor may find that the profitability of serving various types of customers, or customers in different localities, varies because his costs of serving the customers vary. If he can spread his costs over all customers in a given area, he can afford to serve otherwise unprofitable, high-cost buyers. In effect, low-cost customers subsidize high-cost customers by paying for a disproportionate share of the jointly incurred costs of distribution. If intrabrand competition were permitted, however, some of the relatively more lucrative customers might shift to other dealers or distributors; the possibility of spreading distribution costs over a large number of outlets would decrease; and each distributor or dealer would sell to fewer customers.

Although this justification is both difficult to evaluate theoretically[122] and difficult to discount when raised in a particular case, it ap-

120. The cost of a product includes search costs, which encompass the cost of information about the product and the cost of time and transportation required to obtain the product. Stigler, *The Economics of Information*, 69 J. POLITICAL ECON. 213 (1961).

121. Pitofsky, *supra* note 5, at 18, indicates that this may be what the Supreme Court had in mind in *Sylvania* when it said that vertical nonprice restraints allow the manufacturer to attract dealers who will make "the kind of investment in capital and labor that is often required in the distribution of products unknown to consumers." 433 U.S. at 55. The classic statement of the market-penetration argument was made in Preston, *supra* note 23, at 511. *See also* Warren, *Economics of Closed Territory Distribution*, 2 ANTITRUST L. & ECON. REV. 111 (1968).

122. *See, e.g.*, Comanor, *supra* note 22, at 1431:

> What is important is not whether these restrictions enhance market coverage or customer contact, for this they may well do, but rather whether restrictions of this character are likely to improve the competitive process through which resources are allocated to these activities. While society generally approves of improved market coverage, it also generally deplores higher dealer markups and higher costs of distribution. Whether the addi-

pears to be applicable only under several limiting conditions, namely that (1) the cost of selling to customers varies widely; (2) the cost of selling to some of the customers is so high that no sales could be made unless the cost could be shared among all customers; and (3) any invading dealer or distributor selling to low-cost customers would have no incentive to pick up additional sales by also selling to high-cost customers. Where these conditions are not met, it is unlikely that territorial restrictions can be used to increase market penetration.

3. *Increasing investment*. As a corollary to the dealer-services theory, it is sometime argued that intrabrand restrictions are justified because by reducing risk they increase capital investment by dealers; a manufacturer may in effect guarantee his dealers' investment in fixed and unmarketable assets by reducing the risks of loss from intrabrand competition.[123] Although the premise of this argument is true—decreasing risks will increase investment—the argument should be accepted only if the risks are created by a free-rider problem.

The general argument that the risks flowing from competition should be reduced in order to increase investment is, of course, antithetical to the notion of a competitive market. Absent a market failure like the free-rider problem, the proper amount of investment is that which reflects competitive risks and consumers' willingness to compensate for those risks. Inducing a greater amount of investment misallocates resources by drawing more resources into an industry than consumers desire. Thus, antitrust doctrine has never generally accepted the argument that private restrictions on competition can be justified as necessary to provide more investment, or, for that matter, more research or more technology, than the market provides.[124]

Nonetheless, the dealer-investment argument has validity in narrow circumstances. A dealer who agrees with the manufacturer to in-

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> tional gains are worth the additional costs is, of course, the essence of the problem of resource allocation—a problem whose solution we normally leave to the marketplace.

Id. (citations omitted). *See also Hearings on S. 2549 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 2d Sess. 1088 (1966) (statement of Donald F. Turner, then-Professor, Harvard School of Law). The market-penetration argument nonetheless has a strong free-rider aspect that should be considered: sales to less profitable accounts may have a promotional effect that benefits the invading dealer even though the invading dealer need not incur the cost of selling to those accounts.

123. *See, e.g.*, Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 55 (1977) ("new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer").

124. *See, e.g.*, United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 345 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954). *See also* Comanor, *supra* note 22, at 1428-29; Louis, *Vertical Distributional Restraints Under* Schwinn *and* Sylvania, *supra* note 10, at 296.

vest in fixed and unmarketable assets may want to protect that investment by ensuring that the manufacturer does not later undercut the bargain by himself competing with, or appointing a new dealer to compete with, the contracting dealer.[125] The manufacturer assumes, in this respect, the same position as the seller of a business who transfers the good will of the business to the buyer—they are both possible free-riders because they both have the possibility of profiting from an exchange while denying the fruits of that exchange to the other party.[126]

This consideration, however, justifies only restrictions on the manufacturer's freedom. The manufacturer's promise is reasonably necessary to ensure that he cannot appoint a dealer, have the dealer develop the territory, and then render the dealership valueless by himself competing, or by appointing a new dealer, in that territory. The same considerations hardly justify a manufacturer in protecting an appointed dealer from competition with pre-existing dealers, because the appointed dealer takes his dealership subject to the risks of competition. Unless the restriction keeps the manufacturer from purposefully undercutting the good will the dealer develops, the restriction is unnecessary to induce the proper amount of dealer investment and should therefore be unlawful.

