Marquette Law Review

Volume 51
Issue 3 *Winter 1967-1968*

Article 11

Validity of Vertical Restraints

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Validity of Vertical Restraints: Territorial and customer limitations imposed by manufacturers have been the subject of litigation since the turn of the century.[1] But it was not until 1962, in the case of *White Motor Co. v. United States*,[2] and finally and more definitely in *United States v. Arnold, Schwinn and Co.*[3] decided in June of 1967 that the business world received a Supreme Court ruling on the validity of these limitations in light of Section I of the Sherman Act.[4]

The history of the restrictions involved in *Schwinn* found their origin in a distribution program initiated in 1952. Schwinn instituted a program approving only certain retail outlets as franchised dealers. The franchised dealer was free to carry other brands of bicycles, but was limited in that he could only purchase Schwinn bicycles from the distributor authorized to serve the area. He could sell only to individual customers, and could not act as a wholesaler. Schwinn authorized twenty-two distributors to handle its bicycles, and assigned a specific territory to each. They were permitted to sell only to franchised dealers within their respective territories. Schwinn either sold the bicycles to the distributors who in turn sold them to authorized dealers, or more frequently, sold directly to the retailer with the distributor acting as an agent for Schwinn in arranging the sale.

In the District Court[5] the United States instituted suit against Schwinn and alleged price fixing and *per se* violations of the Sherman Act based on Schwinn's allocation of exclusive territories to wholesalers, and customer restrictions on both the retail and wholesale level. The District Court, after lengthy analysis of the distribution program, rejected the charge of price fixing and held that only the territorial restrictions were unlawful *per se* where *Schwinn* sold bicycles to its

[1] With respect to territorial restraints, *see e.g.*, Phillips v. Iola Portland Cement Co., 125 Fed. 593, 595 (8th Cir. 1903), *cert. denied*, 192 U.S. 606 (1904); Boro Hall Corp. v. General Motors Corp., 124 F.2d 822, 823 (2d Cir. 1942), *rehearing denied*, 130 F.2d 196 (2d Cir. 1942), *cert. denied*, 317 U.S. 695 (1943); Pratt v. Marean, 25 Ill. App. 516, 520 (1880); Johnston v. Franklin Kirk Co., 83 Ind. App. 519, 148 N.E. 177 (1925); Revlon Prods. Corp. v. Bernstein, 204 Misc. 80, 119 N.Y.S.2d 60 (Sup. Ct. 1953), *aff'd.* 285 App. Div. 1139, 142 N.Y.S.2d 364 (1955); Thomas v. Belcher, 184 Okla. 410, 87 P.2d 1084 (1939); McConkey v. Smith, 112 Kan. 560, 211 Pac. 631 (1923).
With respect to customer limitations, *see e.g.*, Chicago Sugar Co. v. American Sugar Ref. Co., 176 F.2d 1, 9 (7th Cir. 1949), *cert. denied* 338 U.S. 948 (1950); United States v. Newbury Mfg. Co., 36 F. Supp. 602, 605 (D.Mass. 1941); Authors & Newspapers Ass'n v. O'Gormon Co., 147 Fed. 616 (C.C. D. R.I. 1906); Morris v. Tuskaloosa Mfg. Co., 83 Ala. 565, 3 So. 689 (1887); Lampson Lumber Co. v. Caporale, 140 Conn. 679, 102 A.2d 875 (1954); Dick v. Sears-Roebuck and Co., 115 Conn. 122, 160 Atl. 432 (1932); Staebler-Kempf Oil Co. v. Mac's Auto Mart, Inc., 329 Mich. 351, 45 N.W.2d 316 (1951); Hickock Mfg. Co. v. Fairley Trading Corp., 117 N.Y.S.2d 874 (Sup. Ct. 1952); Colby v. McLaughlin, 50 Wash.2d 152, 310 P.2d 527 (1957).

[2] 372 U.S. 253 (1963.)

[3] 388 U.S. 365 (1967).

[4] 15 U.S.C. § 1 (1964). "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared illegal . . ."

[5] 237 F. Supp. 323 (N.D. Ill. 1965).

distributors. The Court held that the territorial restrictions were not unlawful where the distributor acts as an agent for Schwinn, and also held that customer restrictions were lawful whether incident to sale or agency situations.

