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# Vertical Restraints and the *Schwinn* Doctrine: Rules for the Creation and Dissipation of Economic Power

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*The Supreme Court's rules on vertical restraints and in particular, the rules promulgated in the* Schwinn *case, have been the subject of much critical commentary. By synthesizing static and dynamic theory, the author develops an economic framework with which to analyze vertical restraint law. He propounds three criteria, incorporating static and dynamic considerations, which provide a basis for vertical restraint rules.*

## I. INTRODUCTION

IN THE DECADES since the enactment of the Sherman Act,[1] the nation's economy has undergone massive growth and dramatic change. In few ways have this growth and change been more apparent than with regard to the systems by which goods are distributed. The radical changes in transportation, as well as those in production and sales technologies, have made possible methods and systems of distribution undreamed of at the turn of the century.

Coincident with the changing economy, economic theory has undergone marked change. Traditional theories based on premises of "pure" competition[2] have been supplemented by newer the-

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1. An Act to Protect Trade and Commerce against Unlawful Restraints and Monopolies, 15 U.S.C. § 1 (1970), enacted July 2, 1890.

2. Pure competition exists where there are many sellers of fungible products so that no producer has a large enough share of the market to have any control over price. *See* P. SAMUELSON, ECONOMICS 482 (9th ed. 1973).

ories based on premises of "monopolistic" competition.[3] The theories of Adam Smith and Alfred Marshall[4] have been joined by those of Chamberlin and Robinson.[5] Schumpeter and J. M. Clark[6] have also exerted significant influence with their criticism of an assumed, long-run equilibrium state in which demand and technology were fixed as a theory which does not provide a productive framework within which to deal with the observable economic world which is, in fact, a dynamic place with little equilibrium. Thus, the tools of economic theory are no longer limited to those constructed to analyze efficiency in a long run static equilibrium, but now also include those which provide different and more relevant perspectives on economic policy problems.

The tools of economic analysis are useful and perhaps indispensable, in the effort to explain economic activity. Economic theories and models are tools of analysis; they are not answers. These tools must be used in ways that are consistent with their assumptions and purposes. A model may serve as a good predictor of future events even if it rests on a very bad description of how events occur.[7] Such a model, however, cannot guide a policymaker because it will not direct him to relevant, real-world relationships.

Using economic analysis to explain or evaluate the basis for antitrust rules and policy requires recognition of the assumptions on which a model is built: what is assumed about the goals of firms, their knowledge, the state of technology, demand, and entry conditions. The results of such a theory will be, or at least should be, consistent with its assumptions. Hence, if the object of legal concern is a given in the model, the model will be of little help. Similarly, if the model takes something, *e.g.*, technology, as a given or treats it as an independent variable, then the outcome may have only limited implication for a world in which that aspect is a dependent variable. It is therefore important to understand whether a model is trying to describe how change occurs or what will happen if a change occurs outside of the model. Finally, the model

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3. Monopolistic competition exists where many individual sellers face their own nonhorizontal demand curves and thereby have some measure of control over price. *Id.* at 483.

4. *See* A. SMITH, WEALTH OF NATIONS (1776); A. MARSHALL, PRINCIPLES OF ECONOMICS (1898).

5. E. CHAMBERLIN, THEORY OF MONOPOLISTIC COMPETITION (1947); J. ROBINSON, IMPERFECT COMPETITION (1933).

6. J. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (1934); J. CLARK, COMPETITION AS A DYNAMIC PROCESS (1961).

7. M. FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS 3-46 (1953).

may describe and explain events or advocate a policy required by its theoretical underpinnings. Economics suffers from frequent confusion in the shift between a descriptive model of a hypothetical case, *e.g.*, pure competition, and the prescriptive conclusion that all activity inconsistent with that model is undesirable.[8]

As economic analysis has developed and evolved, so too have the policies and theories underlying the antitrust proscriptions. In few areas has this been more manifest than in the area of vertical restraint law. From its relatively simple beginnings in *Dr. Miles Medical Co. v. John D. Park & Sons, Co.*[9], with its "thou shalt not" proscription of vertical price fixing, a series of rules and exceptions has led inexorably to the complex and, to some, confusing rules of *United States v. Arnold, Schwinn & Co.*[10] For those commentators whose theoretical perspective is grounded in static economic theory, the case law development has appeared to be without a theoretical explanation. As Professor Posner has written,

> for several generations the Supreme Court has been deciding restricted distribution cases without any theory *at all* as to why manufacturers restrict distribution.[11]

Given the theoretical perspective of commentators such as Posner, this perception of confusion is not without merit. But if a framework includes dynamic economic theory which explains the problem of change, innovation and power in the marketplace, then the policy underpinnings of vertical restraint law become perceptible. It is the purpose of this article to suggest what such a framework might be and how it could alter the perception of the case law.

The article first develops the economic theory necessary to understand the case law. After a brief discussion of the distribution systems which the theory must explain, static economics is discussed and placed in the context of a dynamic economy and dynamic theory. The second part of the article reviews the development of the case law and its fit with the static-dynamic theoretical framework. The final section evaluates this framework and the case law, showing the utility and intelligibility of the Court's ap-

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8. This is the basis of much of J. M. Clark's criticism of the use of models of "perfect" competition. J. CLARK, *supra* note 6, at 471-76 (1961).

9. 220 U.S. 373 (1911).

10. 388 U.S. 365 (1967).

11. Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L.REV. 282, 285 (1975).

proach in resolving contemporary legal-economic problems in a world with both static and dynamic constraints.

This article does not develop a detailed economic model. Rather, it is a suggestion for and outline of a framework in which to fit vertical restraint law. Doubtless, more work can and should be done in refining the framework and its application; the aim here is to open the door and point the way for what may be a far more fruitful mode of analysis than that which most lawyer-economists seem to have applied.[12]

## II. VERTICAL RESTRAINTS: THE LAW, ECONOMICS, AND THE MARKETPLACE

All distribution systems have been altered by the changes in transportation, communications, and the producer-distributor structure. In an early suit dealing with resale price fixing, Dr. Miles Medical Company alleged that it used newspapers, pamphlets, handbills and, most importantly, druggists to promote its goods at the point of sale.[13] Today, as Miles Laboratories, the altered corporation employs radio and television advertisements together with printed media, with little reliance on point-of-sale persuasion.[14] The introduction of radio and television as selling media,[15] together with the growing sophistication of advertising itself,[16] has transformed the whole selling process of many goods since the customer can now be presold.[17] The ability to presell has mark-

12. This article presents a different and, it is hoped, more useful way to evaluate the economic environment in which legal rules dealing with economic power must operate. The discussion does not present a rigorous model or theory, nor does it work out all the implications of the suggested framework. This article is, at best, a first approximation.

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

14. Miles Laboratories' products include Alka-Seltzer, Alka-Seltzer Plus, Miles Nervine, One-A-Day Vitamins, Chocks Vitamins, Chocks Bugs Bunny Vitamins, Bactine Antiseptic, Alka-2 and S.O.S. Scouring Pads. MOODY'S INVESTOR SERVICE, INC., MOODY'S HANDBOOK OF COMMON STOCKS (1975). Miles was the 52nd largest advertiser in 1974 spending a total of $43 million on all media. ADVERTISING AGE, Aug. 18, 1975, at 156-57. Miles ranked eighth among drug and cosmetic producers. *Id.* at 32. It was 25th among all T.V. spot advertisers. *Id.* at 106.

15. Radio advertising appeared only in the late 1920's and television was not widely available until the 1950's. The evolution of these media transformed product promotion and sale. For the first time, sellers had an alternative to dependence on local retail promotion.

16. Advertising agencies themselves are primarily a product of the last half-century. This period also saw a significant advancement in social science understanding of how and why people respond to advertising. *See* V. PACKARD, THE HIDDEN PERSUADERS (1957).

17. Preselling works most effectively with impulse and convenience items. W. SCHULTZ, AMERICAN MARKETING 52-54 (1961). As a product becomes more

edly reduced the importance of the final sales location as a place for persuasion, making it, in many cases, little more than a dispenser of a product with a preexisting demand. Advertising thus transfers power from the final seller to any entity in the distribution chain with the requisite size to engage in such promotion.

Promotional changes are not the only changes in distribution over the years. New types of retail institutions have also emerged. Department stores now divide a large facility into many specialized departments and thereby achieve certain economies of scale both in buying and in retailing in addition to the advantages of specialization. Multistore buying units have also evolved in order to take advantage of volume purchases and have opened the way for the creation of their own brand-name products.[18] Still another remarkable change has been effected by shopping centers in which the organizational function of collecting a complementary group of retailers is undertaken by a promoter who is not a retailer at all.

The alterations at the intermediate level of distribution, wholesaling, are less visible but no less radical. Historically, wholesalers were that part of the distribution chain where the wide inventory of goods needed to serve some class of retailers was assembled.[19] These goods came primarily from small manufacturers and went to small retailers. As both retailers and manufacturers grew, however, they discovered and developed ways to handle these functions that did not require the intermediary wholesalers: direct selling to retailers; producer downstream integration into retailing; and distributor upstream integration into production. The role of the wholesaler in contemporary distribution can be broken down into various specific functions: storage and delivery, order-taking, billing and collecting, and, of course, selling. From a more or less monolithic system, wholesale activity has become more specialized, with particular emphasis on functional activities. This, in turn, has altered the relationships of the participants, producing further dynamic pressures on the distribution system.

External factors have also altered the relationships within the distribution system. Perhaps the most dramatic factor has been the development of trucks capable of delivering products anywhere

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complex and involves more choices and options, the final selling activity increases in importance even though the customer is substantially presold. *Id.* at 54-56.

18. Buying groups which are commonly owned, such as Sears and Penney's, have encountered few problems as a result of such efforts, but if they are joint ventures among independent retailers, such control can produce problems. *See* United States v. Topco Associates, 405 U.S. 596 (1972).

19. J. PALAMOUNTAIN, THE POLITICS OF DISTRIBUTION 18 (1955).

that usable highways exist, thereby extending the range and scope of many competitive and distributive activities.

Despite all these changes, three basic techniques of distribution remain: vertical integration, independent contracts for a variety of specific services, and the use of independent distributors. None of these methods of distribution necessarily excludes the use of the others. Rather, producers are far more likely to use a combination of the three: their own employees, some services such as warehousing or transportation provided by contractors, and delegation of some of the responsibility for ultimate distribution to independent distributors. Hence, distribution is far more a matter of mixing the three methods to achieve an efficient system of product dissemination than it is a matter of selecting a method.[20]

In considering the distribution process, it is critical to observe that inherent in both vertical integration and the use of contract services is the necessity for producer control and direction over the conduct of the employee or contractor providing the service. Control is not essential to distribution activity carried on by an independent business entity. Independence is a functional and relative concept; it means here that a business can function independently in distributing and reselling a good or service. Thus, a producer can sell to an independent distributor, such as a hardware store, some light bulbs fully expecting the shopkeeper to resell them. He cannot expect an employee such as a salesman to perform unless given directions which might include the identities of prospective purchasers, geographic areas of coverage, and price schedules. Similarly, an independent contractor, such as a trucker, providing a specific service in relation to the distribution of some product only acts pursuant to direction. Since this element of producer control or direction over employees or contractors is essential, no legal system can absolutely outlaw it.[21]

20. If a producer deals with a few buyers who buy in large lots, or if the producer, like many traditional craftsmen, makes goods, *e.g.*, shoes, only for direct sale in his own shop, the process of distribution is very simple. The need for an elaborate distribution system results from two factors. First, distribution must become more complex as the number and geographic dispersion of buyers increases and their level of use declines or becomes less predictable. Second, as consumers become more convenience-oriented and desire to obtain a product simultaneously with a variety of related products, the producer's system must be able to get its product to retail outlets to meet this demand. Only a sophisticated distribution system will achieve an adequate dispersion of the product or a proper mix with related items. As a general proposition, the more dispersed and complex the final market, the more likely the producer will be to employ independent businesses in its distribution, as a way to maximize distribution while minimizing costs.

21. As a practical matter it may be difficult to distinguish between some contract services and independent distribution. Is a "sales agent" an independent business-

Producer control is not inherent in the producer-independent relationship and thus any restraint on independent distributors has to rest on an agreement by such a distributor to be restrained. Such agreements, absent unlawful conspiracy, however, are only enforceable if the law deems them to be. Hence, the legal system, and not inherent economic relations, will determine the scope of the right to enter into restrictive agreements. For this reason the law must, and has, focused on the relationship of producer and independent distributor. It is the need for a coherent policy on which to base rules on vertical restraints which justifies a detailed examination of the economic aspects of the situation.

For vertical restraint of independent distribution to be feasible, substantial deviation from pure competition must exist. In pure competition, there are large numbers of producers making identical products. The prospect of buyers' substituting one firm's product for that of another induces firms to keep prices as low as possible and compels uniformity in price. Each firm perceives that external forces fix its prices and that its level of production will not affect price.[22] In such a world, control over independent distribution of the kind discussed here would be both impossible and pointless. It would be impossible because any effort to control the resale of one's product which is at all restrictive of, or contrary to, what a distributor wants to do with it would result in the distributor's substitution of an identical product. It would be pointless to seek to control distributor conduct because neither the producer nor the distributor could benefit from the control, given the existence of fungible substitutes. Competing distributors handling other producers' goods could serve the customers as well so that any price or other restraint which deviated from market conditions would be impossible. In short, lacking any power over the product, a producer has no ability and no reason to try to alter the conduct of independent distribution by means of restrictive agreements.

To make restraint possible or worthwhile, therefore, a producer must either have, or have the prospect of acquiring, some monopoly

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man who is distributing a product or is he merely providing a special service? This distinction may become more difficult if, rather than delineating the functions performed by various entities in a distribution system, it takes on legal significance. For example, if greater antitrust freedom exists for the control of contract services than for the restraint of independent distributors, it will make sense to try to make a controlled business look like a contract service. The problem is further compounded where the same entities are acting as both independent contractors and independent distributors.

22. R. LEFTWICH, THE PRICE SYSTEM AND RESOURCE ALLOCATION 22-46 (3d ed. 1966); F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 12-13 (2d ed. 1971).

power over its product.[23] The term monopoly is usually used in a pejorative rather than a descriptive sense. Monopoly or market power, in the sense of some control over a product's market, is not an uncommon feature of the economic landscape.[24] Indeed, some power over a product is probably more prevalent than is pure competition as a characteristic of industrial production.[25] Such power

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23. Of the several commentators on the problem of vertical restraints, only Preston makes this point forcefully. Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards*, 30 LAW & CONTEMP. PROB. 506, 518 (1965). *See also* Telser, *Why Should Manufacturers Want Fair Trade*, 3 J. LAW & ECON. 86 (1960).

To illustrate, the Sealy case involved a group of mattress producers making only a fairly modest portion of all mattresses in the United States. *United States v. Sealy, Inc.*, 388 U.S. 350 (1967). Several manufacturers combined to establish and promote a trade name for a standardized mattress, and arguably, restricted each other's competitive freedom with respect to these brands of mattresses to avoid free-rider problems. The Supreme Court held the restraints as drafted to be illegal.

Posner argues that nine Sealy members produced such a small portion of all mattresses that there could be no restraint of trade. Posner, *Antitrust Policy and the Supreme Court*, *supra* note 11, at 299 (1975). *See also* R. POSNER, ANTITRUST CASES, ECONOMIC NOTES, AND OTHER MATERIALS 225 (1974); Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 75 YALE L.J. 373, 428-29 (1966) [hereinafter cited as Bork, Part II]. This analysis equates Sealy mattresses with all mattresses, but if all mattresses were the same, there would be no reason for a few producers of a fungible product to band together to advertise and restrict each other's practices. The Sealy venture only makes sense if it is viewed as an effort by a group of producers to shift from making just mattresses to making a differentiated product: The Sealy mattress which had a differentiated demand which could only be satisfied by producers of the branded product. This analysis does not compel a conclusion that a court should or should not consider the presence of close substitutes, nor does it suggest that it should be unlawful for a group of producers to attempt jointly to differentiate a product. It does point out that the facts make no analytical sense unless it is understood that the goal of the venture was to create a differentiated product over which the participants would have a "monopoly." In fact, when Posner diagrams the effect of resale price maintenance, he shows its effect as being a new and declining demand curve for a product reflecting implicit acceptance of the differentiation hypothesis. R. POSNER, ANTITRUST CASES, *supra*, at 236. Similarly Bork presents a number of activities which require some restraint on the competitive conduct of the participants. Bork, Part II at 429-64. With the possible exceptions of information exchange and fraud among joint venturers, all of the activities appear directed at changing, maximizing in static terms, demand for a product which of necessity implies that the product is differentiated.

24. Such power is the power to control prices, output, and quality within the limits set by competitive alternatives. As those alternatives become closer, less power remains, until, in the case of "perfect" monopolistic competition, the producer is left with no practical choice, although it can still select different levels of production, price, and quality, because only one combination of these factors will allow the producer to remain solvent.

25. Clark argues that some discretionary power is essential to the proper balance between static and dynamic interests and so is essential to his conception of workable competition. J. CLARK, *supra* note 6, at 471-76 (1961).

can arise either from product differentiation, product uniqueness,[26] or a small enough number of producers that collectively, but perhaps not collusively, controls production of a commodity. Such an oligopoly group will appreciate that collectively it needs to meet the competitive impact of substitutes and to promote total demand for its own product, each member recognizing that all will share in that increased demand. The power that results from such joint action can be ephemeral because it exists only by virtue of the willingness of the participant firms not to engage in strenuous competition *inter se.* Hence, oligopoly groups will have a strong interest in trying, if possible, to move toward product differentiation.[27] One way to do this is to develop brand names, special promotional activities, or special distributor efforts. When this is possible, the oligopolist escapes from its interdependent position in a group of producers by developing its own segmented aspect of the market.[28] In the interest of simplicity, this discussion will use the producer of a differentiated product as its reference point.

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26. Power potential will arise if a product is sufficiently unique so that at least some customers will continue to buy it if its price increases relative to other substitutable products. At this stage, the producer is free to choose a price within some range of alternatives. As that range declines, the power is more limited. Static analysis, moreover, shows that there is a point in that price range which will maximize the profit of the firm holding cost and demand constant. The dynamic analysis, however, indicates that a firm may rationally select some other price, higher or lower than the optimal price, if that has desirable dynamic consequences.

27. Thus, the collective but presumably not collusive efforts of major beer brewers to promote their several brands have had the effect of creating more product differentiation between those brands and the local and regional brands. As a result, the majors can sell at a higher price and do not have to respond specifically to particular local beer price cuts. *See* K. Elzinga, *The Restructuring of the U.S. Brewing Industry,* MODERN BREWERY AGE, Oct. 14, 1974 at 52.

28. In this context, competitive pressure from close substitutes generates contradictory pressures. On the one hand, the close similarity of a substitute makes a cartel in a single product a much less powerful device than if that substitute did not exist. Since both customers and sellers can more easily substitute one product for another, the pressure on the producers of both substitutes to engage in price competition increases. On the other hand, instead of spurring competition in terms of consumer prices, this pressure may well result in more rigid cartel policing. Presumably, by scrupulously enforcing price and territorial restraints, the producer can insulate sellers against intrabrand competition, thereby inducing those distributors to favor the better-policed product in their selling efforts. The cost of this stepped-up policing, however, may well reduce the producer's profits to a "normal" level. In effect, the producers of substitutes will then be competing by the transfer of all monopoly profit to the distributors. If producers can find no alternative method of distribution, they may have to continue to operate the cartel since abandoning the effort would only result in a decrease in the distributors' willingness to handle the product causing further loss of sales and perhaps failure. In such a situation, the producer will perceive its program of restraints as essential even though it is acting as a cartel promoter and manager.

Monopoly or market power as used in this discussion ought also to be defined. A firm has power in its market when it has the ability to make effective choices among prices and outputs all of which will satisfy the demand for its product and will not result in losses to the firm. Power thus means an area of discretion in which a firm is free to select the price and output combination that it wishes without risking its economic viability. This discretionary power can only exist if a firm has a declining demand curve (its product is not a complete substitute for others so that the firm will not lose all of its customers as its price shifts) and if the cost of producing the amounts demanded at individual price levels is less than the revenue that will result (average cost of production must be less than average revenue). A pure competitor may be able to select among production levels, but exercise of this discretion has, by definition, no effect on price or other demand conditions. No relevant discretion is involved since there is no basis for choosing other than the most profitable level of production. To be sure, any non-purely competitive firm will also have a point at which its profits will be maximized within the firm's discretionary range; but the thesis of this view of market or monopoly power is that what is important is that a firm facing differentiated demand and having the choice of production and price levels can elect some other level if there are reasons to do so.

Restraints on the distribution of differentiated products[29] are usually explained by two theories which view the restraints from different perspectives: distributor cartel and producer efficiency. Neither theory by itself purports to explain all cases, but at least in static terms, either one or the other ought to explain any restraint.

The theory of the distributor cartel regards vertical restraints as

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29. It is conceivable that a distributor cartel involving distributors unthreatened by new entrants could be based on a homogeneous product produced in a competitive situation. Absent a reasonably strong understanding, however, among the competing producers that they will operate a producers' cartel to which the distribution cartels are an adjunct, distributors are likely to seek alternative sources of supply which would make a distributor cartel unlikely in practice. So, when one finds a restraint on the resale of such a homogeneous product the overwhelming inference is that it is a manifestation of a producer cartel arrangement.