4. *Quality and safety*. Even under the *Schwinn* per se rule courts accepted the argument that intrabrand restrictions might be necessary to maintain product quality or to promote safety;[127] doubtless, after *Sylvania* the courts will continue to do so. When a product can be safely used only by professionals, a manufacturer should be allowed to restrict distribution to professionals. When product quality diminishes with shipping time, a manufacturer should be allowed to restrict the shipping distance of the product.

The quality or safety argument sometimes includes, however, the assertion that intrabrand competition would take away the profits that dealers need in order to foster quality. In defending its territorial re-

125. *See Hearings on S. 598 Before the Subcomm. on Antitrust, Monopoly and Business Rights of the Senate Comm. on the Judiciary*, 96th Cong., 1st Sess. 31-43 (1979) (statement of Victor P. Goldberg, Professor of Economics, University of California at Davis).

126. *See* National Soc'y of Professional Eng'rs. v. United States, 435 U.S. 679 (1978); Mitchell v. Reynolds, 24 Eng. Rep. 347 (ch. 1711).

127. *See* Cooper Liquor v. Adolph Coors Co., 506 F.2d 934 (5th Cir. 1976); Tripoli Co. v. Wella Corp., 425 F.2d 932 (3d Cir.) (upholding a restriction to professional use only), *cert. denied*, 400 U.S. 831 (1970); Mitchell v. United States Surgical Corp., 1976-1 Trade Cas. ¶ 60,879 (S.D. Ohio 1976) (upholding territorial restrictions said to ensure prompt service); Sulmeyer v. Seven-Up Co., 411 F. Supp. 635, 642 (S.D.N.Y. 1976). *See also* Adolph Coors Co. v. FTC, 497 F.2d 1178 (10th Cir. 1974), *cert. denied*, 419 U.S. 1105 (1975). In *Sylvania*, the Court expressly recognized the validity of cases like *Tripoli*. 433 U.S. at 55 n.23.

straints on bottlers, for example, the Coca-Cola Company argued that its restrictions increased market penetration and thereby permitted bottlers to ensure the proper inventory turnover at each store.[128] Without the territorial restriction, the company argued, market penetration would have been diminished, some chain stores would have taken delivery at central warehouses, and bottlers could no longer have ensured that their inventory was properly turned over. To the contrary, however, because the market normally induces all dealers to maintain their product quality and thus ensure repeat purchases, such arguments should be accepted with caution; they should be successful only when the possible anticompetitive effect of the restraint is minimal, when the need for dealer services or market penetration is a likely explanation,[129] and when quality cannot be maintained by contractual obligations.

IV. Conclusion

The failure of antitrust law to provide a workable, coherent, and settled doctrine applicable to intrabrand restrictions reflects inadequate understanding of the economics of the subject. Economic analysis usually assumes that intrabrand restraints directly increase manufacturers' profits only when imposed by a manufacturers' cartel and assumes that otherwise they increase dealer margins, either in response to a dealer cartel or in an attempt to increase dealer services. Although each of these explanations is valid under some circumstances, they each miss an important alternative explanation: the competitive-advantages theory. That theory states that a manufacturer profits directly from intrabrand restrictions when they enable him to keep his price to dealers higher than would otherwise be possible. With active intrabrand competition, the dealers' profitability on a particular brand decreases and the manufacturer can be forced to lower his wholesale price to compensate for his brand's lower profitability in the retail market. Without active intrabrand competition, the manufacturer can maintain higher wholesale prices. Restraints imposed under the competitive-advantages rationale decrease consumer welfare and are unjustifiable.

The competitive-advantages rationale helps make antitrust doctrine coherent by showing that the Supreme Court in *Sylvania* correctly

128. *See, e.g.*, *In re* Coca-Cola Co., 91 F.T.C. 517 (1978). The Federal Trade Commission rejected the argument, finding that to achieve its quality-control objectives, the Coca-Cola Company could "establish reasonable quality control standards for distribution and storage, including inventory rotation policies, and may further require that each bottler identify itself on the bottle, bottle cap, or on the can so that [Cola-Cola] may reasonably monitor compliance with its quality standards." *Id.* at 634.

129. See text accompanying notes 118-22 *supra*.

distinguished resale price maintenance from nonprice intrabrand restraints. The dealer-services theory never explains resale price maintenance, because resale price maintenance does not solve the free-rider problem and therefore cannot induce desirable services. Resale price maintenance can be explained only by the competitive-advantages rationale, or by a cartel rationale, so that the per se rule prohibiting resale price maintenance is fully justified.

By contrast, nonprice restraints may overcome a free-rider problem with little anticompetitive effect; they may be explained either by the dealer-services or the competitive-advantages rationale. Courts should therefore analyze nonprice restraints under the rule of reason to determine which rationale better explains the case at hand.