On appeal to the Supreme Court, the United States abandoned its contention that the distribution limitations were illegal *per se* and instead asked the Court to consider these limitations in light of the "rule of reason." In the majority opinion written by Mr. Justice Fortas, the Court ignored the prayer for a ruling on the reasonableness of the restrictions, and adopted a potent *per se* ruling, holding that all restrictions that Schwinn placed on its distributors and retailers, as to both territorial and customer restrictions once Schwinn had passed title were illegal *per se*. As to those arrangements in which the distributor acts merely as an agent for Schwinn, the Court held that these limitations would be viewed in the light of the "rule of reason" and concluded that in this case they were reasonable.

The impact of the Schwinn decision can be appreciated only upon examination of the guidelines the Court has employed in the past in deciding cases under Section I of the Sherman Act. Section I finds its historical antecedents in the early English law. While the common law did not approve of contracts by which a man agreed not to practice his trade,[6] it did not absolutely forbid all restraints of trade. In the 1711 case of *Mitchell v. Reynolds*,[7] and later in *Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co.*,[8] the English Courts, applying a flexible rule of reason, held that if a restraint was fair and reasonable it would be viewed as legal. In 1911, in the case of *Standard Oil of New Jersey v. United States*,[9] the Supreme Court adopted and incorporated the common law approach to restraints of trade in interpretation of Section I. The Court concluded that if the restraint were restrictive of competition it was illegal, but that this finding would always be open to a showing that the restriction was reasonable in light of particular economic circumstances. In essence, Section I prohibited only limitations that were unreasonably restrictive. Justice Brandeis, in *Chicago Board of Trade v. United States*,[10] gave form to the concept of reasonableness:

> Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its

[6] Case of John Dyer, Year-Book 2 Hen. V, 5B (1414).
[7] 24 Eng. Rep. 347 (Ch. 1711).
[8] [1894] A.C. 535.
[9] 221 U.S. 1, 51 (1911).
[10] 246 U.S. 231 (1918).

> 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.[11]

Incorporation of the rule of reason into Section I of the Sherman Act, coupled with an increasing number of cases in which the defendent attempted to justify his restraints in light of particular economic facts and conditions,[12] forced the Court to adopt a new rule in determining the validity of restrictions placed on the buyer. If upon examination of the economic background of certain limitations the Court found the limitation to be inherently restrictive of competition, the Court would declare this type of restraint to be a per se violation of Section I of the Sherman Act.[13] The *per se* rule was explained in *Northern Pac. Ry. v. United States.*[14]

> [T]here are certain agreements or practices which because of their pernicious effect on competition and lack any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.[15]

Included among the practices that the Court regards as *per se* violations of the Sherman Act are vertical and horizontal price fixing,[16] group boycotts[17], and tying arrangements.[18]

Beginning in 1949, vertically[19] imposed territorial and customer restrictions came under the scrutiny of the Federal Trade Commission.[20] The FTC, relying on dicta in *United States v. Bausch & Lomb Optical Company,*[21] declared it viewed such restrictions as *per se* violations of

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[11] *Id.* at 238.
[12] Grover, *Control of Sales,* 11 ANTITRUST BULLETIN, 439, 444 (1966).
[13] Elman, *"Petrified Opinions" and Competitive Realities,* 66 COLUM. L. REV. 625, 626-627 (1966).
[14] 356 U.S. 1 (1958).
[15] *Id.* at 5.
[16] Vertical price fixing, *see, e.g.,* Dr. Miles Medical Co. v. John D. Park and Son Co., 220 U.S. 373 (1911); United States v. Parke, Davis & Co., 362 U.S. 29 (1960).
Horizontal price fixing, *see, e.g.,* United States v. Trenton Potteries Co., 273 U.S. 392 (1927); United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940).
[17] Silver v. New York Stock Exchange, 373 U.S. 341 (1963); Radiant Burners, Inc. v. Peoples Gas, Light & Coke Co., 364 U.S. 656 (1961); Klor's Inc. v. Broadway Hale Stores, Inc., 359 U.S. 207 (1959).
[18] United States v. Loew's, Inc., 371 U.S. 38 (1962); Northern Pacific Ry. v. United States, 356 U.S. 1 (1958); International Salt Co., v. United States, 332 U.S. 392 (1947).
[19] Vertical restrictions are restraints that flow down the chain of distribution having their origin in the manufacturer. Horizontal restrictions occur at a particular level in the distribution scheme, *e.g.,* distributors joining together to limit territories.
[20] *See Hearings on H. R. 2688 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce,* 84th Cong., 1st Sess. 89, 362 (1955).
[21] 321 U.S. 707, 721 (1944). "Soft-Lite is the distributor . . . It sells to whole-