Two cases involving sugar seem to be explicable in these terms. *See* Chicago Sugar Co. v. American Sugar Ref. Co., 176 F.2d 1 (7th Cir. 1949), *cert. denied*, 338 U.S. 948 (1950); Fosburgh v. California & Hawaiian Sugar Ref. Co., 291 F. 29 (9th Cir. 1923), *discussed in* Robinson, *Restraints on Trade and the Orderly Marketing of Goods*, 45 CORNELL L.Q. 254, 269-70 (1960). Cement Manufacturers Protective Association v. United States, 268 U.S. 588 (1925), may reflect a similar situation, but the effective control in that case lay in informed producers' not selling more cement than the buyer needed for its own use rather than any actual reliance on resale restraint.

a means of implementing horizontal combinations by the reduction or elimination of competition among participating firms.[30] In its crudest form, the distributor cartel theory assumes an antecedent agreement among the distributors as to the type of cartel required and the conditions to be imposed on its members.[31] If the producer is to have the necessary distribution network, it must bow to distributor pressure to place restraints in its distribution contracts and enforce their terms, because of the aggregate market power of the conspiring distributors. Restraints need not be placed directly on price; a system of territorial assignments or customer restrictions may provide sufficient division of markets among competing retailers to produce the desired (or achievable) level of market power through reduction of competition.[32]

Although some cases may not fit within the terms of the crude distributor conspiracy theory, they may comport with a variation of that theory: the producer-promoted distributor cartel. A producer will benefit from organizing such a cartel if the promised elimination of cut-rate sales of its branded product will induce sufficient dealer loyalty and market sales that the producer's profits are enhanced.[33] Only rigorous manufacturer supervision will control free-rider problems which would threaten the continued existence of a distributors' shared monopoly.[34]

30. This is an element of most government briefs in the area; *see, e.g.*, Brief for United States, White Motor Co. v. United States, 372 U.S. 255 (1963); Brief for United States, United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967) *excerpts reprinted in* R. POSNER, *supra* note 23, 266-72 (1974). It is one of the bases for the decision in Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911), discussed *infra* at notes 109-26 and accompanying text. Since scholars on the whole are critics, this theory, which justifies much of the judicial attitude toward vertical restraints, has received little scholarly development. *But see* Telser, *supra* note 23.

31. The history of resale price maintenance in the proprietary drug field provides a prototypical example. J. PALAMOUNTAIN JR., *supra* note 19, at 90-106 (1955). For example, California druggists in 1935 took all Pepsodent products off their shelves until Pepsodent reinstituted resale price maintenance and made a suitable contribution to the druggists' trade association. *Id.* at 238-39.

32. It may be that some retailers are more concerned with their competitive relationships with other types of retailers and not their competition *inter se*. *Id.* at 38-48. In this case they will be more interested in customer classification or territorial assignment than in direct price control.

33. The cartel theory is not the only explanation for restraints on distributors. The cartel analysis requires that each distributor have an understanding that it will be sheltered from intrabrand competition. Therefore, a genuinely unilateral customer or territorial restraint by a producer, unaccompanied by an understanding that the producer would protect the distributor from the competition of other distributors in that territory, would lack the horizontal mutuality which the cartel theory requires, and could not be explained at all by the cartel theory. *Cf.* Preston, *supra* note 23, at 507.

34. Bork, Part II at 405-06.

In addition, there are some restraints in which the distributors submitting to them are aware that other distributors are subject to the same constraints, and, in the absence of the restraints, would not distribute in the required way, thus demonstrating that there is at least an implicit agreement among distributors. Such agreements have been specifically permitted under antitrust decrees. These agreements include location clauses, profit-passover requirements, and assignment of areas or customers of primary responsibility.[35] If all vertical restraints which rest on some horizontal understanding between distributors were the product of cartels, the logical antitrust solution would be to dissolve such "cartels" and prohibit any restraint. The absence of such a policy of enforcement suggests that courts and antitrust enforcement agencies have persuaded themselves that some restraint, even when it has a clearly horizontal element, can be essential to the operation of an independent distribution system and therefore should not be forbidden.

This perception lies at the heart of the other method of analyzing vertical restraints: efficiency in distribution. In order to understand how control over distribution can promote efficiency, it is necessary to recall that only firms with some market power, actual or potential, can restrict distribution. A key characteristic of such a monopolistic competitor is that the demand for its product at any price is limited. The limitation arises from the willingness of customers to substitute less preferred alternatives or to abstain from use of the product as its price goes up, and the unwillingness of some customers of alternative products to buy the specific product as its price declines. This implies that a monopolistic competitor can expand its sales volume by reducing the price or by changing demand for its product while its price remains unchanged. The ability and incentive to reduce price or to change its demand schedule distinguish the monopolistic competitor from the pure competitor.

A monopolistic competitor will only seek to increase its sales volume if the return on the additional sales exceeds the costs of production and distribution. This result furthers the efficient use of resources because the value of the additional products to their consumers exceeds the cost of producing the additional goods. If consumers do value this use of resources more than any alternative

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35. *See, e.g.*, United States v. Topco Associates, 1973-1 Trade Cas. ¶ 74,391, at 93,797 (N.D. Ill.), *modified* 1973-1 Trade Cas. ¶ 74,485, at 94,153 (N.D. Ill.), *aff'd per curium*, 414 U.S. 801 (1973); United States v. Arnold, Schwinn & Co., 1968 Trade Cas. ¶ 72,480, at 85,568 (N.D. Ill. 1968); United States v. Sealy, Inc., 1967 Trade Cas. ¶ 72,327 at 84,855 (N.D. Ill. 1967).

use,[36] the new level of production is more efficient in its use of resources than the old level.[37]

The usual argument for efficiency in vertical restraints focuses on demand-affecting conduct. In general, this conduct seeks to increase product differentiation.[38] Whenever the product is of a convenience nature or relatively simple to select, the producer can try to reach customers directly and promote the product so that its distinctions will be recognized. In such cases, the direct selling efforts of the producer are sufficient to achieve differentiation. But when the product needs promotion, or servicing, or display to generate the requisite differentiation, the producer needs the active assistance of the distributor. While a distributor may make some effort on its own, greater effort might create added differentiation and expand sales to a more efficient level of production. But so long as other distributors benefit from these promotional activities while one distributor alone pays their cost, no distributor will engage in them. No distributor will make a special effort if it is probable that the advantage from the effort will be realized by the producer in the form of greater sales, but will not also be realized by the distributor who made the effort. In other words, a distributor will want power over the product in which it invests special efforts. The solution to this free-rider problem[39] is to impose restraints on the competition among distributors so that each is accorded power with respect to some customers. To get the desired special effort, then, the producer assigns a distributor to a limited and exclusive territory or set of customers, or insures that there will be no intrabrand price competition. This protection compensates the distributor for its efforts. Bork, Preston, and Telser, among others, have described the kinds of efforts which producers can obtain by use of such restraints.[40] While not always explicitly recognized as demand-affecting effort in these discussions, a close examination of how the special efforts operate reveals that they are, indeed, aimed at changing demand for the specific, differentiated product.

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36. *See, e.g.*, Bork, Part II at 473-74.

37. *Id.* at 402-03. For other examples of efficiency analysis, see Jordan, *Exclusive and Restricted Sales Areas under the Antitrust Laws*, 9 U.C.L.A. L. REV. 111 (1962); Robinson, *supra* note 29; Rowland, *Designing Distribution Systems: Antitrust Problems in Franchising and Marketing*, 34 MO. L. REV. 178 (1969).

38. Differentiation can arise from making different products, E. CHAMBERLIN, *supra* note 5, or by segmenting customers and selling to each segment in different ways, MARKET SEGMENTATION CONCEPTS AND APPLICATIONS (J. Engel, H. Fiorillo & M. Cayley eds. 1973).

39. Bork, Part II at 430-38, 453-54.

40. *Id.* at 430 lists six categories of special or joint efforts.

The second way a producer may seek to expand production is by a price reduction to consumers. Distributors will pass along this price reduction, absent special controls, if the markets in which they sell have sufficient intrabrand or interbrand competition. But distributors, due to location and other reasons, may well have market power of their own; that is, they do not face sufficient competition to force them to adhere to producer wishes. If the product is differentiated and, presumably, attractive to the distributor, the producer has some leverage. In essence, each needs the other. On this basis, a bargain can be struck in which the lower price is passed on to customers in return for other guarantees which enable the distributor to share in the resulting improvement in the producer's market position.

The efficiency analysis, then, assumes that a distributor will have interests which are directly counterposed to those of the producer-supplier. In general, the producer-supplier wishes to sell the maximum quantity of its products necessary to keep its production facilities within a range of maximum profitability. The distributor, on the other hand, wishes to charge the maximum price and to make the minimum effort necessary for its return. An efficiency-justified restraint of this kind is, nevertheless, a multilateral understanding which reduces horizontal competition. In this respect, the efficiency-based restrictive agreement will be indistinguishable from a cartel agreement. There are, however, significant differences in both the motivation for and the understanding of the agreement.

The motivation for an efficiency agreement is primarily producer interest in achieving maximum sales effort and optimal service for a differentiated product. In static terms, a producer with these goals has no interest in providing more restraint than is essential to obtain the desired level of distributor activity. This creates an inherent conflict of interest between the producer and a distributor who wants the maximum competitive restraint on other distributors. The producer seeking efficient distribution is no longer proposing to act as manager, for a fee, of a horizontal conspiracy. Rather, the producer is proposing a joint venture with certain distributors in which the restraints are those reasonably necessary to achieve efficient distribution. To maximize their efficiency, the joint venturers must behave in ways inconsistent with complete independence, that is, they must partly integrate their efforts.

In evaluating the implications for legal policy of the cartel and efficiency explanations, the choice of economic perspective is vital. Thus, Professor Bork, proceeding from a static equilibrium analysis, argues that any vertical restraint must be either for a cartel or an efficiency purpose, but not for both. Further, except for errors in judgment, only reasonable and necessary restraints will occur when efficient distribution is the goal. The producer gains nothing by imposing greater restraint, and it cannot get the maximum efficiency with less.[41]

Equilibrium economic analysis is central to Bork's argument. The analysis assumes a given technology, *i.e.*, costs of production, and a set of consumer preferences which manifest themselves in demand schedules for different products. Given these costs and demands, there is a determinate set of most efficient prices and outputs that are possible when the economy is in equilibrium. The static analysis treats distribution restraints in comparative terms. The model assumes a given "state of technology and managerial sophistication at the moment"[42] and that demand at any level of production is determined by forces outside of the model.[43] It then considers the output that will result with and without a restraint. Under this approach, it would be misleading to speak of this conduct as power creating or demand altering in a dynamic sense, since in the static view the power or demand was always there, potentially, and all that is happening is efficient operation of a business to maximize its profit potential.

Under this approach, given the relationship of cost and demand (both of which are, themselves, given), market power is determined.[44] Not surprisingly, since power is the difference between two givens, it can be demonstrated in static terms that vertical

41. *Id.* at 415-16.

42. *Id.* at 393.

43. In this model, potential demand is variable within a range and the role of restraints is to bring the highest possible level of demand into existence. But the range in which demand fluctuates must be regarded as determined by forces outside the model. Any other conclusion would make demand in part a function of the firm's selling effort and would imply that demand is not solely the product of consumer desires which the producer recognizes and taps.

44. In fact, market power is a most inapt discription since power connotes a dynamic force whereas in the static model, there is only a potential for more or less profit based on the supply and demand conditions in which a firm operates. Maximization of profits in such a context is only the efficient use of power and not the creation of a powerful position in the market. For this reason, in the static model a firm has no reason not to seek the profit maximizing and most efficient combination of price and output (that combination may vary depending on the considerations of new entry.) It should also be noted that in the static model, firms in perfect pure or monopolistic competition do not have market power because their costs of production just equal their revenues at the most efficient point so they have no discretion to choose any other level of output and break even. By definition a monopolist is a firm which in equilibrium has costs that are less than revenues and has genuine discretion to choose some other production and price level.

combinations will not change power.[45] This is the key to Bork's conclusion of per se lawfulness for vertical restraints. They cannot create or augment market power;[46] they can only relate to achieving maximum efficiency.

Even in the static model, however, a horizontal combination of competitors creates a new control over all production in a market and gives its possessors power which those combining did not have individually because of the alteration of the scope of control over the market. Consistent with this principle, Bork recognizes that, even if a restraint has a clear efficiency justification, it must be tested by a rule of reason if it involves two or more competing firms, since even in static terms, it will involve a change in market power.[47] The participants may benefit from both that increase in market power and from the efficiency produced by the joint venture which required the restraint.

Absent judicial review of their conduct, therefore, they cannot be expected to employ the minimum restraint needed to achieve their joint venture goal.[48] Within the framework of static analysis, the distinction between horizontal and vertical is logical, vital, and supports Bork's conclusion.

Because market power in a static approach can only be created by agreement between or among competitors, it follows that once it is established that the restraint is truly vertical, it can have no market-distorting or competitively undesirable effects. This also means to Bork that an apparent vertical restraint must either be horizontal and a product of a cartel or truly vertical, but never both. These conclusions follow from the nature of the approach and do not go beyond it. The static model does not purport to describe

45. This is done well in Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 195-201 (1955). The basic argument is that there is only so much profit to be had from a set of customers and, therefore, adding levels of monopoly will not change this result or increase the monopolist's profit. Under certain conditions this conclusion has been questioned even as a correct statement in static terms. *See* Hay, *An Economic Analysis of Vertical Integration*, 1 IND. ORG. REV. 188 (1974).

46. Bork, Part II at 402.

47. The power in such a case arises from the possible transformation of a competitive market into a monopolized one by virtue of the combination of competitors. Given the degree of market control it can make possible, any such combination will inherently have the potential for monopoly. The question in a particular case will be whether the purpose or effect of restraints is to make possible unnecessary monopoly power (power beyond that incidental to the legitimate needs of the joint venture). Thus, the combination does not create power in the sense of establishing something which the conditions of supply, demand, and market share did not make possible by their given character. The combination is only a vehicle by which the existing power potential may be captured and exploited.

48. Bork, Part II at 429-65.

how market power emerges, is controlled, and can be dissipated. Specifically, the model does not explain how, when, or why demand or costs will shift, nor does it explain when and how particular firms might influence this process.[49] It explains only how firms will respond to such shifts once they have occurred on the assumption that the new conditions will last forever. Only a theory which treats these elements as variables dependent in part, or under certain circumstances dependent on other controllable variables, can truly illuminate the questions of whether and how vertical restraints can create market power. Before turning to such a theory, there are a few caveats that should be noted as to the persuasiveness of Bork's conclusions, even in static terms. Bork assumes that producers can recognize and accurately define the exact scope of their interests. In a world of unchanging conditions, a profit-maximizing producer can discover, at least by trial and error, the most efficient combination of restraints.[50] But if a firm is uncertain of its distributors' likely response to a change in restraint or is unsure of the potential effects of either increasing or reducing restraints, it becomes less likely that any firm will seek an optimal level of restraint.[51] A firm will make more efforts to find an optimal level if failure to justify the restraint will lead to some sanction or if a business or its executives will suffer for an "error" of judgment. Furthermore, where such sanctions exist, the well-advised executive may well err on the side of less restraint, thereby producing the least restrictive distribution system rather than the optimally re-

49. This failing is repeatedly cited as the great gap in classic economic analysis. J. CLARK, *supra* note 6, at 178-209, 609 (1961); J. SCHUMPETER, *supra* note 6, at 30-39 (1961). *See also* J. GALBRAITH, THE NEW INDUSTRIAL STATE (2d ed. 1971).

50. Of course, if a producer is earning monopoly income as it starts this process, it will be under no economic compulsion to achieve maximum efficiency will produce greater profits. So long as one level of restraint produces satisfactory return, the fact that another might produce more will not be compelling if risks and uncertainty are associated with the experiment. *See* Simon, *Theories of Decision-Making in Economics and Behavioral Science*, 69 AM. ECON. REV. 253, 262-65 (June, 1959). Thus, the tendency toward the most efficient restraint is not self-executing, particularly where there is strong managerial control. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW ch. 12 (1972). On the other hand, a firm which is making normal profits or less will be strongly motivated to find the most efficient distribution system.

51. Repeated experimentation with and fine-tuning of a set of restraints will often be impractical because the data derived from past experience will be only partially applicable in a changed world. Thus, if consumer preferences shift, or new selling systems emerge, or new products change the substitution relationships and alter the nature of product interaction, the world of static equilibrium is lost. In this changing world, the ability of a producer to evaluate his options and consistently make the most efficient choice of restraints is more highly questionable. Indeed, the whole concept of efficiency becomes unsettled in the context of a larger dynamic process.

strictive system.[52] To the extent that rules against vertical restraints lead to a less than optimal distribution system in a static world, which by definition must have an optimal level of restraint,[53] the rules themselves are inefficient, and, therefore, undesirable.

Finally, using a distributor to assist in product differentiation or distribution of an already differentiated product through an independent distributor creates the potential for monopoly power or may reinforce the position of the distributor as a monopolistic or oligopolistic competitor in its own right. Thus, in trying to achieve efficient distribution, or in trying to achieve product differentiation itself, a producer finds that it is creating or dealing with a second level of monopoly in its distributor. This result is inevitable whenever the existing conditions of distribution or those created by a producer seeking product differentiation result in differentiation at the distributive level.

A producer, in order to use restraints, has to have some power, and the special distribution efforts should create additions to this power by increasing sales volume to the most profitable level. Moreover, the producer is dealing with a separate and independent distribution system and inevitably faces the problem of sharing power with these distributors. In those cases, where some power exists at both levels, the first problem is whether and how the parties may vary their initial power endowments from the way that power would have been distributed absent agreement by use of restraints. Secondly, in all cases, the power to be allocated includes power created by the joint efforts of the producer and the distributor which has engaged in special efforts to promote the product, so the sum of the combination is more than was inherent in its parts. Because of the free-rider problem, the power created by joint efforts can generally be created or allocated only by assuring all distributors how each will interact with the others and with potential new distributors. To the extent that the distributors become all-powerful over new entry and operate in totally closed territories, they have, as a group, been allocated the bulk of the power. Conversely, to the extent that the producer has freedom to replace a distributor or to create competition for a distributor, or both, the producer has received control over the new, jointly created market power. To

52. Critics of the present law emphasize the impact of this uncertainty. Hibner, *Selected Problems in Vertical Restraint Cases—The Need for Predictability*, 26 MERCER L. REV. 911 (1975); Izard, Stanton & Ross, *Of Bicycles and Beer: Vertical Territory and Customer Restraints from* Schwinn *to* Coors, 26 MERCER L. REV. 507 (1975). The pressure of this uncertainty as to what types of restraints are legally justifiable ought to induce more effort to find effective alternatives.

53. *But see* note 56 *infra*.

evaluate the efficiency argument, it is important to realize that restraints not only facilitate the performance of special efforts by curing the free-rider problem, but that they also allocate both existing power and newly created power whenever such power exists under the control of both producer and distributor.[54]

The implication of this analysis is that the formulation of policy with respect to vertical restraints is the formulation of policy with respect to the creation and allocation of market power. The necessity for legally valid agreements to make possible the vertical restriction of independent business demands that decisionmakers choose between favoring monopolistic competition and favoring pure competition. The policy choices from a static perspective are limited, but not unimportant. In the view of some writers, there is a possibility of a choice between monopolistic competition and pure competition. Under either model, goods can be produced at costs that do not mandate the desirability of one approach or the other. In such a world, if it existed, it is not clear whether perfect pure competition or perfect monopoly competition is preferable. Perfect pure competition has lower costs and perfect monopoly competition has greater product variation so the choice between the two is no longer clear.[55] The result favored, assuming equilibrium, will depend on the relative value assigned to price and variety by decisionmakers. In the more usual view, it is assumed that the conditions of cost and demand under alternative regimes of pure and monopolistic competition will determine that one or the other is more efficient and therefore preferable. In either case, the static theory postulates that the economy is moving toward that equilibrium, and the goal of legal policy is that equilibrium be reached as fast and as inexpensively as possible. The first obvious implication of this general policy is that restraints based on cartels ought always to be illegal. They represent an abuse of market power which results in lower production and higher costs to society. They, by definition, serve no efficiency interest.

With respect to efficiency-based restraints, since the economic power and potential power involved therein already existed, and the restraint operates to expand production in light of that power,

54. This is a classic negotiation situation which can be compared to the economist's duopoly problem. K. J. COHEN & R. CYERT, THEORY OF THE FIRM: RESOURCE ALLOCATION IN A MARKET ECONOMY 229-41 (1965). The interdependence inherent in the vertical relationship between producers and distributors makes it relatively easy for them to reach a solution to their shared monopoly problem. *See also* R. POSNER, ECONOMIC ANALYSIS OF LAW, ch. 24 (1974).

55. E. CHAMBERLIN, *supra* note 5, at 214-15. *See also* Scherer, *supra* note 22, at 15, 21-22.

the only question is whether this power is used efficiently. The truly vertical agreement will produce more sales than no agreement between the producer and the distributor given the differentiated nature of the product and the potential of distributor power. Moreover, the interdependence of the parties makes such negotiation possible. There is no reason to believe, however, that the market will naturally push all monopolistic competitors into the perfect equilibrium conditions. Those conditions require that all real market power be squeezed out of the relationship, not by altruistic acts by the parties to the agreement, but by the entry of enough closely substitutable products to provide the maximum number of alternatives that total demand in the economy will sustain, thus eliminating by monopolistic competition the monopoly profit that would otherwise exist. If existing firms can create any barriers to entry, by patent, copyright, advertising, or special distribution efforts, some residuum of economic power will remain. Hence, even in static terms, there is a basis for concern over the conditions in which the equilibrium is sought.[56]

Rules of law will play a substantial role in determining the relative possibility for pure and monopolistic competition, the speed and certainty with which these processes reach their equilibrium, and the methods available for the pursuit of monopolistic position. A legal system which confers patent rights on inventors, copyrights and trademarks on advertisers, protects manufacturers' trade secrets and legalizes restraints on distributors, has created

56. This very simplistic view does not do justice to the problem of determining the optimal resource allocation in a world of pure and monopolistic competition in which at least some imperfections will remain. In such a world at equilibrium, the necessary conditions for a completely optimal, efficient resource allocation do not exist. The problem is then one of deciding which set of second-best solutions will put that world closest to the optimal condition assuming equilibrium. Professor Markovits has undertaken the task in general terms of specifying how policymakers can seek to improve conditions of allocative efficiency in such a world. Markovits, *A Basic Structure for Microeconomic Policy Analysis in Our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics*, 1975 WISC. L. REV. 950. This analysis combines a Chamberlinian perspective on the nature of market relationships with the use of the general theory of the second-best. It raises very serious problems for any simple approach to efficient resource allocation in equilibrium situations. The recent publication and substantial length and complexity of the argument have precluded any significant consideration of its implications for re-evaluating the traditional analysis of allocative efficiency reflected in the text. In any event, this article takes the position that optimality in equilibrium terms, something which assumes technology and demand as largely determined by external forces, is not the sole basis or even the most relevant basis for antitrust policy analysis in a dynamic world in which there are no givens, and in fact it may be that conditions, inefficient and undesirable in equilibrium, are essential to the process of dynamic change.

a series of rights by which monopolistic competition can be furthered. The choice of rights and their definition will shape and influence the methods participants utilize in their attempts at product differentiation. If several possible ways exist to achieve that goal, anyone seeking it will presumably opt for the method or methods which provide, relative to their cost and efficiency, the greatest and longest lasting monopolistic position vis-à-vis other competing or potentially competing substitutes.