Section I. Through consent decrees "without ever having to subject its legal theory to judicial scrutiny,"[22] the FTC consequently won many cases against manufacturers who employed such restraints.[23] The 1962 case of *White Motor Company v. United States*[24] was the first case to reach the Supreme Court in which these restrictions were in issue. White did not enter a consent decree, and while the District Court[25] by summary judgment sustained the position of the United States that such vertically imposed territorial and customer restrictions were illegal *per se,* on appeal the Supreme Court refused to affirm summary judgment. The Court also refused to decide on the validity of the restrictions in question holding that such issue should be determined only after a trial; but the Court did comment on the limitations in question. As to the restrictive effect of the territorial restraints, Mr. Jusice Douglas writing for the majority said:

> We do not know enough of the economic and business stuff out of which these arrangements emerge to be certain. They may be too dangerous to sanction or they may be allowable protection against aggressive competitors or the only practical means a small company has for breaking into and staying in business [citations omitted] and within the "rule of reason." We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a "pernicious effect on competition and lack any redeeming virtue" [citation omitted] and therefore should be classified as per se violations of the Sherman Act.[26]

In a concurring opinion, Mr. Justice Brennan also showed reluctance to adopt a *per se* ruling because of the lack of information on the competitive effect of such restrictions. He stated:

> To gauge the appropriateness of a per se test for the forms of restraint involved in this case, then, we must determine whether experience warrants, at this stage, a conclusion that inquiry into effect upon competition and economic justifications would be similarly irrelevant. With respect to the territorial limitations of

salers at prices satisfactory to itself. Beyond that point it may not project its power over the prices of its wholesale customers by agreement. A distributor of a trade-marked article may not lawfully limit by agreement, express or implied, the price at which or the persons to whom its purchasers may resell . . . The same thing is true as to restriction of customers." *See also,* Robinson, *Restraints on Trade and The Orderly Marketing of Goods,* 45 CORNELL L. Q. 254, 265 (1960).

[22] Handler, *Recent Anti-Trust Developments,* 112 U. PA. L. REV. 159, 161 (1963).

[23] United States v. Lone Star Cadillac, TRADE REG. REP. (1963 Trade Cas.) ¶ 70739 (N.D. Tex. May 10, 1963); United States v. Sperry Rand Corp., TRADE REG. REP. (1962 Trade Cas.) ¶ 70495 (W.D.N.Y. 1962); United States v. Shaw-Walker Co., TRADE REG. REP. (1962 Trade Cas.) ¶ 70491 (W.D.N.Y. 1962); United States v. Spring-Air Co., TRADE REG. REP. (1962 Trade Cas.) ¶ 70402 (N.D. Ill. 1962); United States v. Dempster Bros., TRADE REG. REP. (1962 Trade Cas.) ¶ 70359 (D. Tenn. 1962).

[24] 372 U.S. 253 (1963).

[25] 194 F. Supp. 562 (N.D. Ohio 1961).

[26] 372 U.S. 253, 263.

> the type at bar, I agree that the courts have as yet been shown no sufficient experience to warrant such a conclusion.[27]

White Motor was the last case on the subject of vertically imposed territorial and customer restrictions before *Schwinn* was decided in June of 1967.

In *Schwinn,* contrary to the posture of the Court in *White Motor,* the Court adopted a *per se* ruling which held that all restrictions imposed after title had passed from Schwinn to its distributors or retailers were illegal. In the agency arrangements, the Court in applying the "rule of reason" held such limitations to be reasonable and not restrictive of competition because (1) other competitive bicycles are available to distributors and retailers in the market place, (2) Schwinn distributors and retailers handle other brands of bicycles as well as Schwinn, (3) the Court found no infection of the vertical restraints by price fixing and (4) competition made necessary the challenged program.

The Schwinn decision does essentially three things. It departs from the usual method of arriving at a *per se* ruling; it sets up an artificial distinction between sale and agency arrangements and treats each differently; it ignores the economic realities of the environment in which the restraints are found.