In selecting and defining the legal rights which businesses may have, the legal system is, at least implicitly, making a selection between more or less perfect pure competition or monopolistic competition. Legal devices which permit the further differentiation of heretofore undifferentiated products are devices which functionally encourage monopolistic competition in favor of pure competition. The definition of legal rights which provides a basis for differentiation will also influence the speed and certainty with which their users move from a position of monopoly to one of monopolistic competition. The greater the scope of power and the longer its duration, the greater is the potential for its user to acquire a position which is unchallengeable by the potentially competitive substitutes which exist or which could exist in the market. This means that the legal definition of rights can operate to speed or retard the movement toward equilibrium according to their role in differentiation activity.

A dynamic theory of economic power must address the causation and control of growth and change in an economy.[57] A good starting point is Mason's paradigm of industrial organization[58] that postulates initial "basic conditions" of supply and demand

57. Many efforts in this direction have attempted to describe in macroeconomic terms what the conditions for growth in any economy are. They do not present any view of the firm or related microeconomic issues. In another direction, such writers as Schumpeter have sought to demonstrate that static efficiency and maximized growth are not necessarily consistent. J. SCHUMPETER, *supra* note 6, *discussed in* F. SCHERER, *supra* note 22, at 20-21. Others, such as Galbraith, have argued that market power is essential for firms to control their own future which itself is essential in the present day and age. J. GALBRAITH, *supra* note 49.

The theory of workable competition associated with J. M. Clark has more direct relevance. Clark, *Toward a Concept of Workable Competition*, 30 AM. ECON. REV. 241, 241-56 (1940). *See also* J. CLARK, *supra* note 6. The literature is reviewed in Sosnick, *A Critique of Concepts of Workable Competition*, 72 Q. J. ECON. 380, 380-423 (1958). The theory of workable competition rejects the usefulness of static models and substitutes a concern for dynamic evaluation of economic institutions involving structural, conduct, and performance criteria to determine whether markets are or are not reasonably competitive. *Id. See also* F. SCHERER, *supra* note 22, at 36-38.

58. *Id.* at 4-5.

which in the first instance determine parameters of "market structure." Market structure, in turn, sets conditions for "conduct" which, in turn, controls "performance." But in addition to that sequence, the paradigm recognizes that conduct influences market structure and basic conditions and that structure itself will also affect conditions. This is a theory of dynamic interaction. It asserts a series of market performance characteristics as its goal. The performance goals such as equity, progress, and efficiency are so general and may have such different measures in varied time frames that their assimilation into a more explicit model is very difficult.

The efforts to grapple with economic dynamics have thus tended to become descriptive of what is and how it got that way. This descriptive approach leads to a Panglossian perception of reality in which what has happened is treated as if it ought to have happened and interference with this evolution is discouraged as uneconomic and potentially harmful to the smooth running of the economy.[59] The approach does not mandate such conclusions.[60] The heart of the problem for the dynamic-model builder is that in a dynamic world the dimensions of the problem are constantly changing and there is no such thing as equilibrium.

To be useful in an analysis of economic power, a dynamic theory should describe the causes of change, whether in cost or demand, the interaction between changes, and power implications of changes of different types. Explanations of the ways a firm interacts with its future and seeks to control it can involve use of game theory,[61] behavioral models,[62] and other theories.[63] These efforts do not focus directly on analysis of the problems of monopoly and market

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59. Thus, Galbraith rejects antitrust enforcement as an arbitrary interference with the new industrial world. J. GALBRAITH, *supra* note 49, at 184-97. Clark has similarly restrained enthusiasm for efforts seeking to impose rules on the natural order. J. CLARK, *supra* note 6, at 324-25.

60. *See* Stigler, *Report of the Attorney General's Committee on Antitrust Policy: Market Power and Business Conduct: Some Comments*, 46 AM. ECON. REV. 496, 505 (1956). *Compare* C. EDWARDS, MAINTAINING COMPETITION (1949) *and* Adams, *Market Structure and Corporate Power: The Horizontal Dominance Hypothesis Reconsidered*, 74 COLUM. L. REV. 1276 (1974) *with* J. CLARK, *supra* note 49, at 324-25 *and* J. GALBRAITH, supra note 49, at 184-97.

61. *See* J. VON NEUMANN & O. MORGENSTERN, THEORY OF GAMES AND ECONOMIC BEHAVIOR (1964) and M. SHUBIK, STRATEGY AND MARKET STRUCTURE (1959).

62. R. CYERT & J. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963); O. WILLIAMSON, THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM (1964).

63. W. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH (1968). *See also* F. SCHERER, *supra* note 22, at 27-38, 285-303.

power. As a result, they are not responsive to the issues which this discussion considers.

The long run goal of any firm in a dynamic world is to accumulate and to entrench sufficient market power to assure some monopoly profit.[64] A firm may effect this goal by charging lower prices or by segmenting the market demand curve. If the producer, by changing the manner of sale, distribution, product design, service, and quality control, can differentiate the product in consumers' minds, thereby altering his demand curve, that is, making it less price elastic, then a lower production cost will not necessarily be the primary corporate goal or strategy. Indeed, the product differentiation of the kind required may increase production costs.

In dynamic terms, then, the interest of the firm is not in its cost or demand in isolation, but rather in preserving the spread between them, *i.e.*, preserving or increasing its potential profit. Corporate management may even risk reduction of income in order to assure the longrun stability of the firm's profit margin.[65]

There is a significant implication of the static model for dynamic concerns. The model of pure competition does suggest that a firm operating in such an environment, even in a dynamic world, ought to focus its attention on reducing its costs. Such a firm faces a horizontal demand. It can sell as much as it wants at a given price, none at any higher price, and would be giving away value to sell at a price below present market. If the firm sought to change demand, any actual change would redound to the benefit of the industry as a whole.[66] In such a world, a firm ought to focus primarily on its

64. To the extent that static analysis has a motivating force for change, it is the drive for monopoly position; the proposition that a business will seek more rather than less profit, and more rather than less certainty of that profit, appears sensible. If it is stated in this manner, the proposition falls short of the rigorous maximization hypothesis employed in static analysis, but is clearly related to it. Stated in this manner, it does identify the goal of a firm in a dynamic world.

65. This presumes that the managers own the business, that the shareholders lack the capacity or awareness to resist management's decisions, or that the shareholders agree that a long run, but reduced profit stream is worth more to them than short run profit maximization.

66. The industry of which this firm is a part might collectively regard demand as an element to be changed but will act only if joint action can be achieved and if the member firms can capture a sufficient level of profits to justify the effort. In the classic model, such a gain would be temporary at best. The model assumes (a) that all existing firms were operating at the most efficient rate of output, and (b) that new entry by equally efficient firms will occur if existing firms make excess profits. Therefore, when demand rises existing firms increase production. Because of their cost increases, however, the firms do not expand production to satisfy the new demand completely. As a result, prices rise, yielding some excess profit to the existing firms and offering the prospect of monopoly profits to new entrants. Entry then occurs, and production by existing firms declines until each firm is again

costs of production, and conclude that it is pointless to try to exercise control over the larger world, especially product demand.

The monopolistic or oligopolistic competitor confronts a directly variable demand and is able to survive at several levels of demand.[67] The monopolistic competitor has the potential to influence an added dimension of its existence because an increase in the amount of its product demanded at a given price will directly change its own environment. Any firm with a variable demand for its product faces directly the dynamic questions of what causes change in demand, how the present level of return (the relationship of demand to cost) can be maintained, and how it can be increased.[68]

But while the static model shows that monopolistic competitors interact with the economic environment in which they operate in a way that is significantly and strikingly different from that in which purely competitive firms interact,[69] the static models of monopoly and monopolistic competition do not answer the dynamic ques-

producing at the most efficient level. The number of firms should have increased so that all added demand at the new cost level is supplied. Thus, even the industry gets no long run advantage out of changing demand, unless the assumption about entry can be changed. K. COHEN & R. CYERT, THEORY OF THE FIRM: RESOURCE ALLOCATION IN A MARKET ECONOMY, 149-53 (1965).

67. "Survival" here means the resulting losses will not be so devastating that the alternative is economically impossible, even if it implies negative earnings on an accounting basis. This would include, therefore, some monopolistic competitors which are not presently making monopoly profits, *i.e.* have some clear freedom of action, but which can nevertheless survive for a while in an effort to alter their economic world.

68. Whether such changes in demand must be only at the expense of other producers or whether total consumption in an economy can be changed is significant for broader economic analysis. This is not a suitable place to get into an extended inquiry about macroeconomics. Suffice it to say, the Keynesian analysis suggests that total consumption is a variable which can be controlled, in part at least. J. KEYNES, GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY (1936). To what extent individual producers can act directly to shift consumption totals or broad patterns is not addressed in the usual analysis; but, some commentators have asserted that such control is essential for the survival of major corporations. J. GALBRAITH, *supra* note 49, at 203-07 (1967). Certainly, there is a need for more explicit theorizing and empirical investigation into the question of the interaction for firm and industry demand with total consumption functions in our economy.

69. The significance of this in explaining the role of monopolistic and oligopolistic competitors in innovation is substantial. Such firms have, by definition, the actual or potential resources to support innovative efforts, but in a static model given such a firm which already had power, it was not clear why it would invest in any project or which projects it would select. Viewing the firm in a long run monopolistic competition with other firms or industries, its interest in innovation is clear—this is a way to increase or preserve existing market power—and its agenda for innovation is also clearer. It will prefer those innovations, either technological or otherwise, which serve to strengthen its position over time in the market. Hence, a drug firm may value innovative advertising of its products which serves to create

tions; they only reveal what should happen to maximize present profit assuming that such conduct will not affect future power.[71] If it is assumed that vertical restraints do play—or can play—a significant role in the creation and allocation of market power, it then becomes necessary to formulate a policy toward such restraints in dynamic terms.

Professor William Adam's recent article explicates the dynamics of the creation and entrenchment of market power in the context of merger analysis, but his analysis can be more generally applied.[70] Adams' argument, in broad terms, is that firms of substantial size act in part to enhance and to preserve their long run economic power. The implication for distribution is that large producers would seek to impose restraints on distributors in a manner which would minimize the distributors' potential future economic power.[72] For example, a manufacturer might confer favorable limitations on price competition or assign territories to its distributors, thus giving the distributors increased short run profits in order to constrain their future freedom of conduct and, thereby, their future ability to develop power at their levels that could be turned against the producer. In order to make such restraints mutually agreeable, it is only necessary that the producer value future power a bit more than the distributor. If an individual distributor has substantial short run concerns or a great uncertainty about long run considerations, he may be quite willing to mortgage his future, nebulous, and uncertain power, perhaps to his later regret.[73] Adams' large

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for them a special market over investments in new basic or applied pharmacology. Thus a dynamic view of monopolistic competition helps to explain why innovation may be reasonable for the firm even if it is not necessarily socially desirable.

70. Adams, supra note 60. Another relevant article is Comanor, *Vertical Territorial and Customer Restrictions: White Motor And its Aftermath*, 81 HARV. L. REV. 1419 (1968), which is a rebuttal to Bork. Comanor's discussion does not make clear that the basis of disagreement is primarily in the economic approaches being employed, not in the conclusions that can be drawn from those economic models. *See also* Gould & Yamey, *Professor Bork on Vertical Price Fixing*, 76 YALE L. REV. 722 (1967), Bork, *A Reply to Professors Gould and Yamey*, 76 YALE L. REV. 731 (1967).

71. The limits of pure static analysis have been recognized in this connection and various qualifications, most notably the theory of limit pricing, have been offered. Bain, *A Note on Pricing in Monopoly and Oligopoly*, 39 AM. ECON. REV. 440 (1949). The theory of limit pricing, whatever its merits, see Markovits, *Potential Competition, Limit Price Theory and the Legality of Horizontal and Conglomerate Mergers Under the American Antitrust Laws*, 1975 WIS. L. REV. 658, is a recognition that market power is dynamic and that the optimal conditions of static theory are not optimal over time or when entry conditions become variable.

72. *Id.* at 1280-81.

73. A good explanation for many of the franchise restraint cases, *e.g.*, *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), and *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971), is that the distributors have reached

firm can be equated with all firms which fit the definition of monopolistic or oligopolistic competitors—firms which evidence an interest in the future state of demand for their product.

A primary problem with dynamic analysis, however, is that, lacking a detailed model of the dynamic aspects of the economy, it also lacks specific rules or tests with which to evaluate whether a change facilitated by producer restraints would, in fact, be desirable.[74] Even if it is presumed that change is desirable, policymakers will have no guidance in dealing with distribution restraints, since both the presence and absence of restraint will influence the quantum of change. The prohibition of all distribution restraints would permit the retention of power by those already so possessed. A rule permitting all restraints would also yield a similar result since restraints that would wrest power from producers would be equally effective in preserving that power. This result is objectionable if change in the marketplace is to be directed at the erosion of entrenched power and at the facilitation of the transfer of power from those who have power to those who do not. Clearly, an agnostic approach to power is no more neutral in effect than is total damnation.

The broad social and political distrust of unchecked power in the hands of any institution is characteristic of our political and economic heritage. Neale noted the importance of this sentiment in antitrust law:

> It is always hoped that any particular holder of power, whether political or economic, will be subject to the threat of encroachment by other authorities . . . and at the same time that any authority which seeks to encroach on another's power will be strenuously resisted and held in check . . . . It is important to this conception that the individual's right to engage in business activities of his own shall be preserved and that no single economic unit, whether in monopoly or combination, shall be able to exclude rivals at its own behest and so render its own power immune from invasion.[75]

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a point at which they regret their initial bargain and realize that they now value the lost freedom more highly than before.

74. Adams' concern is primarily to establish that nonhorizontal mergers create means by which market power can be exercised or created. Adams, *supra* note 60, at 1281. Having demonstrated this, he can conclude that since the Clayton Act forbids mergers which have such effects, any such merger is illegal. This analysis is successful within its specific statutory frame of reference, but it does not provide guidance outside of that framework. To extend the analysis, it must be determined when and where added power is desirable.

75. A. D. NEALE, THE ANTITRUST LAWS OF THE UNITED STATES OF AMERICA 430 (1970).

This preference for erosion of established power and for rules which impair the ability to entrench power is justifiable in both static and dynamic economic terms. Viewed through a static framework, entrenched economic power permits the producer to produce at a level that, although profitable to him, results in diminished consumer want satisfaction and, therefore, inefficient resource allocation. Viewed in a dynamic framework, the more entrenched a producer's power has become, the greater its capacity to control or frustrate dynamic change. Such power may be used to restrict or retard socially desirable change thereby greatly increasing the costs of change to society. The general dynamic mandate, then, is to prefer those arrangements least likely to create economic power in the future.

The static justification assumes that if less power is permitted at the production level, the result will be, at worst, not much less efficient than if more power exists on that level. This is a valid premise with respect to restraints, if it is true that efficiency is not dependent on a unique set of relationships which mandate a single level of restraint. The dynamic justification assumes that the greater the existing power is in an economy, the more difficult change will be. It may be, however, that the greater power produces more monopolistic pressure which acts as a stimulus to change. The source of power may be important, and to the extent that economic power is derived from political, social, or legal power, it will be harder to overcome.[76] This perspective suggests the difficulty with evaluating restraints. As restraints approach firm and enforceable legal rights, they may weaken the dynamic capacity of the economy. This is particularly true because their legal character may preserve these restraints long past their dynamic usefulness and may permit an otherwise no longer economically powerful entity still endowed with legal rights to capture and control unreasonable quantities of new power. To the extent that legal rights manifest changing economic realities, they will change in response to the power dynamics of the market. Restraints in a dynamic approach must be limited to those reflecting economic power as far as possible.

This suggests that dynamic analysis should focus on the existing power of those engaged in the restraint.[77] The greater the ex-

76. Power based on purely economic advantage is likely to attract investment in developing ways to share this advantage, that is, alternative or duplicative technologies will be sought after. Power based on legal or political power, precedent, or position, however, suggests that resources are best employed in seeking legal protection through investment in legislative, political or judicial resources and not in trying to find better ways to produce or distribute goods.

77. Adams, *supra* note 60, at 1287-90.

isting power of the firm, the more reluctant a court should be to allow the use of restraints, even purely vertical ones, to expand or to entrench that power. A dynamic approach would apply a strict rule against any restraint imposed by a very large firm because such firms may further increase their market power over time by this device.[78] Logically, small firms or new entrants ought to be subject to different and less onerous rules until they have obtained a reasonable quantum of power.

In this initial formulation, the dynamic approach does not concern itself with the static distinction between cartel and efficiency restraints. The crucial concern is the role of the legal system in setting the direction of the power transfer.[79] Thus, if a few marginal distributors combine with a marginal or failing producer to create a cartel in which the participating distributors receive territorial and price security, the combination could be regarded as a dynamically favorable event because it transfers power away from the more powerful distributors and the leading producers. A static efficiency analysis[80] would demonstrate that this result was inefficient[81] since the producer would have failed without the cartel.[82]

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78. Integration must be the concern of antitrust policy whether or not it is associated with ostensible horizontal dominance. Efforts to curb parallel integration, acquisition of assets generating substantial internal funds, or restrictive practices facilitating the use of power investment funds should not be made contingent on a finding of horizontal dominance of some distinct market.

> The simplest procedure for accomplishing that task is to establish a rebuttable presumption against any of the leading 200 firms in the country either acquiring another corporation or adopting one of the restrictive practices identified in the Clayton Act (such as requirements contracts or exclusive dealing). In effect, such a procedure would express the belief that once a firm reaches a certain scale the probability it will injure competition by means of integration or certain business practices is so great that the firm should carry the burden of justifying its desired course of conduct.

Id. at 1292.

79. In dynamic terms, any transfer of power away from those possessed of power could be regarded as positive since even a cartel, an inefficient transfer device, would stimulate the firms who lose power to competitive reactions.

80. In the static analysis, it is hard to identify the source of the cartel power. Assuming that a seller needed an exclusive label in order for it to be able to use its power over customers, and that the only way to get such a label was to combine the buying ability of a group of such sellers to obtain a common product, it is possible to imagine a cartel based on the product of a marginal producer. *See also* GTE Sylvania Inc. v. Continental T.V., Inc., 1974-1 Trade Cas. ¶ 75,072, *withdrawn for rehearing en banc* 1974-2 Trade Cas. ¶ 75,435 (9th Cir. 1974).

81. The static argument for competition over monopoly and, therefore, against cartels as a form of monopoly is well made in F. SCHERER, *supra* note 22, at 12-19. *See also* McGee, *Ocean Freight Rate Conferences and the American Merchant Marine*, 27 U. CHI. L. REV. 191 (1960).

82. Had that firm failed, it would have either created greater sales opportunities

But dynamic analysis is not necessarily indifferent to the basis of a power-shifting device. Some power-shifting devices which are unrelated to increased efficiency may prove undesirable even under dynamic evaluation. Thus, where a cartel agreement creates power unjustified by, and unrelated to, any change in the efficient conduct of distribution, dynamic analysis may conclude that such an arrangement is so unlikely to produce real economic benefits that, even if the beneficiaries are powerless, the restraint is without justification. In other words, if the only justification is the power transfer itself, the restraint is not dynamically justified because such a shift in power is not socially desirable if it has no present or future economic efficiency to justify its occurrence. Conversely, an efficient restraint which enhances the power of an already powerful firm might be justified by the present value of the increased efficiency, at least if the chosen distribution method is the only means of achieving the socially desired level of efficiency.

A further implication of the dynamic analysis is that there is no reason to believe that a restraint can necessarily be classified as either purely efficiency or cartel in nature. In a dynamic context, a restraint may combine cartel and efficiency motivations. The efficiency motivations may be a shorter-run event, a dynamic adjustment accepted by the parties in order to combine efforts to produce new power. Once created, that power will continue because its creation involved dynamic change in the economic environment. A cartel aspect to this same agreement would then provide for the allocation of that newly created power and seek to control future conduct in order to perpetuate that power among the cartel members.[83] Once this potential for a dual aim of restrictive distribution agreements is recognized, that is, creation of future power and allocation of that power, then the complexity of the economic analysis is apparent. This suggests that a decisionmaker may face irresolvable ambiguity if he either tries to say that a restraint is to create a cartel or to achieve efficiency or if he tries to allocate weights to the motives for a restraint.[84] This has great significance for the legal system and its policies because it postulates that any rules dependent upon a distinction between cartel

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for more efficient competitors and/or opened the way for new entry by a more efficient firm.

83. It is possible to reverse the argument: A cartel might be the immediate goal through which the participants can realize profits to engage in innovation or otherwise make dynamic changes in the distribution or market structure.

84. The *Sealy* case reveals such a dynamic change in the market for mattresses. *See* note 23 *supra* and accompanying text.

and efficiency restraints will be costly, difficult, and uncertain in a dynamic world.

Dynamic analysis thus greatly complicates the policymaking process. And it is this threatened complexity that may explain why in many areas of law opinions reflect an otherwise inexplicable refusal to consider the dynamic consequence of rules.[85] But the rules on vertical restraints deal, as they must, with power and power-producing relationships. Hence, a court's refusal to include dynamic considerations in its deliberations would produce confusion.

Dynamic analysis cannot and should not replace static analysis. Static analysis focuses on the issue of efficient use of resources in equilibrium conditions. As such, it is a powerful tool for the analysis and evaluation of many economic problems,[86] problems about which dynamic analysis would perhaps have little to say of any value, but it is not a tool which deals with the issue of the creation or maintenance of economic power except in the case of horizontal combination. Therefore, it will not by itself be a very relevant tool for that set of antitrust problems which involve creation and maintenance of power in the market.

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85. As Posner has demonstrated, there is a remarkable congruence between the mandates of many common law rules in torts, property, and contract, and the rules which the static model of economic equilibrium would project in order to achieve the most economically efficient results. R. POSNER, ECONOMIC ANALYSIS OF LAW, ch. 2-5 (1972). Judges probably find it hard to regard their own activities as part of an ongoing dynamic process. Thus, a static view of the world in which the only issue is the efficiency implication of a rule of law is perhaps a necessary simplification to avoid concern with secondary, dynamic problems which are often too broad for any particular case and too amorphous and incremental in impact to be dealt with constructively in a case by case context. In altering a rule of law, a judge is, in fact, changing the environment in which the parties operate and this will trigger the search for a new equilibrium. Judicial nonrecognition of the implications of law for changing the environment perpetrates the myth that the common law simply restates and reapplies preexisting rules and has no independent policymaking power. Policymaking is in essence a dynamic activity, an effort to change the givens of the environment in which equilibrium is sought. Economic planning is so frequently ineffective because it does not take into account that it is action to change the environment in ways which will facilitate further change. Hirschman & Lindblom, *Economic Development, Research and Development, Policy Making: Some Converging Views*, 7 BEHAVIORAL SCI. 211 (1962). *See also* D. BAYBROOKE & C. E. LINDBLOM, A STRATEGY OF DECISION: POLICY EVALUATION AS A SOCIAL PROCESS (1963). Given that they are not the only actors in our legal system, the courts are often well-advised not to undertake the task of assessing the dynamic implications of their acts. *Cf.* Linde, *Judges, Critics, and the Realist Tradition*, 82 YALE L.J. 227 (1972). Such is not the case when the issue facing the court is that of the dynamic implications of economic power.

86. Tax policy analysis can frequently proceed on the basis of an efficiency analysis. Certainly, the rejection of cartels under antitrust laws is fully supported by a static economic efficiency analysis. *See, e.g.*, McGee, *supra* note 81.

Consideration of the dynamic and static aspects of the market as well as the monopolistic position which underlies restricted distribution increases not only the complexity, but also the realism of the evaluative framework far beyond that based on solely cartel and efficiency theories.

The complexity of the problem is revealed in the cases themselves and can be illustrated by an analysis of two recent decisions.

*Adolph Coors Co. v. FTC*,[87] involved a challenge to the restrictive practices which Coors had employed to control the prices and territorial freedom of its wholesale distributors and the pricing freedom of its retailers. In essence, Coors had required its distributors to sell only within specific geographic areas and only to retailers who would abide by Coors' suggested retail prices. Besides promotional activities, the wholesaler was expected to distribute Coors beer exclusively, to make a substantial investment in specialized warehousing facilities and, presumably, to develop a distribution system. It is noteworthy that since Coors used a brewery process which did not include pasteurization, the flavor of its beer was easily damaged unless the beer was kept properly refrigerated at all times.[88] This necessitated special distributor investment in refrigeration systems for warehouse facilities.[89]

In the early 1960's Coors decided to expand. In pursuit of this goal, the brewer exercised stringent controls over its distribution process. When Coors first entered a target market, it would sell its beer to taverns stipulating that the beer should be resold only at the premium price although Coors would charge the tavern owner a lower price than he would have to pay for other premium beers.[90] Having once established its presence in the premium beer market through its tavern marketing, Coors would then move into retail stores, particularly supermarkets, where its product would be priced a few cents below other premium brands.[91] In a little over a decade, Coors had captured one-third of the market and had become the largest selling beer in California. It is now the fourth-largest brewer in the country even though it markets

87. 497 F.2d 1178 (10th Cir. 1974), *cert. denied*, 419 U.S. 1105 (1975). *See also* Copper Liquor, Inc. v. Adolph Coors Co., 506 F.2d 934, (5th Cir. 1975); Adolph Coors Co. v. A & S Wholesalers, Inc., 1975 Trade Cas. ¶ 60,187 (D. Colo. 1975); R. E. Spriggs Co. v. Adolph Coors Co., 37 Cal. App. 3d 653, 112 Cal. Rptr. 585 (1974).

88. *The Brewery That Breaks All the Rules*, BUSINESS WEEK, Aug. 22, 1970, at 60.

89. It costs about $50,000 more to equip the warehouses in the way Coors wishes. *Ignoring the Rules*, 103 FORBES, Feb. 1, 1969, at 34.

90. *Id.*

91. *Id.*

in only eleven states.[92] The hard question is whether these results were accomplished by a cartel or through greater efficiency.

A cartel approach would analyze Coors' actions as those of a producer of a somewhat differentiated beer attempting to make itself more attractive to wholesale distributors. Most retailers will be interested in promoting a beer which guarantees a good return[93] and that return can only be attained if there is control over price competition. In order to obtain the desired distribution, the brewer creates a beer retailing cartel in which the participants are assured that no one will break the price line. This assurance, once given, makes the product more attractive to the retailer than other close substitutes not promising similar price security. If a retailer or wholesaler were to succumb to the cheating urge, the pricing structure would be broken down, so distributors, with the assistance of the producer, will watch retailers' sales prices closely. In order to reduce the potential for "cheating" by wholesalers and to insure that the source of beer at each retail location is known, the wholesaler is assigned to a territory and given a price schedule to follow. This procedure fosters a wholesale cartel which includes all distributors who, by respecting each other's territories and maintaining the uniform retail price, help to preserve and promote the illusion of Coors' distinction to consumers and thus insure profitability to retailers. If the territory assigned to a distributor is of a reasonable size so that the distributor can operate efficiently, it can also share in the monopoly profit. If this distributive plan is to yield real profit for its participants, the product itself should be reasonably distinctive within its class.[94] In other words, there has to be some basis on which the cartel is to operate, but, once such a basis is established, it is the skill of the conspirators that determines the degree of its success.

This approach would tend to view the ostentatious insistance on a single brewery, antedeluvian advertising, lack of pasteurization,

92. The Wall Street Journal, September 11, 1975, at 24, col. 1.

93. Coors charges lower prices to wholesalers and the latter charge lower prices to retailers. *The Brewery That Breaks All the Rules*, BUSINESS WEEK, August 22, 1970, at 61. The result is a larger return at each distributive level provided the prices for the next level are not subject to competition.

94. There is some evidence that Coors is distinctive. The Milwaukee Journal, February 18, 1975; 34 CONSUMER REPORTS 474 (1969). There is also evidence that beer drinkers cannot tell beers apart and that their preferences are almost entirely manipulable by advertising and other image-making activity. Ackoff & Einshoff, *Advertising Research at Anheuser-Busch, Inc.* (1968-74), 16 SLOAN MANAGEMENT REV. 1, 12 (1975). (Subjects shown differing commercials about identical beer with differing brand labels "all . . . believed that the brands were different and that they could tell the differences . . . . Most felt that at least one of the four brands was not fit for human consumption.")

and need for special distributors' facilities as part of the necessary hokum to establish a basis for the cartel—a differentiated product, sufficient to support the monopoly profit demands of the several layers of participants.

An efficiency explanation of the same facts would start by reference to the problems faced by a small brewer desiring to expand, especially its need for substantial distribution through wholesaler outlets[95] and for large investment by these independent wholesalers in both promotional activity and in the special facilities for Coors' distribution. No independent distributor could consider an investment of this size keyed to a product manufactured and controlled by another, in the absence of some understanding that the producer would not unreasonably compromise the chances of return.

When the program also requires carefully timed price adjustments and coordinated marketing to insure the success of a total effort, it is necessary to draft a careful understanding that assigns a clearly defined role to each participant and sets forth clear territorial and price limitations. In fact, there is substantial restraint on the freedom of the individual participants, but their restraint is essential to the joint-venture nature of the distribution. This distribution system may rigidify so that its members and the structure itself become inflexible. An efficiency analysis would also suggest that there are many other beers which are chemically similar and which have well-established distribution systems. The existence of these other brands would support the inference that this effort was a joint venture between a producer and its distributors organized to compete effectively and efficiently within the existing distribution networks.

Without an examination of all the evidence in *Coors*, it is impossible to denominate one or the other of these explanations as the more nearly correct. Certainly the explanations differ markedly in the way the same facts are viewed and characterized. In a static analysis, the problem is simply deciding which explanation, cartel or efficiency-based joint venture, is better. The clear implication is that a cartel is inefficient and undesirable; if only some aspect of the distribution system is cartel-like in character, it is reprehensible to that degree. Otherwise, a system like the one Coors developed is acceptable as provocative of competition in the market. In considering the validity or efficiency explanations, however, it may be relevant that other brewers do not use the same system.

95. In California, neither a brewer nor its wholesaler can provide direct assistance to or financing for a retailer, so the only available route to compensate retailers for their investment in and risk taking on a new beer is to assure them of a reasonable price. *See* CAL. CORP. CODE ¶ 25501 (West 1964).

A dynamic perspective would stress Coors' rise from obscurity to dominance in an eleven-state region displacing the leading national beers. In California alone, it acquired more than one-third of the market. All of this occurred at a time when regional brewing was said to be on the wane and a significant trend toward concentration in the industry was emerging.[96] Whether cartel- or efficiency-based, Coors worked a radical change in the market. Furthermore, it does not appear to be easily reversible by merely eliminating the restraints. A dynamic analysis might well use Coors' program as an example of the use of distribution restraints to create and allocate market power.

It does not follow, however, that just because the restraint had a desirable effect on the loci of power in the market, the preservation of such restraints is desirable. Coors' distributors are now leading beer merchants in their assigned territories. To continue to allow their actual and potential competition with each other and with other distributors in handling Coors and competing beers to be directed by Coors rather than by each distributor's business judgment places control of a substantial segment of the beer distribution process into the hands of one producer. Dynamic analysis would suggest that whatever the mixture of cartel and efficiency motivation that went into the creation and evolution of Coors' leading market position, the restraints were not harmful to a long run interest in dynamic competition until the participants had achieved a leading position. At that somewhat indefinite time, the restraints became objectionable because they now permitted a leading producer and leading distributors to combine their power to the detriment of dynamic competition.

*GTE Sylvania, Inc. v. Continental T.V., Inc.*[97] has excited much discussion[98] even though the Ninth Circuit withdrew the opinion to permit reargument en banc.[99] The facts, as reported, are that in the early 1960's Sylvania faced the prospect of the total loss of its television business. Instead of withdrawing from the market and without, so far as appears, making any change in its product, Sylvania adopted a policy of handling its own wholesale activity

96. United States v. Falstaff Brewing Corp., 410 U.S. 526 (1973); United States v. Pabst Brewing Co., 384 U.S. 546 (1966); MODERN BREWERY AGE, October 14, 1974, at 52.

97. GTE Sylvania, Inc. v. Continental T.V., Inc., 1974-1 Trade Cas. ¶ 75,072 (9th Cir. 1974), *withdrawn for rehearing en banc*, 1974-2 Trade Cas. ¶ 75,435 (9th Cir. 1974).

98. *See e.g.* 1975 DUKE L.J. 935; 26 MERCER L. REV. 629 (1975); N.C.L. REV. 775 (1975); 21 WAYNE L. REV. 1087 (1975).

99. GTE Sylvania, Inc. v. Continental T.V., Inc., 1974-2 Trade Cas. ¶ 75,435 (9th Cir. 1974).

and allowing only a limited number of retailers in any geographic area to handle its product and then only in authorized locations. The purpose of this policy was "to reduce intrabrand competition . . . as an incentive for them [retailers] to carry and promote the Sylvania brand."[100] The apparent effect of this program was that Sylvania increased its market share from between 1 and 2 percent in 1962 to 5 percent in 1965. Sylvania did not insist on exclusivity nor did it give dealers a veto over awards of new franchises to locations near the dealers' assigned location.

Continental, a retailer with eight permitted locations, became embroiled in various controversies with Sylvania about the granting of a franchise to another dealer in the San Francisco area, Continental's addition of an unauthorized location, and a change in Sylvania's credit terms with Continental. During this period, Continental moved many of its Sylvania products to its new unauthorized location, resulting in the loss of its franchises for all locations.

A jury verdict for Continental on an instruction which made any restriction on outlets or store locations unlawful per se was appealed by Sylvania to the Ninth Circuit. Neither Judge Skopil, writing for the majority, nor Judge Ely, in dissent, presented adequate data upon which to determine whether this program was cartel- or efficiency-based. The court did not inquire into Sylvania's reasons for creating "elbow room" among its retailers. Sylvania may have created a cartel for a group of retailers using the residual value in the Sylvania trade name to provide a product each could sell without facing competition from the identical item in the hands of other retailers. Or Sylvania may have fairly concluded that, in light of its marginal position, only if a retailer were fairly sure that it could recapture all its sales effort could retailers be obtained and retained for its products which would provide the necessary promotional effort. Neither the majority nor the dissenting opinion, however, suggests that the franchisee had any defined duties with respect to promotional or other investments in the Sylvania products. In addition, the retailer could sell other brands of TV's, and Sylvania could introduce new sellers at its discretion. The looseness of these controls cuts equally against either a cartel or efficiency explanation. Under a cartel theory, the greater managerial discretion to select participants and the freedom for the participants to decide how much of a commitment to make to the cartel may balance and manager can introduce new members only if existing members would not respond by reducing their own commitments.

100. GTE Sylvania Inc. v. Continental T.V., Inc., 1974-1 Trade Cas. at 96,793.

In an efficiency analysis, the manager's discretion undercuts the argument that promotional services can only be had by the detailed protection of the seller. But the retailer's freedom of choice in its own allocation of promotional efforts offsets the producer's discretionary power and creates, perhaps, more of a bargaining context.

Judge Skopil and Judge Ely both recognize an aspect of the static-dynamic problem in their opinions, and agreed that restraints introduced to save an otherwise failing firm might be subject to a different standard. This is a dynamic analysis. Neither majority nor dissent distinguished between cartel- and efficiency-promoting restraints as dynamic devices. The majority concluded that

> Since the antitrust laws are concerned with the preservation of competition in a relevant market, the possible loss of Sylvania's competition in that market was of legitimate concern. But there are several crucial flaws in Sylvania's argument in the present context. If an otherwise illegal practice may be justified at one point of time under the "failing-company" doctrine, it is not necessarily forever after justified regardless of changes of circumstances. [Citation omitted]. Sylvania's proffered instruction overstated the doctrine. More important, the evidence which it offered was not particularly relevant to the circumstances in the case. The danger of failure was in the early sixties. By Sylvania's own testimony, it has prospered and increased its market share to five percent by 1965, when these events occurred. Furthermore, its market share in Sacramento was ten percent. Sylvania makes no claim it was about to leave the television business in 1965. It is important to recall that the case focused not so much on location restrictions as an abstraction but on what Sylvania did to Continental in the fall of 1965. We agree that there was insufficient evidence to go to the jury that Sylvania's conduct toward Continental was necessary to enable it to remain in the television industry. Therefore, the trial judge properly refused the instruction.[101]

Judge Ely objected in his dissent:

> . . . *United States v. Arnold, Schwinn & Co.* [citation omitted] indicates that the defense is available in cases wherein a vertical restraint is being challenged. Unlike merger or acquisition situations, which involve a single challenged act, a vertical restraint usually involves an ongoing practice or method of distribution. For the defense to be available, a company must show that prior to the institution of the practice it was failing economically. And

101. *Id.* at 96,796.

> the company should be able, I think, to justify the on-going use of the practice by showing that, but for the restraint, the company would still fail. Here, the majority takes the position that Sylvania could not be entitled to the defense unless the company is in a failing state as long as the practice continues. To me, it is inconceivable that such an unreasonable, incongrous result was intended by the Supreme Court in its *Schwinn* decision.[102]

The majority thus recognized some scope to this dynamic defense but, without defining that defense very precisely, rejected it on the grounds of failure of proof. In this latter context, Judge Ely's comment that a restraint might be necessary for an indeterminate period of time in order to save a company from failure suggests that a cartel created by a failing firm should be lawful if it makes a success of its organizer even though the retailer participants are taking the less attractive goods only in order to get the cartel advantage and would cease to handle the product in the absence of that advantage. In the absence of indefinite continuation of the restraint (cartel), the firm will arguably still fail. Imputing that view to the dissent, a reader might consistently imply that the majority would restrict the failing-company defense to cases in which the restraint directly made possible a change in a relevant aspect of a product or its promotion, thus creating new relationships from which new power would evolve. Once this new power had evolved, the restraint could be terminated, having served its purpose by providing either a short-term boost in profits or a degree of certainty from which the producer could improve its product or its distribution system. This issue is obscured in *GTE* by the efforts of both Judge Skopil and Judge Ely to fit their conclusions into the *Schwinn* language without regard to a more fundamental analysis of what problems the rules of vertical restraints face and how they attempt to resolve those problems.

Both *Coors* and *GTE* reveal the difficulty of applying traditional cartel and efficiency explanations for vertical restraints and suggest that some clear-cut standards would both save time and promote clarity of decision. In establishing such standards, however, courts must consider both static and dynamic implications and must decide to what degree the legal system can induce change in economic phenomena without creating long run risks of inefficiency. In a truly determinate model, the system operates, changes, and grows independently of the social or legal context. In less overtly deterministic formulations, this proposition takes the form of a

102. *Id.* at 96,802 (footnotes omitted).

suggestion that law operates either to help or to hinder the achievement of the most efficient economy.[103] But under neither formulation does law have a constructive role to play in changing fundamental costs, technology, or demand. Traditional static analysis gives rise to this determinism because it assumes that the legal system is a given which is a factor in determining costs. Even the long run equilibrium deals only with the alternative costs that are possible given expertise, knowledge, and potential. Once again, then, there is an implicit holding constant of the legal system. On the assumption that the economic system is fundamental and that the legal system is derived from it, the lawyer-economist can determine which rule is more efficient by comparing static results under different sets of rules. But this determination assumes that the economic system, and perhaps its changes, are given, and that at any point in time there is only one efficient way of doing things. The conclusion as to which rule is more efficient follows from the deterministic perceptions of the classic model, which always shows a single most efficient point and implies by the use of a single continuous cost curve that there are not alternative ways of behaving. If the economic system is responsive to changes in other aspects of life, the deterministic problem is complicated because different states of economic activity imply different human conduct which is not easily or quickly rearranged by legal rules for behavior. In a broader perspective, however, this interaction destroys the easy determinism of the lawyer-economist, since interaction between legal rules and the economic system suggests that the economic system should be efficient in terms of the rules and its dynamics should be responsive to social priorities.

This view would justify a belief in law as a reforming and social planning device.[104] A rule which alters some significant aspect of commercial life will have the effect of changing conduct if the cost of avoiding the rule is too great.[105] Once this cost threshold is crossed, the legal rule, and not the economic one, will govern conduct. In the deterministic view, such a rule of law will generate no change

103. R. POSNER, ECONOMIC ANALYSIS OF THE LAW (1972), is an example of this kind of covert determinism. Its implications are discussed in Leff, *Economic Analysis of Law: Some Realism about Nominalism*, 60 VA. L. REV. 451 (1974).

104. Posner recognizes not only that change occurs, but also that both law and business have conspicuously sought such results. R. POSNER, *supra* note 103, at 299, 333.

105. This cost will include both the transaction costs associated with dealing with beneficiaries of the new rule and the payments to those beneficiaries to waive their rights under the rule (because it is presumed that the old way was more profitable, *i.e.*, efficient, the actual payments can be made provided the cost of the transaction is not too great). This is covered in more detail in *id.* ch. 23.

in the economic foundations, only continued market inefficiency. But even the static economic model suggests that further analysis is in order. If the costs of doing business in a particular way change, the static model would support substitution of different and less expensive elements for the new, costly elements. The firm might substitute capital for labor or direct selling for sales to independent distributors. In essence, then, a firm may change its method of doing business rather than just sustain the costs of continuing the same practice. The static approach considers such a change to be, by definition, a more costly way of doing business than would have been employed in the absence of the rules. Therefore, if the rules were eliminated, the old practice would reoccur. It is crucial to this assumption that all costs remain fixed relative to each other. If an innovation occurred outside the static model which reduced costs, at least to the level of cost under the old method, then even if the rule was withdrawn, no changes would occur. In a dynamic world, however, technology and ways of doing business are not given. If changes are responsive to external pressures such as cost changes, then rules in a dynamic world should cause a firm to evaluate present and alternative methods of operation.[106] Unless it is assumed that changes are entirely independent of incentive, the changed incentive ought to produce new and different directions for innovation. Innovation responsive to new rules will not necessarily follow their formulation, but changes can and probably will come about with some frequency. Such innovation results in the development of new ways of doing business which can be as efficient, or perhaps more so, than the old ways. More technical aspects of enterprise such as plant size may be unamenable to change induced by new rules, but areas subject to extensive legal influence such as independent distribution may well be amenable to change and to the development of alternative, but equally efficient, methods of doing business.

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106. The Robinson-Patman Act was a force in causing the development of house brands and thus adding a new dimension to mass retailing. J. PALAMOUNTAIN, THE POLITICS OF DISTRIBUTION 159-87 (1955). The chainstore tax system was among the factors leading to the disintegration of their formerly vertically integrated gasoline selling systems and the creation of independent distribution businesses. *Id.* at 187. The Sherman Act makes price fixing unlawful and so encourages product differentiation among those seeking monopoly profits thereby creating more diversity in fact. The Sherman Act prohibition on monopolizing a product line induces firms to invest monopoly profits in other activities. *See U.S.M.'s Hard Life as an Ex-Monopoly*, 86 FORTUNE, Oct. 1954, at 124. This also tends to support new product innovation and efforts to find or create new demands. The effect of the strong rule against merger of competitors also encourages product extension and conglomerate mergers.

## III. THE LAW OF VERTICAL RESTRAINTS:

Vertical restraint law appears to many observers to be a hodgepodge of rules and exceptions without sound or consistent theoretical basis. Upon closer analysis, however, the rules may be much more consistent than has been previously recognized. In order to perceive that consistency, it is necessary to reject exclusive adherence to any one economic perspective because the rules reflect a pragmatic formulation based on both static and dynamic policy considerations.