Where the Court has applied the *per se* rule to other marketing practices, it has done so only after repeated examination of the economic conditions indicated that the practice was inherently restrictive of competition.

> . . . in deciding whether to place a practice in the per se illegal class, we ask whether actual experience over the years has demonstrated that the practice is so harmful and without redeeming virtue as to warrant forbidding it across the board, without consideration of its particular effects in every case . . . [P]er se rules are not drawn out of thin air; they are the product not of abstract theory but of practical experience and market realities.[28]

The Court made no finding that the restrictions in *Schwinn* were anticompetitive in nature and without redeeming value. Instead the Court based its *per se* ruling on (1) the ancient common law rule against restraints on alienation (without realizing that this ancient rule was never exclusive in nature and that the common law did allow restraints that were reasonable and fair;[29]) and (2) an attempt to make consistent the District Court ruling that if territorial restrictions in sale situations were illegal, then all restrictions in situations where title

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[27] *Id.* at 265.

[28] Elman, *supra* note 13, at 626-627.

[29] *See* Letwin, *English Common Law Concerning Monopolies,* 21 UNIV. OF CHICAGO L. REV. 355, 373 (1954). *See also,* Jordan, *Exclusive and Restricted Sales Areas Under the Antitrust Laws,* 9 UCLA L. REV. 111, 132 (1962).

passes should be considered illegal. But the majority opinion in *Schwinn,* as pointed out by Mr. Justice Stewart in his partially concurring and partially dissenting opinion,[30] overlooks the fact that the illegality that the District Court found in regard to territorial restrictions was not vertical in nature but a horizontal conspiracy among the distributors. In so ruling this to be *per se* illegal,[31] the District Court was simply following precedent.[32] The Supreme Court though, in its decision, viewed the restrictions under consideration in a different light. "[W]e are dealing here with a vertical restraint embodying the unilateral program of a single manufacturer."[33] Consequently, the Supreme Court's attempt to make consistent the lower court's decision as a basis of its *per se* ruling is on as tenuous a ground as its reliance on a misinterpreted rule of law.

Primary to the Supreme Court's decision is the distinction it draws between sale and agency arrangements used in Schwinn's distribution program applying to the former, the *per se* illegal rule, and to the latter, the "rule of reason." The Court fails to show that the restrictions in the sale situations are somehow more anti-competitive than the restrictions accompanying the agency relationship. The Court also fails to show why the four reasons used to sustain the reasonableness of the restrictions where the distributor acts as an agent for Schwinn cannot be used to sustain the restrictions in situations where Schwinn passes title.

By contrast to the importance the Supreme Court placed on the notion of sale, the District Court held that in relation to customer restrictions, there was no sale in the usual sense of the word when Schwinn passed title to its distributors. The ". . . sale is not made to the distributors for use but as an intermediate step to the retailer who sells to the public."[34]

In stressing the form of the arrangement rather than analyzing its impact in terms of competitiveness, the Court overlooks the position it took in *Simpson v. Union Oil Company*[35] which dealt with the refusal of consignees to maintain suggested prices.

[30] 388 U.S. 365, 390 (1967).
[31] 237 F. Supp. 323, 342 (N.D. Ill. 1965).
[32] Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951).
[33] 388 U.S. 365, 378 (1967).
[34] 237 F. Supp. 323, 334 (N.D. Ill. 1965).
[35] 377 U.S. 13 (1964). The Court in *Simpson* stated that it was not going to allow a drafting device to control the outcome of the case. *Simpson* dealt with a consignment arrangement, as opposed to the agency and sale situations found in *Schwinn.* Through coercion, consignee in *Simpson* were required to sell at prices specified by the consignor. There are important factual differences between the two cases, namely the coercive element in *Simpson* along with the particular restraint involved, price maintenance. Nontheless it appears that the Court in *Schwinn,* in upholding the restrictions in the agency arrangements simply because title did not pass is receding from its position in *Simpson* which held that the effect of a restraint on competition would be analyzed regardless of whether there had been passage of title or not.