Although courts have been less than clear in articulating the reasons for the rules, a review of the case law suggests that two policies underlie the decisions. The first is a concern for efficiency in static terms, without which a firm must inevitably fail. The second is a concern with the power of one independent firm over another equally independent one, a situation which has an obvious dynamic implication for the potential for change and innovation. The rules found in *United States v. Arnold, Schwinn & Co.*[107] and the cases involving vertical price controls manifest an implicit balancing between these static and dynamic interests which can be explained in terms of a single set of criteria.

### A. *The Evolution of Vertical Restraint Law: From Cartel Hypothesis to Protection of the Independent Business*

In developing rules regarding restraints on distribution, courts have categorized restraints according to the activity or conduct restrained rather than looking to the function that the restraint, regardless of form, is meant to perform. With respect to restraints imposed in the setting of a distribution system, the courts have developed three main categories, the first two of which are relevant to *Schwinn* and this article: (1) price control; (2) nonprice controls over the distributor's business, such as territorial or customer control, and (3) restrictions on dealings with either other suppliers or distributors. The third category includes a variety of "restraints" including some tying arrangements, requirements contracts, and full-line forcing, not all of which are necessarily based on monopolistic position, and thus do not lend themselves to this discussion.[108] The general conclusions advanced, however, will apply to

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

108. The analysis of exclusive dealing or requirements contracts is difficult.

all cases in which such restraints arise in the context of monopolistic competition.

In *Dr. Miles Medical Co. v. John D. Park & Sons, Co.,*[109] the first leading case involving a vertical restraint decided by the Supreme Court, a producer of proprietary medicines had, by contract, fixed both the prices at which its wholesalers sold Dr. Miles medicines to the retail drug stores and the prices at which the retailers in turn sold to the public. Having discovered that John D. Park was obtaining and reselling supplies of Dr. Miles products at cut rates, Miles claimed that these sales were destroying its resale price maintenance program, thus threatening its market position. Miles sought to enjoin Park from continuing to obtain its products in violation of contracts. On a demurrer by Park, the trial court dismissed and the court of appeals affirmed.[110]

Miles did not deny that its contracts were restraints of trade. Rather, it tried to justify the restraints primarily on the theory that

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Given a long lead time to create production capacity and/or known long run needs for a fungible good, long term contracts may make sense to both producer and consumer of such a commodity. Because fungible substitutes exist, such contracts would presumably involve no more restriction on either party than was fully justified in terms of savings generated by the reduced uncertainty. *See, e.g.,* Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961); *cf.* United States v. General Dynamics Corp., 415 U.S. 486 (1974). Such restraints may, however, also occur in a program of monopolistic competition. *See, e.g.,* Standard Oil Co. (Calif.) v. United States, 337 U.S. 293 (1949). Because of the analytic ambiguity that this creates, it is deemed best to exclude this area from extensive treatment in this discussion.

109. 220 U.S. 373 (1911). *Dr. Miles* was decided during a particularly active period of Supreme Court consideration of basic antitrust principles. *Dr. Miles* was argued on January 4 and 5, 1911, while United States v. American Tobacco Co., 221 U.S. 106 (1911), was reargued on January 6, 9, 10, 11, and 12, and United States v. Standard Oil Co., 221 U.S. 1 (1911), was reargued on January 12, 13, 16, and 17. Further, the decision in *Dr. Miles* was handed down on April 3, 1911, less than 45 days before the announcement of the *Standard Oil* decision and, with two exceptions (Holmes and Lurton), all of those in the majority in *Standard Oil* voted for Hughes' opinion in *Dr. Miles.* As a circuit court judge, Lurton, however, had written the opinion in *Dr. Miles,* 164 F. 804 (6th Cir. 1908), which had followed Lurton's earlier opinion in John D. Park & Sons, Co. v. Hartman, 153 F. 24 (6th Cir. 1907), *cert. dismissed,* 212 U.S. 588 (1908). Not surprisingly, therefore, language in *Dr. Miles* anticipates the *Standard Oil* rule of reason. *See* 220 U.S. at 406.

110. Dr. Miles Medical Co. v. John D. Park & Sons Co., 164 F. 803 (6th Cir. 1908). The Supreme Court had already granted certiorari on a similar case but it was about to become moot. *See* John D. Park & Sons, Co. v. Hartman, 153 F. 24 (6th Cir. 1907), *cert. dismissed,* 212 U.S. 588 (1908). Furthermore, there were apparently a large number of similar cases pending in the courts at this time. Petitioner's Brief for Certiorari at 12, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911). The prompt grant of certiorari in *Dr. Miles,* 212 U.S. 575 (1908), coupled with these facts may well indicate the Court's desire to resolve the problems involved in vertical price fixing.

any manufacturer has a legal right to restrain the pricing freedom of its vendors.[111] The Court dealt with this claim in several ways. First, relying upon ancient texts on restraints on alienation, it stated that the right to sell or to refuse to sell did not include the right to sell any interest less than a total one.[112] Second, the Court declined to recognize an "inherent power incident to production" that would enable a manufacturer to announce and enforce price or other controls over subsequent users of the property.[113] Any such control, according to the Court, could arise only under a statute or contract. Since no special statutory right existed, Miles' power must perforce have arisen through a contract in restraint of trade. Such contracts were to be tested by their "reasonableness," first in terms of the "public interest" and second with respect to the parties.[114]

The thrust of Miles' defense had been that the restrictions were designed to prevent retailers, particularly department stores, from selling at a discount. If this could not be prevented, Miles contended that

> the majority of retail druggists . . . are "unwilling to, and do not keep" [its] . . . medicines "in stock" or "if kept in stock, do not urge or favor sales thereof, but endeavor to foist off some similar remedy or substitute."[115]

Justice Hughes concluded that Miles had claimed that

> the advantage of established retail prices primarily concerns the dealers, the enlarged profits which would result . . . would go to them . . . [I]t is through the inability of the favored dealers to realize their benefits, on account of

111. Miles also argued that, since its medicines were made by secret process, it had a right to control prices by analogy to patent holders' rights. Patent law at this time allowed such control, *see, e.g.*, Bement v. National Harrow Co., 186 U.S. 70 (1902), although the Supreme Court has since implicitly reversed the rule. *See* Standard Oil Co. (Indiana) v. United States, 283 U.S. 163 (1931). Justice Hughes rejected this argument, 220 U.S. at 401, because any such right had to arise from a statutory grant based on public considerations.

112. *Id.* at 404-05. Others have questioned the accuracy and relevance of the Court's argument. *See, e.g.*, United States v. Arnold, Schwinn & Co., 388 U.S. 365, 392 (1967) (Stewart, J., dissenting).

113. 220 U.S. at 407. Such a power, akin to that of a patent or copyright holder in dealing with infringers, had even been rejected at common law. *See* Anonymous—"The Schoolmaster Case," Y.B., anon. 11 Hen. IV, f. 47, pl. 21 (1410), *reprinted in* M. HANDLER, H. BLAKE, R. PITOFSKY, & H. GOLDSCHMID, CASES AND MATERIALS ON TRADE REGULATIONS 42-43 (1975).

114. The Court did not find it necessary to test the reasonableness with respect to the parties, but the opinion suggests that the key would be whether or not there is a less restrictive alternative available. 220 U.S. at 406.

115. *Id.* at 375.

> the described competition, that the complainant works out its alleged inquiry.[116]

Justice Hughes thus read Miles as claiming nothing more than that it was acting as an overseer for a dealer agreement to fix prices and boycott price cutters. Justice Hughes found that this was not in the public interest and thus was unreasonable.[117]

Justice Holmes' dissent is notable in that it laid the foundation for the future debate over the legality of vertical restraints. First, he pointed out that if the retailer were a consignee, no one would deny the right of the producer-consignor to control the price at which the retailer sold the consigned goods.[118] Moreover, Holmes saw the majority opinion as "extending a certain conception of public policy to a new sphere."[119] Favoring a contrary policy of letting "people manage their own business in their own way"[120] and believing that demand for Dr. Miles products was relatively elastic,[121] he argued that the "Dr. Miles Medical Company knows better than we do what will enable it to do the best business."[122] Holmes did not respond to Hughes' analysis that Miles was operating a retailer cartel. Under Holmes' analysis, Miles was operating in a market in which nearly perfect pure competition existed; in the long run only a competitive price could prevail, thus making irrelevant any concern with misguided attempts by Miles to set up a cartel.[123]

As a historical matter, Hughes was correct on the cartel nature of this agreement. Only five years earlier, a druggist boycott of

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116. *Id.* at 407.

117. Since the activity thus came within the category of vertically sponsored cartels, even the most vigorous defenders of vertical restraints would admit Miles' contracts were illegal. Of course, Miles may have had other reasons for its vertical price controls, but if it had, it should have pleaded them. *See generally* Bork, Part II.

118. 220 U.S. at 411.

119. *Id.*

120. *Id.*

121. *Id.* at 412. Holmes described Miles' products as nonessentials and from that deduced that there would be a high level of substitution between them and similar products based on comparative price. This would check and control any abuses. By assuming that Miles is in perfect or nearly perfect competition, Holmes could argue that it has no market power and thus no change in the way it sold goods would affect that.

122. *Id.*

123. Holmes' assumption of something approaching perfect competition among producers of differentiated nonessentials is critical to his analysis. At the time that Holmes wrote, economics had yet to develop a theory of product differentiation so that rejection of his position would have had to rest on only a sense that his model did not conform to reality.

producers who sold to price cutters had been enjoined.[124] The contract defended by Miles was one of twelve similar contracts entered into almost simultaneously by major drug producers and wholesalers following the first druggists' convention after the injunction against the druggists' boycott had been entered.[125] This illuminating background was not part of the formal pleadings and was barely mentioned in the briefs.[126] Given, then, that this was a dealer cartel and that Miles and the other producers were rationally run businesses, Holmes' perception of the substitutability of specific medicines, even if justified, becomes irrelevant when the substitutes are also offering competing cartels.

In 1919, in *United States v. Colgate & Co.*[127] the Court sought to clarify the doctrine of *Dr. Miles*, unanimously holding that a manufacturer could suggest retail prices and refuse to sell to distributors not honoring those prices, provided that this was not done pursuant to an agreement. The Court declared that the Sherman Act, absent

> any purpose to create or maintain a monopoly . . . does not restrict the long recognized right of a trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, course, he may announce in advance the circumstances under which he will refuse to deal.[128]

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124. Jayne v. Loder, 149 F. 21 (3d Cir. 1906).

> *Jayne v. Loder*, cited above, was decided by the Third Circuit Court of Appeals. It was an action under the seventh section of the antitrust act against a combination of three distinct national associations, one that of wholesale druggists, another that of retail druggists and the Association of Manufacturers of Proprietary Medicines. The object of the combination was to exclude every dealer from trading in proprietary medicines of all who would not consent to sell to members of the combine only and at prices named by it.

John D. Park & Sons Co. v. Hartman, 153 F. 24, 35 (6th Cir. 1907); *cf.* FTC, REPORT ON RESALE PRICE MAINTENANCE 36-38 (1945).

125. J. PALAMOUNTAIN, POLITICS OF DISTRIBUTION 94 (1955).

126. Dr. Miles referred in passing to the consent decree without discussing or describing it. Petitioner's Brief for Certiorari at 7, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911). The only reference to the practice of the drug producers was to point to the uniformity of their actions as evidence of the necessity of dealing in this way. *Id.* at 13.

127. 250 U.S. 300 (1919).

128. *Id.* at 307. The Court was working on the assumption that no agreement existed in the case. In light of the facts, this seems a bit strained. The government charged that Colgate had engaged in

> Distribution among dealers of letters, telegrams, circulars, and lists showing uniform prices to be charged; urging them to adhere to such prices and notices, stating that no sales would be made to those who did not; requests, often complied with, for information concerning dealers who had departed from specified prices; investigation and discovery of those

By sanctioning, in such unqualified terms, prior announcement of the conditions under which a seller will deal, the Court created an obvious tension with *Dr. Miles*. Recast in *Colgate* terms, all that Dr. Miles Medical Company had done was "to announce in advance," albeit through its contracts, the terms on which it would deal with customers. Although the *Colgate* opinion did not reject the ruling in *Dr. Miles*, it did appear to limit application of *Dr. Miles* absent a formal "combination . . . which undertook to prevent dealers from freely exercising the right to sell."[129] After *Colgate*, it might have seemed that a firm could fix prices provided it used announcements and other informal practices but did not use a formal written contract.

What *Colgate* really did was to announce in sweeping terms the right of a producer freely to select distributors in ways consistent with the producer's notion of effective distribution. The Court's next task was that of explaining and defining the limits of this freedom. Justice McReynolds began this effort in *United States v. A. Schrader's Sons, Inc.*[130] In this case, the district court thought the sole distinction between *Dr. Miles* and *Colgate* was the presence of a formal written contract in *Dr. Miles*.[131] The Supreme Court, however, pointed out that the distinction did not rest on the mere form of the agreement. Rather, in reaffirming the teaching of *Dr. Miles* that vertical price-fixing agreements were

> not adhering thereto and placing their names upon "suspended lists"; requests to offending dealers for assurances and promises of future adherence to prices, which were often given; uniform refusals to sell to any who failed to give the same; sales to those who did, similar assurances and promises required of, and given by, other dealers, followed by sales to them; unrestricted sales to dealers with established accounts who had observed specified prices, etc.

*Id.* at 303. Certainly such facts have proven sufficient in subsequent cases to sustain a case. *See, e.g.*, United States v. Parke, Davis & Co., 362 U.S. 29 (1960). In *Colgate*, however, the trial court construed the indictment as not charging that an agreement or contract existed and thus under federal law the Court was bound by that interpretation. 250 U.S. at 301-02. *See also* United States v. Parke, Davis & Co., *supra*.

129. 250 U.S. at 308. A minor irony in *Colgate* is that former Justice Hughes, having left the Court and returned to private practice, was the chief advocate for Colgate in the Supreme Court. Hughes' brief explained *Dr. Miles* as follows:

> That case dealt simply with the validity of contracts by which dealers were restrained in selling what they owned. . . . The question, as the Court said, was as to "the validity of the restrictive agreements" . . . . This Court fully recognized the right of a manufacturer to sell or not, as he pleased. . . . It was the restraint upon the right of alienation of property sold, not the right of the manufacturer to refuse to sell, that was involved.

Petitioner's Brief for Certiorari at 24, 25, United States v. Colgate & Co., 250 U.S. 300 (1919).

130. 252 U.S. 85 (1920).

131. 264 F. 175 (N.D. Ohio 1919), *quoted in* 252 U.S. at 97.

illegal, the Court, speaking through Justice McReynolds, limited *Colgate* to the proposition that a manufacturer could unilaterally decide on and announce its policies and could refuse to deal with those who did not adhere to them. The Court noted that, in *Colgate*, it had been bound by the lower court's determination that no agreement had been alleged.[132] Even under *Colgate*, a manufacturer could not enter into agreements with all its customers "which undertake to bind them to observe fixed resale prices"[133] and thus "take away dealers' control of their own affairs."[134] The crucial issue under both *Dr. Miles* and *Colgate* was the existence of such an agreement.

Although the *Schrader* Court had mentioned that the agreement could be either express or "implied from a course of dealing or other circumstances,"[135] in *Frey & Sons, Inc. v. Cudahy Packing Co.*,[136] the Fourth Circuit had found that the *Colgate* doctrine controlled because there had been "no formal written or oral agreement with jobbers for the maintenance of prices."[137] The Supreme Court, again speaking through Justice McReynolds, rejected this interpretation in an almost summary fashion. Repeating what had been said in *Schrader*, it held that the agreement could and, in the instant case, should have been implied from the facts.[138] The subsequent development of the case law on vertical price controls became a matter of defining and redefining "agreement." The Court slowly, but consistently, chipped away at the apparently strict requirements of the original McReynolds formula.[139] But, at least through *Parke, Davis*, one element that consistently existed was some form of explicit understanding among competing distributors.[140]

In static terms this line of cases can be seen to rest upon a rather uncomplicated and unsophisticated view of vertical restraints: Whenever two or more distributors knowingly have their freedom of action on prices restrained by "agreement," the preconditions of a distributor cartel exist, and so the restraint may be

132. 252 U.S. at 99.
133. *Id.*
134. *Id.* at 100.
135. *Id.* at 99.
136. 256 U.S. 208 (1921).
137. *Id.* at 210.
138. *Id.* McReynolds' subsequent dissent in FTC v. Beech-Nut Packing Co., 257 U.S. 441, at 458 (1922), seems to turn on the failure of proof on this issue.
139. This history is set forth in United States v. Parke, Davis & Co., 362 U.S. 29, 38-49 (1960).
140. *Id.* *See also* Albrecht v. Herald Co., 390 U.S. 145, 160-65 (1968) (Harlan, J., dissenting).

concluded that the distributors were in fact agents and so could be legally controlled in pricing as well as other aspects of their competitive conduct.[145] *United States v. General Electric Co.*,[146] decided several years later, went even further in accepting any anticompetitive arrangement as long as it was cast in the form of an agency. In this case, the Court distinguished *Dr. Miles* on grounds of little more significance than drafting error. Although Miles had called its distributors consignment agents, the Court found it obvious, based on the wording of the agreement, that there had been a sale of medical products to the wholesaler.[147] General Electric, on the other hand, had made no such drafting error, and therefore prevailed. It was permitted to retain its price control system.[148]

Merely changing the form of the producer-distributor relationship from vendor-purchaser to principal-agent was, as Holmes had noted, of great significance to the Court of the 1920's. With little concern for the functional relationship of the parties, the Court seemed willing to accept any restraint without inquiry into its function or purpose so long as it was cast in terms of an agency relationship. This mechanistic approach had the effect of reducing the principles set forth in *Dr. Miles* to mere traps for unwary draftsmen since economically equivalent transactions could be created under either sale or agency rubrics.[149]

The agency device thus became useful in any cartel plan. It had the potential totally to vitiate the effectiveness of the antitrust prohibitions on price fixing. A functional analysis was essential to avoid this result.

The first major case to employ a functional analysis involved a horizontal price-fixing scheme under cover of an agency distribu-

145. *Id.* at 581-82. Chief Justice Taft, with whom Brandeis concurred, wrote a separate opinion expressing doubt as to the majority's conclusion that the Court did not need to remand the case to the FTC for further fact findings with respect to the existence of an agency relationship. *Id.* at 582. But even they seem to have accepted the idea that a lawful agency would end the inquiry.

146. 272 U.S. 476 (1926). GE made large numbers of retail stores its "agents" for the purpose of selling light bulbs sent on "consignment." These descriptions, while legally correct, were not functionally very accurate.

147. *Id.* at 486. Although the Court's opinion in *Dr. Miles* had formally avoided deciding that issue, the resolution was sufficiently clear that this rewriting does no violence to the opinion. *See* Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 396-400 (1911).

148. 272 U.S. at 488.

149. Whatever the parties call a transaction, the use of appropriate contract terms can reallocate risks and responsibilities in any way the draftsmen desire. *See* United States v. Masonite Corp., 316 U.S. 265, 280 (1942).

held per se unlawful. Despite the recognition in *Colgate* that a producer can have a substantial, if not dominant, interest in the conduct of distribution, the probability of horizontal motivation was sufficiently great to preclude inquiry into the reasons for and purposes of anything defined as an "agreement." The negative implication is that any "restraint" not involving "agreement" is likely to be ancillary to some producer interest and reasonable so that it is per se lawful.

There is, however, a second strand in these cases which suggests that the independence of distributors and producers is an important factor in the Court's analysis. This emerged most clearly in the *Albrecht* case.[141] There the plaintiff did not claim any agreement among competitors but instead focused on agreements among the defendant and others whose purpose was to influence and control plaintiff's prices; nevertheless, the Court decreed that the defendant had violated the antitrust laws in its effort to restrain plaintiff's conduct. Justice Harlan's dissent appears to argue that the proper reading of the prior cases is that the definition of agreement was to serve the purpose of differentiating between lawful restraints based on producer efficiency interests and unlawful ones based on cartel motivation. He then argues that the *Albrecht* facts involved restraints that were clearly of efficiency origin. While the majority suggests that even these restraints could be part of a cartel package, they do not argue that the cartel inference is the more compelling. The real thrust of the opinion is that the scheme "intrude[s] upon the ability of buyers to compete and survive in that market."[142] After *Albrecht* it is clear that considerations beyond eliminating cartels lay behind the judicial hostility toward vertical restraints. The basis of this attitude would seem to lie in a perception of the market as dynamic and the general effect of vertical restraints as being adverse to desirable dynamic characteristics of the market.

In *Dr. Miles*, Holmes had suggested that the easy solution for a manufacturer was to recast the transaction in such a way as to make the "reseller" an agent.[143] The first case which presented the agency defense was *FTC v. Curtis Publishing Co.*[144] The FTC challenged Curtis' practice of employing large numbers of formerly independent magazine distributors as its "exclusive" agents serving assigned territories and charging specified prices. The majority

141. Albrecht v. Herald Co., 390 U.S. 145 (1968).
142. *Id.* at 152, 153. *See also id.* at 151 n.7, 154.
143. Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 411 (1911).
144. 260 U.S. 568 (1923).

tion. In *United States v. Masonite Corp.*,[150] the producer, who held a patent for the manufacture of fiberboard, was able to get other producers of the product to sign agency distribution contracts which, among other things, gave Masonite the power to fix prices.[151] The presence of strong horizontal overtones made it especially easy for the Court to reject the agency idea as justifying the elimination of competition by "competitors" of the producer through an arrangement, the purpose of which was "to fix prices at which the competitors may market the product."[152] The Court, refusing "to allow the form into which the parties chose to cast the transaction to govern,"[153] distinguished between permissible and impermissible restraints on the basis of the functional character of the distributor upon whom the restraints were imposed. "[I]f it may fairly be said that that distribution is part of the patentee's own business,"[154] it is permissible; but where a producer

> utilizes the sales organization of another business—a business with which he has no intimate relationship—this arrangement poses quite different problems, since such a regimented marketing system is peculiarly susceptible to the restraints of trade which the Sherman Act condemns.[155]

The Court's reasons for this conclusion heavily emphasized the potential for competing patented, *i.e.*, differentiated, products that was suppressed by the agreement.

Two decades later, the Court dealt with the issue of vertical price restraints imposed through an agency contract in which the horizontal conspiracy elements so obviously involved in *Masonite* were less evident. In *Simpson v. Union Oil Co.*[156] the Court reaffirmed the logic and conclusion in *Masonite*: Distribution restraints must be viewed functionally, in terms of the nature of the parties. Writing for the Court, Justice Douglas pointed out that the consignment device created vertical price restraints that took from the independent distributors "[p]ractically the only power they have to be wholly independent businessmen, whose service depends on their own initiative and enterprise."[157] The Court again employed a functional rather than formal distinction between those upon whom a producer could impose restraints and those upon whom such impo-

150. 316 U.S. 265 (1942).
151. *Id.* at 279.
152. *Id.*
153. *Id.* at 278.
154. *Id.* at 279.
155. *Id.*
156. 377 U.S. 13 (1964).
157. *Id.* at 20-21.

sition would be illegal. *Simpson*'s teaching was that if the distributor is functionally independent, control of his resale prices is generally illegal regardless of whether the technical basis on which he holds the goods is described as agency or consignment.[158]

The applicability of this expansion of the *Dr. Miles* rule turned on the definition of independent business. The Court, having opted for a functional definition, did not, however, articulate tests by which the independent distributor could be distinguished from the agent.[159] The Court said only that:

> Dealers, like Simpson, are independent businessmen; and they have all or most of the indicia of entrepeneurs . . . . The risk of loss of the gasoline is on them, apart from acts of God. Their return is affected by the rise and fall in the market price . . . . [They] are in reality small struggling competitors seeking customers.[160]

As indicated earlier, there is a crucial distinction between functionally independent distributors, who can and do perform without the necessity for control, and employees, whose function is defined by the orders they get. While risk and title are relevant to an inquiry, they are not functional tests which directly examine the roles of the participants in the activity of distribution. *Albrecht v. Herald Co.*[161] provided an ideal factual setting for an analysis of those factors which make someone who is providing a distribution service an independent distributor, but neither side raised the question because, ironically, the only common ground between the parties was that those who delivered the Herald's newspapers were independent businessmen.

Despite the absence of a clear Supreme Court definition of functionally independent businesses, lower courts have developed a

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158. *See* United States v. General Elec. Co., 358 F. Supp. 731, 735, 736 (S.D.N.Y. 1973); Rahl, *Control of an Agent's Prices: The Simpson Case—A Study in Antitrust Analysis*, 61 Nw. U.L. Rev. 1 (1966).

159. This failure in the context of the *Simpson* case is understandable. The gasoline producers had for so long promoted the idea of independent station operators that it would hardly do for the Court to let this be denied. There are a variety of tax, union, liability, and motivational reasons which compelled producers to transform their original system of owned stations into leased stations. *See* Phillips v. Crown Cent. Petroleum Corp., 395 F. Supp. 735 (D. Md. 1975). *See generally* J. Palamountain, *supra* note 106. But having done so, the teaching of many cases is that the producers cannot then treat their former employees as if they were still employees. *See, e.g.*, FTC v. Texaco, Inc., 393 U.S. 223 (1968); Atlantic Ref. Co. v. FTC, 381 U.S. 357 (1965); Simpson v. Union Oil Co., 377 U.S. 13 (1964); United States v. Standard Oil Co. (Cal.), 337 U.S. 293 (1949).

160. 377 U.S. at 20-21.

161. 390 U.S. 145 (1968).

working notion of this class or type of business. The courts appear to consider a number of factual elements as indicia of the independent businessman but have not fully articulated the underlying functional character which they seek to ellucidate.[162] Perhaps the clearest example of such a distributor is found in *United States v. General Electric Co.*,[163] decided in 1973, which finally struck down GE's agency distribution system. The GE system employed as agents primarily retail grocery, hardware, and drug stores and industrial and electrical supply houses.[164] Such businesses are usually owner-initiated and owner-financed, supply more in the way of goods and services than merely GE products, do their own billing, collections, and hiring, and make final sales on their own initiative. Their contracts with GE were, nevertheless, "genuine contracts of agency under private contract law."[165] The court had no trouble finding

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162. A careful analysis of the cases in this area yields the following characteristics:

> (1) The independent businessman bears the risk of loss, his income arising from the difference between what he pays the producer and what he charges his customers. *See* Simpson v. Union Oil Co., 377 U.S. 13, 20 (1964); Knutson v. Daily Review, Inc., 383 F. Supp. 1346 (N.D. Cal. 1974); Lepore v. New York News, Inc., 346 F. Supp. 755 (S.D.N.Y. 1972). *See also* Fagan v. Sunbeam Lighting Co., 303 F. Supp. 356 (S.D. Ill. 1969) (agent assumes no risk).
>
> (2) The independent businessman's contract with the producer will often stipulate that he is not an employee or agent, but rather an independent contractor. *See, e.g.*, Knutson v. Daily Review, Inc., 383 F. Supp. 1346 (N.D. Cal. 1974); Lepore v. New York News, Inc., 346 F. Supp. 755 (S.D.N.Y. 1972).
>
> (3) The independent businessman will usually have his own capital invested in both the goods and the equipment necessary to distribute them. *See, e.g.*, Albrecht v. Herald Co., 390 U.S. 145, 155 (1968) (Stewart, J., dissenting) ("He purchased his route for $11,000 receiving a list of subscribers, a used truck, and a newspaper-tying machine."); *cf.* Ammerman v. Bestline Prods., Inc., 352 F. Supp. 1077 (E.D. Wis. 1973).
>
> (4) The independent businessman provides a variety of services which may include, in addition to selling the product, delivery of the product, billing and collections, and recruitment or hiring of personnel. *See, e.g.*, Lepore v. New York News, Inc., 346 F. Supp. 755 (S.D.N.Y. 1972); *cf.* Bowen v. New York News, Inc., 366 F. Supp. 651 (S.D.N.Y. 1973) (in this refusal-to-deal case, the aggrieved independent dealers also distributed other publications); Fagan v. Sunbeam Lighting Co., 303 F. Supp. 356 (S.D. Ill. 1969) (agent only solicited orders).
>
> (5) The independent businessman will usually have the power to consummate a sale without further producer approval. *See, e.g.*, Simpson v. Union Oil Co., 377 U.S. 13 (1964); Lepore v. New York News, Inc., 346 F. Supp. 755 (S.D.N.Y. 1972); *cf.* Fagan v. Sunbeam Lighting Co., 303 F. Supp. 356 (S.D. Ill. 1969) (no such power in agent).

163. 358 F. Supp. 731 (S.D.N.Y. 1973), *consent decree entered*, 1971-1 Trade Cas. ¶ 74,942. For an independent dealer with whom producer has refused to deal, see Bowen v. New York News, Inc., 366 F. Supp. 651, 656 (S.D.N.Y. 1973). *See also* Rahl, *supra* note 158, at n.26.

164. 358 F. Supp. at 734.

165. *Id.*

that the "agents" were independent businesses for antitrust purposes.[166]

Taken as a whole the cases on vertical price control reflect a more complex, if not clearly intelligible, set of rules than the term per se would appear to convey. Thus, producer control of prices set by functionally independent distributors is condemned whenever it is done by "agreement." *Colgate* recognizes a producer interest in distributor pricing sufficient to justify cancellation of a distributor's franchise without antitrust liability provided that cancellation is not done by way or in pursuit of an "agreement."[167] Moreover, the implicit teaching of *Simpson* is that while a producer cannot disguise its functionally independent distributors as agents and then control their conduct, it is free to use such controls whenever the distributor is not functionally independent. Therefore, to the extent that a producer has the choice between agents or employees and functionally independent distribution, it can select the degree of control it wishes by judicious selection of the functional character of the medium through which it operates. A line emerges from these cases which looks to the functional character of the distributor subject to control and establishes zones in which conduct otherwise apparently similar in purpose and effect is labelled either per se illegal or per se legal.

Cases involving nonprice, vertical restraints are generally a more recent occurrence. Although the early vertical price cases usually included customer and territorial controls,[168] the only early Supreme Court case in which territorial and customer restraints were predominant was *Curtis Publishing*.[169] In this case the FTC had charged Curtis with seeking to foreclose magazine distribution by causing many formerly independent dealers to become its agents and, as agents, agree not to distribute other magazines.[170] The Court sanctioned the restraints as necessary and reasonable incidences of the agency employment agreements of which they were a part. This decision came in the mid-1920's, a time when judicial enthusiasm for strict antitrust rules was at an alltime low;[171] its broad

166. *Id.* at 736.

167. Dart Drug Corp. v. Parke, Davis & Co., 221 F. Supp. 948 (D.D.C. 1963), *aff'd*, 344 F.2d 173 (D.C. Cir. 1965); *cf.* Packard Motor Car Co. v. Webster Motor Car Co., 243 F.2d 418 (D.C. Cir. 1957).

168. This was usually in conjunction with resale price maintenance. *See, e.g.*, United States v. General Elec. Co., 272 U.S. 476, 481-83 (1926); Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 375-83 (1911) (customer restraints).

169. FTC v. Curtis Publishing Co., 260 U.S. 568 (1923).

170. *Id.* at 574.

171. In 1923 the Court handed down a number of decisions which have since been implicitly repudiated. *Compare* FTC v. Sinclair Ref. Co., 261 U.S. 463

sweep may explain in part why so few nonprice vertical restraint cases seem to exist. In the mid-1940's, when the issue of producer-imposed territorial or customer assignments again reached the Court, an equally divided bench refused to reverse the lower court's decision upholding the lawfulness of such restraints.[172] Interest in nonprice vertical restraints reappeared about a decade later when the Department of Justice announced that territorial restraints were illegal per se.[173] On June 30, 1958, the government filed both the *Schwinn*[174] and the *White Motor* complaints[175] and during this same period some of the major merger litigation was initiated.[176] Taken as a whole, these cases represented a broad program[177] of attack on increased concentration through merger and on restrictive trade practices. Because the trial judge in *White* granted summary judgment for the government,[178] it became the first case in which the Supreme Court dealt at any length with nonprice vertical restraints.[179] The Supreme Court held that absent a complete record, it could not decide whether vertical nonprice restraint was, as a

(1923) (tying of gasoline sales to low-cost lease of storage tanks held not illegal) with FTC v. Texaco, Inc., 381 U.S. 739 (1965), *and compare* National Ass'n of Window Glass Mfrs. v. United States, 263 U.S. 403 (1923) (territorial allocation sustained), *with* United States v. Topco Associates, 405 U.S. 596 (1972), *aff'd on rehearing*, 414 U.S. 801 (1973).

172. United States v. Bausch & Lomb Optical Co., 321 U.S. 707, 728-29 (1944).

173. This declaration took the form of testimony before a congressional committee. *See Hearings on Automobile Marketing Legislation Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 84th Cong., 1st Sess. 89, 362 (1955). The government obtained a number of consent decrees in line with this position. *See* United States v. Bostitch, Inc., 1958 Trade Cas. ¶ 69,207 (D.R.I. 1958); United States v. American Type Founders Co., 1958 Trade Cas. ¶ 69,065 (D.N.J. 1958); United States v. Rudolph Wurlitzer Co., 1958 Trade Cas. ¶ 69,011 (W.D.N.Y. 1958); United States v. Necchi Sewing Mach. Sales Corp., 1958 Trade Cas. ¶ 68,957 (S.D.N.Y. 1958); United States v. J.P. Seeburg Corp., 1957 Trade Cas. ¶ 68,613 (N.D. Ill. 1957); United States v. AMI Inc., 1957 Trade Cas. ¶ 68,758 (W.D. Mich. 1957); United States v. Philco Corp., 1956 Trade Cas. ¶ 68,409 (E.D. Pa. 1956). *See also* Robinson, *Restraints on Trade and the Orderly Marketing of Goods*, 45 CORNELL L.Q. 254, 265 n.82 (1959).

174. United States v. Arnold, Schwinn & Co., 237 F. Supp. 323 (N.D. Ill. 1965).

175. United States v. White Motor Co., 194 F. Supp. 562 (N.D. Ohio 1961).

176. Brown Shoe Co. v. United States, 370 U.S. 294 (1962), was filed Nov. 28, 1955. FTC v. Proctor & Gamble Co., 386 U.S. 568 (1967), started on Sept. 30, 1957; United States v. El Paso Natural Gas Co., 376 U.S. 651 (1964), had started on July 22, 1957.

177. Indeed, the program laid out in Thurman Arnold's *The Bottlenecks of Business*, stripped of its labor union component, is the outline of the program initiated under the Eisenhower administration in the 1950's. *See* T. ARNOLD, THE BOTTLENECKS OF BUSINESS 240-59 (1940). Although it did not bear formal legal fruit until the Kennedy-Johnson era, it did result in some voluntary charges and consent de-

178. United States v. White Motor Co., 194 F. Supp. 562, 587-88 (N.D. Ohio 1961).

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

general matter, good or bad and so could not say whether a per se rule was in order. It therefore remanded the case for a full trial although the opinion failed to instruct the trial court as to what information it should collect.[180] The Court did not say that vertical restraints were to be judged by a rule of reason; it only said it did not know what standard to employ.[181] The Court, however, did seem implicitly to assume that, given a fully litigated record, it could decree the per se unlawfulness of territorial or customer restraints for all future cases.[182]

The result in *White Motor* was an invitation to the lower courts to make open-ended examinations of the facts and claims of both sides in vertical nonprice distribution cases. Lower courts read the opinion as implying that if a producer could show appropriate justification for the nonprice restraint on its distributors, the restraints could be lawful. Since any producer of a differentiated product dealing with and through independent distributors has an obviously substantial interest in the distribution process and since the producer usually introduces vertical restraints in the stated belief that they will further its business interests so that the restraints fit the efficiency explanation for vertical restraints, it is not surprising that such defenses were presented successfully in a number of leading cases over the following several years.[183]

By not following the rules of vertical price restraints in *White Motors*, the Court gave the impression that there was some significant difference between vertical price and nonprice restraints. Otherwise, as Justice Clark pointed out in his dissent, the case should have been governed by the same rules that applied to vertical price fixing, *i.e.*, *Dr. Miles* and the per se rule.[184] However, a persistent insistence on differentiating price control from other controls on competition makes no sense. While a price-fixing agreement

180. *Id.* at 263. Brennan's concurrence does not solve this problem; it focuses on the problem of when restraint may be reasonable in a specific case and not the legislative problem of when in general the practice will be prohibited. *See id.* at 264-75.

181. *Id.* at 262-64. Douglas' opinion is very explicit on this point, but it is ultimately consistent with the argument that vertical restraints involve a category of law in which presumptive lawfulness or unlawfulness can be decreed if sufficient information is available.

182. The Court was not to have the opportunity in this case, however, as White Motors immediately entered into a consent decree giving the government most of the relief it had sought. *See* White Motor Co. v. United States, 1964 Trade Cas. ¶ 71,195.

183. *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).

184. *See* United States v. White Motor Co., 372 U.S. at 275-83.

may strike at the vital center of a selling relationship,[185] all of these restraints are part of a single class of conduct and are substitutable in many cases.[186] To the extent that territories and customers are assigned to each participant in an agreement, the need for price fixing can be reduced or eliminated since there will be no competitive selling effort if each seller has his "dancing partners."

A restraint, whatever its form, is just that: a restriction on the seller's (or buyer's) freedom of action which will affect competition and the price of goods directly or indirectly; it can make little policy sense to say that businesses cannot agree to one restraint but that they can agree to another which is functionally the same. The rules established for comparable restraints ought to yield consistent results. If there is not at least this level of consistency, then the rules are absurd and can serve no policy function except charade. Thus, the *White Motors* - *Dr. Miles* tension had to be resolved one way or the other: vertical restraints were to be appraised either under a rule of reason or resort was to be had to a per se rule.

The Supreme Court's clarification began with the *General Motors* case in 1966.[187] There, a district court had dismissed the government's challenge to General Motors' efforts to keep its dealers from reselling to discount houses. The Court recast the evidence in such a way that it appeared that GM dealers and their association had coerced GM (actually "requested" jointly and individually that GM adhere to its dealer agreements) into refusing to deal with the nonconforming dealers. To the Court this conduct fit the case into the mold of the traditional boycott cases[188] and so made the practice illegal. The Court relied heavily on *Parke, Davis*[189] in support of its argument that this was not a unilateral refusal to deal on the part of GM. But in doing all this, the Court ignored the producer's efficiency interest in control over distribution which it had recognized in *White Motor*. Indeed, *White Motor* was not referred to at all in the opinion; yet GM's location assignments and its insistence that each dealer perform only at its assigned location would seem, under *White Motor*, to have called either for a rule of

185. *See* United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 220-24 (1940).

186. There is recognition of this truism in *Schwinn* and in the writings of commentators, *see, e.g.*, United States v. Arnold, Schwinn & Co., 388 U.S. 365, 379 (1967); Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L. REV. 282, 298 (1975); Robinson, *Recent Antitrust Developments: 1974*, 75 COLUM. L. REV. 243, 278-80 (1975). *See also* Bork, *Part II.*

187. United States v. General Motors Corp., 384 U.S. 127 (1966).

188. *See, e.g.*, Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959): Eastern States Retail Lumber Ass'n v. United States, 234 U.S. 600 (1914).

189. United States v. Parke, Davis & Co., 362 U.S. 29 (1960).

reason analysis as to the validity of these quasi-territorial assignments or for a declaration that this form of vertical restraint was unlawful per se. If location clauses were valid, then so long as GM itself was enforcing them in the interest of the efficient distribution of its differentiated product, its conduct would seem to have been reasonable absent a specific showing to the contrary. In ignoring this aspect of the case,[190] the Court can be said to have reversed *White Motor* sub silentio.

When *Schwinn*[191] finally reached the Supreme Court in 1967, there had been four years of experience with the *White* approach, and the tension between it and the rules on vertical price fixing were becoming obvious.

The facts appeared to be that Schwinn faced a declining market position in the early 1950's due in substantial measure to the competitive pressure from the mass merchandisers.[192] As Justice Stewart explained in his partially-concurring opinion, Schwinn decided to reorganize its distribution system selecting a limited number of retailers with special and specific characteristics in the belief that

> Proper promotion of its products required an active and stable dealer organization, composed of experienced people who could properly promote, assemble and service bicycles. Such dealers were to be found primarily in small independent bicycle sales and repair shops rather than hardware stores or mass merchandisers that sold bicycles unassembled in the carton and provided no service and repair facilities.[193]

In order to achieve that goal, Schwinn prohibited any of its retailers from selling to anyone other than a final customer. Like Miles, a half-century earlier, Schwinn did not want its dealers to have to compete with anyone other than those to whom Schwinn had chosen to sell its products. More importantly, and again like Miles, Schwinn faced the problem of how to get its products to the selected retailers. This was a task which involved serving many small outlets all over the country. It was apparently not something which Schwinn could do exclusively with its own employees. Ultimately, Schwinn developed four plans of distribution: the Schwinn plan, an agency plan, a consignment plan, and sales to distributors subject to restrictions on resale. In each case the plan required that some ser-

190. General Motors' brief did rely on *White Motor* to justify its conduct, so the issue was presented to the Court. *See* Respondent's Brief at 7, 12, 23, United States v. General Motors Corp., 384 U.S. 127 (1966).

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

192. *See id.* at 368-69.

193. *Id.* at 383 (Stewart, J., concurring in part and dissenting in part).

vices of a middleman be used in reaching the retailer. Restraints were employed in each of these plans to insure that only those retailers that Schwinn had selected received its product.

Under the Schwinn Plan, the "distributor," for a fee, booked orders from franchised Schwinn dealers and relayed those orders to Schwinn; Schwinn shipped directly to the retailer and billed it directly.[194] Under this plan, Schwinn controlled the final sale and could reject buyers of which it did not approve.

Under the agency plan the "distributor" was a warehouseman leasing storage space to Schwinn and shipping goods from that inventory to any retailer which Schwinn had authorized to order bikes. Schwinn billed the retailers and the distributor collected a fee for the services rendered.[195]

Under the consignment plan, the distributor received a supply of Schwinn bikes to which Schwinn retained title and assumed certain risks and responsibilities for so long as those bikes remained at the distributor's warehouse. The distributor was only to deliver the bikes to approved retailers, meaning Schwinn franchisees, in the distributor's territory. But when the distributor took a bike and shipped it, he paid all expenses of the transaction, billed the retailer directly (apparently taking the risk of nonpayment), and remitted to Schwinn only the net amount that Schwinn required, keeping the difference as compensation for his various efforts and profits.[196]

Finally Schwinn would sell bikes outright to the distributor and the distributor would resell them to retailers. In this type of transaction, title would pass to the distributor who would assume more risks, although some risk presumably did remain with Schwinn as, for example, with respect to defective bikes which could probably be returned. Schwinn required that the distributor agree to limit its sales to those dealers which Schwinn had decided ought to retail Schwinn bikes in the territory that Schwinn assigned to the distributor.[197] There was no fixed price imposed on the distributor; but this is probably explained by the existence of the Schwinn and agency plans in which Schwinn retained price-setting control that maintained an effective maximum price and by the use of exclusive territories that eliminated the risk of competitive price cutting among distributors.

The government saw the Schwinn case as one in which Schwinn

194. *See* Pollock, *Alternative Distribution Methods After Schwinn*, 63 Nw. U.L. Rev. 595, 606-07 (1968). The article was written by one of the defense counsel for *Schwinn*.

195. *Id.* at 607.

196. *Id.* at 606-08.

197. U.S. v. Arnold, Schwinn & Co., 388 U.S. 365, 371 (1967).

dealt in several ways with functionally independent wholesalers and retailers.[198] In its original formulation the government charged that there were price-fixing agreements as well as customer and territorial allocations. Under the government theory, the several distribution plans would then be alternative policing devices which insured that each distributor would adhere to the overall market allocation plan. In essence, then, the government's approach was to cast Schwinn as the administrator of a distributor cartel. This theory, if adopted, would require that all of Schwinn's controls over its wholesalers and distributors be eliminated and that the forms of the transactions be recast as the sale to the independent distributors that they would have been had there been no need to police the cartel.