> To allow Union Oil to achieve price fixing in this vast distribution system through this "consignment" device would be to make legality for anti-trust purposes turn on clever draftsmanship. We refuse to let a matter so vital to a competitive system rest on such easy manipulation.[36]

Lastly, in restricting the manufacturer's voice in marketing practices after title has passed to the distributor or retailer, the Court's decision fails to consider the economic background out of which these vertical restrictions arise. Basing a decision on an old common law principle may provide an expedient way to decide a case, but it decidedly raises the question of the relevancy of the decision to today's business world. A cursory examination of today's marketing practices indicates that the 20th century manufacturer, unlike his 17th century counterpart, has a vital interest in the marketing of his goods, notwithstanding the type of distribution arrangement employed. The manufacturer promotes and advertises his product directly to the public. It is the manufacturer who will be held responsible if the product is defective, and in certain products like bicycles, where qualified service and sale of parts play an important role in a total sales program, the manufacturer has a real interest in providing his ultimate customers with responsible sales outlets.[37]

> . . . it is nonsense to say that it is none of the manufacturers business how his product is marketed to the consuming public; that once he parts with legal title when he sells to a wholesaler or retailer, he has lost the right to participate in the marketing of his product to the consumer. Today's manufacturer not only has that right, but exercises it all the time; and he does so because he is competing, as he must and should, with manufacturers of rival products and brands.[38]

It is unfortunate that the Court adopted a *per se* ruling declaring illegal any restrictions imposed vertically once title passes. In so holding the Court overrules the only case on point, *White Motor*.[39] *White* held that vertical restrictions must be tested under a "rule of reason," analyzing their actual impact in a competitive context.[40] Justice Stewart, in his partially concurring and partially dissenting opinion in the *Schwinn* case states that:

> . . . we have not yet in the short interim accumulated sufficient new experience or insight to justify embracing a rule automatically invalidating any vertical restraints in a distribution system, based on sales to wholesalers and retailers.[41]

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[36] *Id.* at 24.
[37] Elman, *supra* note 13, at 630.
[38] *Id.* at 630-31.
[39] 388 U.S. 365, 388 (1967).
[40] 372 U.S. 253, 263 (1963).
[41] 388 U.S. 365, 389 (1967).

In fact, in the cases that arose in the four year period between *White Motor* and *Schwinn,* the lower courts, applying the "rule of reason" have permitted vertical restraints where there was economic justification and the restraints did not in fact unduly restrict competition.[42]

Hopefully the Court will review the position it has taken in *Schwinn* and apply the test of reasonableness to situations where a manufacturer employs vertical restrictions and passes title to his distributors and retailers until examination of these restrictions proves them to be anti-competitive in nature and without redeeming value, and truly deserving a *per se* illegal ruling.

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Bradley v. State: The Morgue and Voluntariness: The police started questioning Sherry Bradley about the murder of her two infant children at 2 a.m. She was taken to the Safety Building at about 3 a.m. For the next four and a half hours there was a police officer with her at all times, although there were substantial periods when she was not being questioned. At 7:30 a.m. she was taken to the morgue to see the bodies of her two strangled children. This apparently had an intense emotional impact for she threw herself on the examination table and was allowed to lay with the dead bodies for thirty-five minutes. Her confession, however, was not made until approximately 2 p.m. In that interval she was allowed some respite from interrogation and visited with her husband and a minister.

The trial court denied a motion to exclude the confession as involuntary. On review the question of voluntariness was actually twofold; first, whether the view in the morgue constituted psychological coercion and second, whether the confession was far enough removed in time to cure the defect. The Wisconsin Supreme Court affirmed the lower court decision and held that the confession was voluntary and admissible in evidence.

In considering the view of the bodies in the morgue as psychological coercion the Wisconsin Supreme Court said:

> We cannot, however, condone the conduct of the police in taking this girl of eighteen to the morgue to view her strangled babies. Counsel, during oral argument, found it impossible to defend this reprehensible conduct. The visit had no legitimate police purpose. There was no question of identification that might have required the mother to see these children.[1]

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[42] *See, e.g.,* Sandura Co. v. FTC, 339 F.2d 847 (6th Cir. 1964); Snap-on Tools Corp. v. FTC, 321 F.2d 825 (7th Cir. 1963); C.B.S. Business Equipment Corp. v. Underwood Corp., 240 F. Supp. 413 (S.D. N.Y. 1964); United States v. Penn-Olin Chem. Co., 217 F. Supp. 110 D. Del. (1963), *rev'd on other grounds,* 378 U.S. 158 (1964).

[1] Bradley v. State, 36 Wis. 2d 345, 356, 153 N.W.2d 38, 42-43 (1967).