Schwinn, taking its lead from *White Motor*, argued that there was no price control and, more importantly, that the restraints were reasonably necessary to its continued viability as a competitor in a world of mass merchandisers. Thus Schwinn lumped all of its restraints together under the efficiency rubric. The four plans, as well as the restraints on retailers, were all necessary ingredients in functionally similar operations: each plan of distribution was designed to serve the same function, *i.e.*, to get the bikes to the retailers, and the retailer restraint was designed to keep the retailer from becoming a distributor by reselling to other retailers. From its perspective, Schwinn did not see any reason to regard the plans as distinguishable.

The district court found no price fixing but did find unlawful the territorial restraint on resale by distributors of bikes they had purchased. The court did, however, uphold the customer restraints with respect to both the distributors and the retailers. It also upheld as reasonable all restraints on distributors who were operating under the Schwinn, agency, or consignment plans. The judge regarded the activity of the distributor in these roles as being akin to that of an employee or agent under the control of the producer.[199]

On appeal the government did not challenge the price fixing findings. Instead, it focused its arguments first on the customer and territorial assignments, contending that the partial outlawing of the territorial and customer restraints made no sense and thus the restraints should be held illegal in their entirety. Secondly, the government renewed its argument, based on the implicit cartel theory,

198. See Brief for the United States, United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967), *excerpts reprinted in* R. POSNER, ANTITRUST CASES, ECONOMIC NOTES, AND OTHER MATERIALS 266-72 (1974). Posner, himself, participated in preparing this brief and argued the case for the United States.

199. 237 F. Supp. 323 (N.D. Ill. 1965).

that the several forms of distribution were similar and that it made no sense to forbid control with respect to bikes purchased while allowing it with respect to those distributed under the Schwinn, agency, and consignment plans. Schwinn defended those restraints sustained by the trial court as reasonably incident to its distribution program in order to achieve efficiency through effective control over the participants.

The Supreme Court agreed with the government that no restraint on territories or customers was permissible where the distributor or retailer was a buyer of the bikes. Such control was per se illegal.[200] But the government failed to persuade the Court that the nonsale forms of distribution were mere shams, presumably because the efficiency explanation for the overall scheme seemed more plausible than the cartel explanation.

As a result the Court declined to treat these restraints as per se unlawful. Having concluded that the distributors were in fact "indistinguishable in function from agents or salesmen,"[201] it invoked a rule of reason and found that the restraints were reasonable. In reaching this conclusion the Court cited four factors: substitutes were available for both retailers and wholesalers; both distributors and retailers handled other bicycles; there was no price fixing to taint the case; and competition made necessary the challenged program which itself went no further than required by competitive pressure.[202]

Moreover, with respect to, its per se rules, the Court was very clear that they were not absolute. "[I]t is unreasonable *without more* for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it."[203] Thus a manufacturer may apparently

> reserve control over [a product's] destiny or the conditions of its resale . . . in an appropriate and impelling competitive setting. . . . [W]e are not prepared to introduce the inflexibility which a per se rule might bring were it applied to prohibit all vertical restrictions of territory . . . . Such a rule might severely hamper smaller enterprise resorting to reasonable methods of meeting the competition of giants.[204]

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200. 388 U.S. at 382.
201. *Id.* at 381.
202. *Id.*
203. *Id.* at 379.
204. *Id.*

The point of this passage is not clear. While it certainly means that restraints over non-functionally independent distributors is permissible, it probably also means that some forms of vertical restraint may be lawful in an "impelling" circumstance, even if there is a sale. Consistent with this mandate, the ultimate decree in the case allowed Schwinn to continue to use territorial allocation in the form of areas of primary responsibility and to refuse to deal with any distributor which failed to perform its responsibility.[205]

In any event, in *Schwinn* the rules governing nonprice restraints achieved rough congruence with the rules governing resale price controls. To have adopted any other approach could have led only to demonstrably inconsistent treatment of fundamentally similar restraints resulting from a formalistic rather than functional classification of restraints.[206] As the case law now stands, with respect to dealings between two functionally independent firms, it is usually lawful to suggest resale prices,[207] assign territories or customers as areas of primary responsibility,[208] and require that a distributor selling to unauthorized customers pay some portion of the revenue from those sales to the firm to which that customer was assigned.[209] But it is usually per se unlawful to agree to adhere to a price list[210] or agree not to sell to customers in certain areas[211] or categories.[212] Moreover, if the controlled distributor is not functionally independent, then, in general, control is lawful unless its effects are unreasonable. These rules have been greatly criticized[213] both because

205. United States v. Arnold, Schwinn & Co., 1968 Trade Cas. ¶ 72,480 (N.D. Ill. 1968). The decree was entered by consent of all parties.

206. *Cf.* Kalven, *Tort Watch*, 34 AM. TRIAL LAWYER'S L.J. 1, 31 (1972) ("The role of logic in law is to iron out the small contradictions, the big ones we leave alone.")

207. *See, e.g.*, United States v. O.M. Scott & Sons Co., 303 F. Supp. 141 (D.D.C. 1969).

208. *See, e.g.*, Colorado Pump & Supply Co. v. Febco, Inc., 472 F.2d 637 (10th Cir.), *cert. denied*, 411 U.S. 987 (1973).

209. *See, e.g.*, United States v. Topco Associates, 1973-1 Trade Cas. ¶ 74,485 (N.D. Ill.), *decree aff'd*, 414 U.S. 801 (1973).

210. *See, e.g.*, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911); United States v. General Elec. Co., 358 F. Supp. 731 (S.D.N.Y. 1973).

211. *See, e.g.*, Fontana Aviation, Inc. v. Beech Aircraft Corp., 432 F.2d 1080, 1084 (7th Cir. 1970); Todhunter Mitchell & Co. v. Anheuser-Busch, Inc., 375 F. Supp. 610, *modified*, 383 F. Supp. 586 (E.D. Pa. 1974); Ammerman v. Bestline Prods., Inc., 352 F. Supp. 1077 (E.D. Wis. 1973).

212. *See, e.g.*, Fontana Aviation, Inc. v. Beech Aircraft Corp., 432 F.2d 1080, 1085 (7th Cir. 1970); Ammerman v. Bestline Prods., Inc., 352 F. Supp. 1077 (E.D. Wis. 1973); Interphoto Corp. v. Minolta Corp., 295 F. Supp. 711, 720 (S.D.N.Y.), *aff'd*, 417 F.2d 621 (2d Cir. 1969).

213. The critics of the rules include a large number of private litigators and, of course, cases such as *Schwinn* arise in substantial part because well-counseled cor-

they appear to make the passing of title a crucial element in distinguishing between per se unlawful and reasonable restraints and because even within the per se category the exact form of the restraint appears to determine whether it is per se illegal.

In order to explain the nature and meaning of the rules on vertical restraints and to lay the foundation for a consistent policy upon which to base these rules, it is first necessary to explore the use of the per se and rule-of-reason categories in antitrust case law, especially as these categories are employed in cases involving arguably ancillary, *i.e.*, efficiency, restraints such as those in the *Schwinn* case.

### B. *Ancillary Restraints and the Per Se Rules: A Theory of Presumptive Illegality*

Although the Sherman Act purports to outlaw "every contract, combination . . . or conspiracy, in restraint of trade or commerce,"[214] a literal reading of this broad language has long been recognized as ill-suited to the needs of a competitive marketplace. A per se prohibition of all agreements that have the effect of restraining trade would prohibit many necessary contracts. Thus, as Professor Bork pointed out:

> The per se concept does not accurately describe the law relating to agreements eliminating competition as it is, as it has been, or as it ever can be. Alongside cases announcing a sweeping per se formulation of the law there has always existed a line of cases refusing to apply it. . . . The persistent refusal of courts to honor the literal terms of the per se rules against price-fixing and market-division agreements demonstrates a deep seated though somewhat inarticulate sense that those rules, as usually stated, are inadequate.[215]

The distinction between naked and ancillary restraints provides the point of departure for this explanation.[216]

A naked restraint is one which is valuable and valued for itself, *i.e.*, for the direct effect on competition which it produces. An

porate defendants believe that the adjustments which they would be forced to make under a consent decree are so costly as to justify the costs of litigation.

214. 15 U.S.C. § 1 (1970).

215. Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division (Part I)*, 74 YALE L. J. 775, 777 (1965).

216. This has not, however, been recognized in many cases. *See, e.g.*, Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918). *See also* White Motor Co. v. United States, 372 U.S. 253, 261-62 (1972); M. HANDLER, H. BLAKE, R. PITOFSKY & H. GOLDSCHMIDT, CASES AND MATERIALS ON TRADE REGULATION 331-34 (1975). The most general explanation runs in terms of some sort of evaluation of the purpose and effect of the restraint. *See* Northern P. Ry. v. United States, 356 U.S. 1 (1958).

ancillary restraint, as the name implies, is one necessarily incidental to the achievement of some other productive goal. In terms of the prior explanations for vertical restraints, a restraint explained in cartel terms is a naked restraint while one explained in efficiency terms is an ancillary one.

Any restraint may have desirable consequences in a particular case; but the per se approach specifically rejects the admission of evidence of such consequences.[217] In *Trenton Potteries*[218] the Court held illegal a price-fixing scheme without reference to its reasonableness. Justice Stone, writing for the Court, started with the proposition that a restraint "is the elimination of one form of competition" and "involves power to control the market," and "agreements which create such potential power may well be held to be in themselves unreasonable without the necessity of minute inquiry whether a particular price is reasonable or unreasonable as fixed."[219] There were already some cases in which the Court had made such an inquiry and there were others in which it had not. The problem was to sort the cases and decide when restraints "may well be held . . . in themselves to be unreasonable." The defendants in *Trenton Potteries* were understood to contend that their agreements were for the purpose of producing a reasonable price and that this was the only object or goal of their activities. This was therefore a naked restraint. The only possible test of reasonableness of such a restraint is the desirability of the specific result, but "the reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow . . . . Moreover . . . we should hesitate to . . . make . . . the difference between legal and illegal . . . depend upon so uncertain a test as whether prices are reasonable."[220]

Thus, the argument is two-fold. First, the changing nature of supply and demand makes any determination of reasonable price a very impermanent decision. More importantly, given the role of price specifically and competition generally in adjusting supply and demand, there is no logically consistent test for reasonableness in these matters except as a result of market interaction. Any attempt to create a naked restraint is both evidence of power to control a market (for such a restraint only has effect if there is market control) and proof that any consequences cannot be tested by any logically

217. *See* United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940); United States v. Trenton Potteries Co., 273 U.S. 392 (1927).

218. *Id.*

219. *Id.* at 397.

220. *Id.* at 397-98.

consistent standard; as a result such a restraint ought always and without exception be held illegal. This total prohibition of naked restraints puts the Sherman Act in accord with at least one view of the common law's attitude toward restraints.[221] With very few exceptions, none of which has had continuing vitality, all cases involving naked restraints have been condemned in the Supreme Court without reference to the reasonableness of the results achieved by the restraint.

The basis for the categorical rejection of restraints because of the impossibility of logically determining whether specific prices are "reasonable" does not, however, extend to cases where a logical and consistent standard can be employed. When the basic asserted benefit of a restraint comes from a transaction or activity other than the restraint itself, and the restraint has only made possible or facilitated that benefit, it is then feasible to examine the restraint in light of the need for it, and ask whether it is reasonable in terms of facilitating the transaction or activity to which it is an incident.[222] The issue in such a case is the reasonable necessity for the power created by the restraint in terms of the benefit obtained and not the reasonableness as such of the specific price or other restrictive action.

If one takes a static view of the economic world, then evaluation of the relationship between the restraint and the benefit in terms of the necessity of the first for the full achievement of the second determines reasonableness.[223] This analysis suggests that three tests must be applied to the restraint: (1) is joint activity necessary to achieve the primary benefit; (2) is the restraint reasonably necessary to the efficient conduct of the beneficial activity, *i.e.*, is it reasonably related to achieving the primary benefit sought; (3) are there less restrictive alternatives which could achieve the same benefit? The first two tests are primarily directed at whether the restraint is truly ancillary, while the third directs the inquiry towards whether the purpose behind its imposition was really effectuation of the joint activity. If a restraint fails any of these tests, it is unreasonable.

221. Bork, *supra* note 215, at 783-85.

222. This test is found in common law restraint cases and was early said to be applicable in antitrust analysis. United States v. Addyston Pipe & Steel Co., 85 F. 271, 279 (6th Cir. 1898), *aff'd*, 175 U.S. 211 (1899). *See also* Bork, *supra* note 215, at 799-801, 829-32.

223. This is the approach used by Justice Hughes in *Dr. Miles*, but it will be recalled that he rejected the restraint because of its injury to the public interest, not its disutility in achieving its end. This is logical and consistent with the analysis presented here if we assume that Miles, in Hughes' view, had created a cartel, *i.e.*, that the restraint was naked and so on its face objectionable.

The agreements to which a restraint can be ancillary may involve either a single sale or a joint venture. The essential characteristic is that the transaction is adversely affected by the absence of some obligation on the part of parties affecting their competitive freedom.[224] In the classic case of the sale of a business, the buyer wishes to have a reasonable opportunity to obtain the goodwill of customers and establish his capacity to serve them as satisfactorily as the seller. If there is a risk that the seller of a business may reopen a similar business in the same area, the buyer may immediately discount the price of the business with the good faith seller getting less for it. To insure that the buyer gets what he wants and that the seller gets the full value of what he sells the buyer may ask for an agreement not to compete for a reasonable time in a specified area. This example illustrates some of the difficult problems in ancillary analysis. For example, what is a reasonable time depends primarily on what we define as the seller's transferable interests. If we define the transferable right as one limited to a chance to compete without the threat of a specially advantaged competitor during a period of entry and establishment, then the restraint can be weighed. What makes this example difficult is that it involves some transfer of monopoly power.[225] The amount and type of such power that can permissibly be transferred must be narrowly circumscribed.

The ancillarity issue arises only when there is some integration or interaction between the parties and can arise in both vertical[226] and horizontal[227] contexts. The common characteristic of the cases is

224. An agreement on price is, for example, a necessary incident in any bargained sale; but, it is also essential to the full completion of the transaction and so is in a sense an ancillary restraint. Of course, the restraint is so essential that, absent other factors, we would not regard it as a restraint. But if it covers many potentially separate sales, it can be called a requirements contract, or tie-in, or exclusive dealing arrangement.

225. The restraint is only necessary in the context of a differentiated demand which is being transferred from buyer to seller. When a farmer sells his wheat farm, for example, no covenant would make sense.

226. These are the cases in which the joint venture produces an input or provides a service for or acts as marketing agent for the participants. *See, e.g.*, Associated Press v. United States, 326 U.S. 1 (1945); Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933); Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918).

227. For example, United States v. Penn-Olin Chem. Co., 378 U.S. 158 (1964), is horizontal in the sense that both participants were potential competitors of the joint venturer but served different markets. The proper way to look at such activity is under standards applicable to mergers and not as "per se" restraints. *Compare* United States v. Penn-Olin Chem. Co., 246 F. Supp. 917 (D. Del. 1965) (opinion on remand) *with* United States v. Penn-Olin Chem. Co., 378 U.S. at 177 (Douglas, J., dissenting). If, however, the joint venture does the same thing as the participants and does it in the same market, a justification is implausible unless the joint venture is in the form of a merger, which is the usual way such ventures are cast. The horizontal merger and monopoly cases where the monopoly is a product of acquisition

the need to spell out the relationships among the participants. There are two leading cases involving reasonable restraints. In *Chicago Board of Trade v. United States*[228] an allegedly illegal price-fixing agreement was found to be reasonable because of its importance in maintaining the integrity of the Board of Trade, a joint venture among grain dealers for the purpose of providing a market for futures. In *Appalachian Coals, Inc. v. United States*,[229] the joint venture among coal producers for the purpose of providing a common selling agent was found reasonable despite the fact that it minimized price competition. The underlying theory in both cases seemed to be that the restraints were necessary to the functioning of the joint venture. This approach is clearly illustrated by *Associated Press.*[230] The Court addressed the question of whether the membership rule in issue was reasonable as an incident of a joint venture to produce news and not whether AP could have rules which would serve to exclude some papers, thus creating a boycott.[231] Implicitly, the Court sustained AP's general right to boycott for good cause.[232]

The cases thus support the conclusion that ancillarity is a necessary condition before a rule of reason can apply. But a showing of ancillarity is not always sufficient to trigger a full rule of reason inquiry. Thus, where a sale is conditioned on the purchase of another good, *i.e.*, a tie-in arrangement, there is an ancillarity argument that the restraint is incidental to the sale of the tying good, but in *Northern Pacific* tie-ins were clearly labeled per se illegal.[233] In another well-known case, Topco sold brand name goods to its member owners for resale, limiting the territory in which each member could resell. This restraint was at least arguably incidental to the

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involve cases in which there is a joint venture, if you will, which controls the former participants, but it might be justified by showing the necessity of the combination to achieve some economy or efficiency. This defense in practice is limited to the failing-company cases. *See, e.g.*, International Shoe Co. v. FTC, 280 U.S. 291 (1930).

228. 246 U.S. 231 (1918).

229. 288 U.S. 344 (1933).

230. Associated Press v. United States, 326 U.S. 1 (1945).

231. *Id.* at 14. The opinion makes clear that reasonable restraints on membership would be lawful. *Id.* at 13-14.

232. Such a notion is unthinkable in the per se boycott restraint situation. *See, e.g.*, Klors, Inc. v. Broadway-Hale Stores, Inc. 359 U.S. 207 (1959).

233. Northern Pac. Ry. v. United States, 356 U.S. 1 (1958). *See also* Fortner Enterprises v. United States Steel Corp., 394 U.S. 495 (1969); United States v. Loew's, Inc., 371 U.S. 38 (1962). For an economic analysis of tie-ins see Bowman, *Tying Arrangements and the Leverage Problem*, 67 YALE L.J. 19 (1957); Markovits, *Tie-ins, Reciprocity, and the Leverage Theory*, 76 YALE L.J. 1397 (1967). For a fuller legal discussion see Ross, *The Single Product Issue in Antitrust Tying: A Functional Approach*, 1974 EMORY L.J. 963 (1974).

joint venture which created Topco and called into being the Topco brands, but it was declared per se illegal.[234]

That these latter cases proceed on a different basis from those where restraint is naked is manifest. Thus, despite the strictures on the evil of tie-ins, in *Northern Pacific* and subsequent decisions some tie-ins have been sustained.[235] The Supreme Court, even as it has formulated its condemnation, has recognized and allowed these exceptions.[236] In *Topco*, having declared that territorial division is per se unlawful, a conclusion which would seem to apply to any division of territory however formulated, the Supreme Court sustained a decree which allowed Topco to assign territories and require any member which goes into the territory of another to assess against the entering member charges for losses suffered by the firm whose territory was entered.[237]

If per se rules are viewed as absolutely precluding any defense, then these cases present analytical difficulties. If territorial restraints were governed by a per se rule, how could a lower court consider the arguments advanced to justify the modified restraints imposed by *Topco* after the Supreme Court's apparently unequivocal ruling? If tying arrangements are naked restraints and per se illegal, how is it possible to entertain a new entrant defense, as in *Jerrold Electronics*?[238] The critical difference between these and naked restraints is that these restraints are at least arguably ancillary to some other activity or transaction. However strongly such a restraint may be condemned in general, the courts do recognize that narrowly circumscribed situations arise in which its use is justified. Nevertheless, the rules announced in these cases are put in terms of per se illegality. These cases do demonstrate that ancillarity is not itself always sufficient to bring on a full-scale rule-of-reason inquiry.

Thus, the per se rules of antitrust cover two categories of cases. The first category consists of those cases involving naked restraints. Such a restraint can only be justified in terms of its benefit as a restraint; once identified, it is always illegal per se in the absence of specific legislation declaring when and under what conditions such restraints are reasonable.[239] The second class includes those cases

234. United States v. Topco Associates, 405 U.S. 496 (1972).

235. *See, e.g.*, United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961).

236. *See, e.g.*, *id.*

237. United States v. Topco Associates, Inc., 414 U.S. 801, *aff'g per curiam*, 1973-1 Trade Cas. ¶ 74,485 (N.D. Ill. 1973).

238. United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961).

239. *See, e.g.*, 15 U.S.C. §§ 1011-15 (1970) (governing insurance cartels); 49 U.S.C. § 5(b) (1970) (legalizing railroad price-fixing agreements).

in which a restraint is part of a package of relationships and is at least arguably ancillary or incidental to the main purpose of that package. These restraints may be quite justifiable under a full rule-of-reason inquiry but, due to the great burden that they impose or to the excessive power that they create, they are denied rule-of-reason treatment. Unlike the rules denying rule-of-reason treatment to naked restraints, however, the per se rules governing these types of restraints allow limited defenses in which the reasonableness of the restraint can be presented.[240]

To label both those rules that govern certain classes of ancillary restraints and those that apply to naked restraints as per se rules is confusing and misleading. It serves only to confuse cases which are in fact treated in analytically quite different manners. This leads courts and commentators, after fruitless attempts at reconciling them, into thinking that the antitrust rules are more irrational than they are.[241] It would be preferable for the courts, when faced with those situations involving ancillarity but in which fairly rigid rules are desirable, to adopt a category of presumptively unreasonable restraints. In this category the ways in which the presumption can be rebutted would be limited and clear. Naked restraint cases in which no defense is possible once the operational facts are established could be more easily distinguished, in the minds of judges and commentators, from cases in which some rule-of-reason inquiry may, in fact, be allowed.

The so-called per se rules on vertical restraints are classic examples of rules creating presumptively unreasonable restraints. What has emerged most clearly from *Schwinn*, but also from the cases generally, is a set of rules which tells courts when certain restraints shall be presumed to be unreasonable unless the defendant raises certain specific defenses and when the restraints shall be presumed reasonable unless the plaintiff rebuts the presumption by a showing that the effects of the restraints are in fact undesirable.

240. A good way to distinguish naked restraint cases from those under this second category is to look to the relief to be given. If the relief is simply an end to the restrictive practice, the case involves a naked restraint. If the relief involves reformulating the restraint so as to limit its terms or impact, the case involves an ancillary restraint. This test, however, will not always be dispositive. In the information-exchange cases such as United States v. Container Corp. of America, 393 U.S. 333 (1969), the issue is whether there is a restraint on competition that is part of the information exchange or ancillary to it. In these cases, it may be necessary to define in a decree what is permissible, *i.e.*, nonrestrictive conduct, and what is impermissible, *i.e.*, restrictive conduct.

241. *See, e.g.*, Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L. REV. 282, 283-90 (1975).

If we assume that these rules are intended to include ancillary restraints, this suggests that even an ancillary restraint which passes the three tests of reasonableness and is therefore the minimum necessary to achieve the desired benefit is nonetheless objectionable because it is deemed too harmful to long run competitive interests when compared to the benefit that it produces. This is a dynamic economic inquiry. If it results in a determination that a particular restraint is so objectionable, the logical result should be general illegality for that restraint, except where its effects are not deemed harmful either because the undesirable result is unlikely or because of the character of the parties benefiting from the restraint.

In static terms there are also possible reasons for such a strict view of certain arguably ancillary restraints. It is possible that the apparent joint venture is but a cover for the market-allocating or price-fixing activity purportedly incident to it. Having reached that general conclusion, a court could justify severely limiting its inquiry unless some relevant defense were presented, *e.g.*, the failing-company defense. Secondly, if a full rule-of-reason inquiry were generally available upon a claim of ancillarity, the litigation process would be greatly delayed and complicated; this is especially likely if the origin of a restraint is at all ambiguous. A third reason for such rules is that once the courts have considered the general case for a restraint and evaluated the general argument which justifies its use as an incident to some other activity, they may be able to formulate guidelines in the form of per se rules for other courts as to the merits of the defense, thus greatly simplifying resolution of subsequent cases.

### C. *The Economic Theory Behind the Rules of Presumptive Illegality: The Static and Dynamic Bases*

The question thus becomes to what extent, if at all, do the rules on vertical restraints reflect dynamic economic consideration and to what extent are they grounded on the static theory, simply seeking to facilitate the distinction between cartel- and efficiency-based restraints.

The hypothesis that would emerge from an application of the static analysis is that courts tend to believe that, whenever there is a showing that two or more distributors have a similar understanding of the restraints that exist on their competition *inter se*, they are part of a cartel and that the proper response is to dissolve it. This would, of course, explain why some courts insist on evidence of active enforcement of the territorial limits before finding illegality,[242] since such evidence might be thought to support the inference of producer as cartel promoter.[243] Conversely, this would mean that unilateral commands to dealers and commands which varied from dealer to dealer ought generally to be accepted as valid.[244] The cases in general comport with static theory if one accepts a broad definition of evidence of cartel. Moreover, if these cases are cartel cases, then they are properly disposed of on a per se approach, even under Bork's analysis.

The cartel explanation was a critical factor in *Dr. Miles.* Miles asserted that it could get favorable treatment for its products only if it could reassure competitors which would handle them that there would be a price fix on the products; that is, Miles had to create and police its own cartel. By viewing a producer as a promoter of the cartel, the case creates horizontal conspiracy. All of the subsequent leading cases except *Albrecht*[245] have some element showing that more than one reseller was aware of the restraint and stood to gain something from its enforcement. While it is demonstrable that the rationalization for the rule against price fixing varied in the cases,[246] the common factual setting of horizontal understanding was also present from which one can argue that it was this fact that controlled.

Under this approach, if the restraint is associated with a new

242. *See, e.g.,* Colorado Pump & Supply Co. v. Febco, Inc., 472 F.2d 637 (10th Cir.), *cert. denied,* 411 U.S. 987 (1973).

243. Of course, this evidence would also be consistent with an ancillary restraint aimed at avoiding free-rider problems.

244. Such personalized restraints are not usually the subject of litigation, but when they are, the verdict is usually for the defendant. *See, e.g.,* Weather Wise Co. v. Aeroquip Corp., 468 F.2d 716 (5th Cir. 1972), *cert. denied,* 410 U.S. 990 (1973); Edwin K. Williams & Co. v. Edwin K. Williams & Co.—East, 377 F. Supp. 418 (C.D. Cal. 1974); Beckman v. Walter Kidde & Co., 316 F. Supp. 1231 (E.D.N.Y. 1970), *aff'd,* 451 F.2d 593 (2d Cir. 1971), *cert. denied,* 408 U.S. 922 (1972); Top-All Varieties, Inc. v. Hallmark Cards, Inc., 301 F. Supp. 703 (S.D.N.Y. 1969); E.A. Weinel Constr. Co. v. Mueller Co., 289 F. Supp. 293b(E.D. Ill. 1968). If, however, the restraint was the product of group pressure, it will probably be struck down. *See, e.g.,* United States v. General Motors Corp., 384 U.S. 127 (1966); American Motor Inns, Inc. v. Holiday Inns, Inc., 365 F. Supp. 1073 (D.N.J. 1973), *aff'd in part and rev'd in part,* 521 F.2d 1230 (2d Cir. 1975).

245. Albrecht v. Herald Co., 390 U.S. 145 (1968), may be an exception, since the maximum fixed price did not appear to be a joint distributor interest. Each distributor did, however, have an exclusive territory and price control. In the context of the partially monopolistic market of a daily newspaper, the maximum price may be viewed as an element of a cartel for dealers (submonopolists) that requires them to limit their monopolistic exploitations in order to gain admittance to the cartel. It is, of course, in the producer's interest to minimize that exploitation, so maximum price may only be the producer's condition for policing the cartel.

246. *See* Posner, *supra* note 241.

entry, then the premise that the restraint involves the creation and maintenance of a cartel is called into doubt. Thus a rule of presumptive illegality based on the inference of a cartel should not apply. In *Sandura*,[247] where the defendant demonstrated that it had created new distributors and did not work with established ones, the court sustained the restraint. Similarly, the *Snap-on Tools*[248] decision is consistent with the argument that the parties demonstrated that their restraint did not operate horizontally.

What, then, can be said about *Schwinn*? The focus of the government's factual claims was a territorial allocation of customers among four distributors.[249] By emphasizing that these firms engaged in selling bicycles and that their existence was independent of Schwinn, it is possible to argue that Schwinn was administering a market allocation plan for the benefit of those firms. The customer restraints imposed both on distributors and retailers can fit a cartel theory, but the fit is very poor, and certainly the result of allowing customer controls when the distributor is acting as an agent suggests that the Court did not perceive the issue of cartel as a central one. In this analysis the decision in *White Motor* becomes not an effort to revise the law but a recognition that Bork's position on the facts is valid: not all vertically imposed restraints will look unilateral, and the defendants should have greater scope to demonstrate that a restraint is purely vertical. *Schwinn* in this reading becomes a testimony to the failure of counsel on both sides to convince.[250]

Such an analysis, however, does violence to the view stated in many cases that purely, *i.e.*, non-cartel inspired, vertical restraints are illegal. Thus in the post-*Dr. Miles* price-fixing cases, the unwillingness to consider the possibility that the restraint was purely vertical, once it was shown to exist, or to ask for any showing that the restraint might facilitate a cartel arrangement suggests that courts did not see the cartel issue as central. If they had, they could have said so directly and greatly focused the inquiry in subsequent cases. Moreover, the relief accorded in the cases, especially *Schwinn* and *Topco*, suggests that the courts did not see simple naked restraints under fancy covers. There is a clear effort to preserve the covers in part which is not consistent with a cartel-naked restraint

247. Sandura Co. v. FTC, 339 F.2d 846 (6th Cir. 1964).

248. Snap-on Tools Corp. v. FTC, 321 F.2d 825 (7th Cir. 1963).

249. Brief for Appellant at 12-20, United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

250. Had the government convinced the Court, then the entire system of control should have been dismantled as the conclusive manifestation of a cartel; and if Schwinn counsel had been convincing, then nothing should have been done because the restraints were efficiency-justified.

analysis. Thus while the static model of per se lawfulness of ancillary vertical restraints might be more useful in explaining court action than the language of the decisions often suggests, it is not fully explanatory of the results. Nor is static theory totally explanatory of the factors at play in a producer's decisionmaking process. Although every firm must be aware of its present situation in the market, it must also consider its growth and progress over time. It must plan not only for today's efficiency but for tomorrow's change. And, although an economist can afford to presume that technology or demand are constant, a firm in the real world cannot. In fact, if there is a certainty in the business world, it is that the economic environment is dynamic, that technology and demand will change. This is the subject of dynamic theory and policy discussed earlier. The very indefiniteness of dynamic theory, however, makes recognition of its invocation and application much harder. Still, beginning with *Dr. Miles*, there is a sense that the Supreme Court is not unaware of this dynamic quality of business life.

In *Dr. Miles*, the producer gave as a reason for specifying prices a desire to control and eliminate price cutting by department stores and cut-rate drug stores[251] which had taken a different approach to retail distribution, emphasizing price discounts instead of personal service. Miles clearly wished to keep from stimulating a new and more powerful class of retailers more able than individual drugstores to find and promote alternatives. Miles also asserted that if existing resellers of its products were subjected to competition, some of those sellers would find other products to promote. Behind this claim presumably lurked the fear that there might be new entry at the producer level if the existing sellers became dissatisfied.

Thus, the complaint can be read as impliedly charging that one of the goals of the Miles restraints was to retard any change in the present scheme of production and distribution which would work to the disadvantage of Miles and its existing distribution system. Viewed in this light Miles was asserting its right, via agreements with other independent businesses, to restrict and control new, alternative forms of competition that presented threats to its existing market power. While the pleadings certainly present dynamic

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> [C]ertain retil establishments, particularly those known as department stores, had inaugurated a "cut-rate" or "cut-price" system, which had caused "much confusion, trouble, damage" to the complainant's business . . .; this injury resuted "from the fact that the majority of retail druggists as a rule cannot, or believe they cannot, realize sufficient profits."

Dr. Miles Medical Co. v. John D. Park & Sons, Co., 220 U.S. 373, 374-75 (1911). The implication is clear that the new forms of competition threatened existing competitors.

issues, the majority opinion fails to advert to them in any recognizable manner. Since a dynamic analysis would have led to the same result, however, its absence is understandable.[252]

The *Colgate* decision[253] can also be cast as a dynamic problem: development and implementation of new distribution techniques. Unless a producer can develop new ways to distribute and solicit new distributors who are willing to try the new technique, as well as to eliminate undesirable distributors, the producer's ability to cope with a changing world is greatly circumscribed. As defined and modified in subsequent cases, the *Colgate* doctrine has primarily dynamic meaning: protecting producers in their efforts to find new and more efficient distributors. The source of dynamic change in distribution rests in the functionally independent businessman whether as merchant for soaps or as discount department store. This is no more than the received tradition of economics.[254] The entrepreneur, the person who combines labor, land, and capital to create the productive firm, is the independent businessman. Later theorists have suggested that even he can be hired or that many businessmen are not truly entrepreneurs in the special sense of perceiving and creating new businesses.[255] But, if one accepts traditional perceptions, it was the independent businessman who did these things. A set of rules based on the dynamic value of change and innovation with respect to some activities would put greater store in the preservation of such independence of those elements functionally independent with respect to that activity than in the independence of mere agents or employees.

In the 1920's the Court explicitly recognized the dynamic nature of the economy in explaining why naked restraints should be per se

252. Holmes' dissent focused specifically on the static issue of efficient production and did not address this broader formulation. I would suspect that it drew such limited support in part because it ignored the dynamic issues. Holmes could answer that a new system of distribution will come into being whenever it is sufficiently attractive for this to happen. Such an analysis denies that restrictive agreements create barriers to entry. Since an element of Miles' case was that these restraints were supposed to have just that effect, it is somewhat inconsistent to say that Miles is rational and irrational at the same time. It can be said that such restraints are unlikely to bar any substantially more efficient system and that, whatever dynamic goal might exist, its achievement is unlikely if the alternative is very attractive. This is a kind of deterministic response, but even in those terms if the new system is not much more efficient, especially at the outset, then, at least as to marginal experiments, strong support for existing restraints would retard or defeat efficient dynamic change. Those devices, which substantially retard freedom to innovate, are also objectionable if one is less deterministic about the economic environment on the basis that they deny a free choice among alternatives.

253. United States v. Colgate & Co., 250 U.S. 300 (1919).

254. *See* 1 A. MARSHALL, PRINCIPLES OF ECONOMICS 291-313 (9th ed. 1961).

255. *Cf.* P. SAMUELSON, ECONOMICS 619-20 (9th ed. 1973).

illegal.[256] A couple of years earlier in the *GE* case the Court had sanctioned a detailed restrictive distribution system which utilized an agency-consignment system.[257] While the *GE* case can be explained on patent grounds, the Court's rationale had more to do with distribution generally. Taken together with *FTC v. Curtis Publishing Co.*,[258] the *GE* case suggests a perception of agents as the kin of employees, to be controlled and directed. These cases are consistent with *Dr. Miles* and *Colgate* if the categories of employee/agents and independent businessmen are perceived as functionally different. In the dynamic view, which focuses on functionally independent businesses, the difference is significant: independent businesses can innovate and are dynamic (they are self-propelled) while agents have no similar attributes with respect to the overall distribution process. Consequently, control of them is always permitted both as part of a static efficiency-promoting program and as a way to provide for dynamic change.

The subsequent reduction of the scope of the agency defense is understandable primarily in terms of an altered, or perhaps more precise, perception of sources of dynamic change. As the Court saw genuinely independent businesses being controlled and directed by the use of consignments, it realized that the label did not always comport with the reality of the functions performed by the purported agent. For example, after transforming gas station attendants into independent businessmen, the oil refiners then sought to control them as if they were still employees by use of the consignment device.[259] And so in the *Simpson* case, the Court rejected price control even though the goods were on consignment since the consignees were held out and appeared to function as independent

256. United States v. Trenton Potteries Co., 273 U.S. 392 (1927).

> The aim and result of every pricefixing agreement, if effective, is the elimination of one form of competition. The power to fix prices, whether reasonably exercised or not, involves power to control the market and to fix arbitrary and unreasonabhe prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow. Once established, it may be maintained unchanged because of the absence of competition secured by the agreement for a price reasonable when fixed. Agreements which create such potential power may well be held to be in themselves unreasonable or unlawful restraints, without the necessity of minute inquiry whether a particular price is reasonable or unreasonable as fixed, and without placing on the government in enforcing the Sherman Law the burden of ascertaining from day to day whether it has become unreasonable through the mere variation of economic conditions.

*Id.* at 397-98.

257. United States v. General Elec. Co., 272 U.S. 476 (1926).

258. 260 U.S. 568 (1923).

259. *See* Standard Oil Co. (Cal.) v. United States, 337 U.S. 293 (1949); *cf.* J. PALAMOUNTAIN, THE POLITICS OF DISTRIBUTION (1955).

businesses.[260] The opinion would exempt a case in which a seller only uses one or, at most, very few consignees. The seller in such a situation is by implication not a substantial factor in any market and therefore, under a dynamic rationale, has a greater right to try to acquire market power by use of controls over others in the distribution process.

A recurring note in many of the per se cases which involve rules of presumptive illegality is the exception for new or failing firms. The idea that such firms may legally make use of tying,[261] vertical territorial allocation,[262] or other restrictive devices makes very limited sense in static terms. If it is efficient for firms to use restraints, there is no good reason to limit the use of efficiency-producing devices to a small class of firms that are, in some respects, the least likely to make efficient and productive use of this right. Such a distinction is at best arbitrary and, on static grounds, not justified. But if, as appears in dicta in the *Brown Shoe* merger case,[263] the Court's presumption is that these restraints are devices for dynamic change in market power over time, it can be argued that the Court, in the interests of a dynamic economy, has sought to authorize the class of competitors most in need of and most likely to advance positive dynamic interests to use devices otherwise impermissible to create or increase their market power.

In general one can discern a concern not with static efficiency but rather with promoting change in the marketplace. The key to change is the preservation of the free alienability of power. This

260. There is, however, some basis in the cases for the proposition that change from manager to lessee operator does indeed alter the conduct of those operating a station. *See, e.g.*, Phillips v. Crown Cent. Petroleum Co., 395 F. Supp. 735 (D. Md. 1975).

261. *See* United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961).

262. Sandura Co. v. FTC, 339 F.2d 847 (6th Cir. 1964); *cf.* Packard Motor Car Co. v. Webster Motor Car Co., 243 F.2d 418 (D.C. Cir. 1957).

263.

> Thus, unless the tying device is employed by a small company in an attempt to break into a market, cf. *Harley-Davidson Motor Co.*, 50 F.T.C. 1047, 1066, the use of the tying device can rarely be harmonized with the strictures of the antitrust laws . . . . Similar considerations are pertinent to a judgment under § 7 of the Act.
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> The importance whih Congress attached to economic purpose is further demonstrated by the Senate and House Reports on H.R. 2734, which evince an intention to preserve the "failing company" doctrine of *International Shoe Co. v. Federal Trade Comm'n.*, 280 U.S. 291. Similarly, Congress foresaw that the merger of two large companies or a large and a small company might violate the Clayton Act while the merger of two small companies might not, although the share of the market foreclosed be identical, if the purpose of the small companies is to enable them in combination to compete with larger corporations dominating the market.

Brown Shoe Co. v. United States, 37 U.S. 294, 330-31 (1962) (footnotes omitted).

is achieved by rules of the sort found in *Schwinn* and vertical restraint law generally, which make continued control over independent businesses for any reason illegal unless it is justified in specific ways.

Although one can largely explain the basis for the rules of presumptive illegality in terms of either static or dynamic theory, the weight of evidence is that dynamic concerns do in fact underlie the rules adopted by the Court. Keynes has said, "In the long run, we are all dead."[264] For the firm, this translates into the proposition that unless the firm is sufficiently profitable in the short run, which implies reasonable efficiency in terms of the world at the moment, there will be no long run dynamic future. Thus, a set of antitrust rules cannot rest entirely on a dynamic theory. Any policy basis for these rules must therefore account for and respect the interest in static efficiency as well as dynamic change.

### D. *The Static-Dynamic Synthesis:* Schwinn *and the Vertical Restraint Rules*

A description of the policy behind vertical restraint law must look to a balance between static and dynamic considerations. Only after one has recognized that the Court is in fact balancing these two perspectives and articulating a set of rules reflecting that balance can one find any logic in the results of the cases.

In trying to strike this balance, the Court has to face difficult problems. Primarily, how is it to separate illegal naked restraints from reasonable, lawful ancillary ones, and thereby allow for a proper recognition of both the substantial static interest of the producer and distributor in the efficient operation of the distribution process and the dynamic interest in preserving the freedom of the participants to innovate, to redistribute market power, and generally to keep distribution from becoming too rigid. As developed earlier, recognition of a dynamic economic world also implies recognition that restraints, even vertical ones, may be power-creating as well as efficient, and so may include certain cartel characteristics. This in turn means that no easy separation between cartel and efficiency restraints is possible, and that any restraint may have power-creating potential which in dynamic terms may be objectionable. This process of balancing, moreover, must occur in a context of monopoly because none of the restraints on resale can exist in its absence. This means that the dynamic choices to be made also

264. J. KEYNES, *Tract on Monetary Reform*, in 5 COLLECTED WRITINGS OF JOHN MAYNARD KEYNES 6 (1971).

involve choices of more or less product differentiation with its resulting monopoly potential. The choice is real and relevant only if the world is in fact not determined by conditions beyond the influence of our legal system. Finally, the Supreme Court, in selecting rules, confronts a judiciary with a static orientation that, frequently, is understandably, but regrettably, unwilling to face the fact that law has a dynamic effect upon a nondeterministic society and economy. This means that whatever balance is struck, lower court judges will tilt toward static efficiency. Anticipation of this predictable response may explain the apparently strict form of many of the resulting rules. But such rules, seeming on their face to deny the relevance of important facts, serve perhaps to reinforce the belief that the Supreme Court knows not whereof it speaks.

Approaching the economy as an area in which, at least over time, the most efficient solutions are not always determined and beyond control, but rather may well respond to altered legal environments, one can use both static and dynamic elements to postulate three criteria which provide a policy basis for the observable rules of vertical restraint law. The first criterion is that no purely cartel-based restraints are always unlawful. This criterion relies heavily on the static equilibrium economic analysis described earlier in this paper but it does not contradict any reasonable dynamic policy interest and so is consistent with both. For reasons already discussed, such restraints can, in static terms, only be inefficient. Though perhaps more justifiable in dynamic terms, an evaluation of that justification, especially the question of how much restraint for how long, is not really a very practical possibility. Although the rules themselves do not separate naked from ancillary restraints overtly, the application of the criterion emerges in terms of relief. If there is a solely naked restraint, the only possible relief will be an absolute prohibition.

The second criterion is a primarily dynamic one, directed at those restraints potentially justified by efficiency which have escaped condemnation under the first criterion. Because of their adverse impact on the dynamic flexibility of participants, such restraints will not, in general, be accepted unless the participants either are in the class of new and failing firms to which more power should flow, or are not functionally independent within the distribution process. The freedom to control those participants who are not functionally independent recognizes the dynamic change and static efficiency in making possible the use of alternatives other than functionally independent entities. Once that right is recognized, as it must be in any complex economy, the right to exercise control follows from the inherent nature of the relationship. The significant portion of the criterion is its general command that no control is permissible when the entities are functionally independent unless one or both are new or failing firms. In terms of fulfilling the overall function of distribution, the independent and nonindependent entities can play identical roles, so that this criterion cuts as deeply as possible into the general potential for control that might otherwise exist in order to provide the maximum freedom of action for dynamically relevant classes of business. An added justification for the differing treatment accorded functionally independent distributors and nonindependent ones is that in the latter case the prospect of a cartel is substantially less.

The second criterion operates on a strong presumption against a deterministic view of the world by implicitly asserting that static interests in efficiency can always be served in other ways, whether by no restraint or by use of nonindependent entities. This is balanced by a third criterion primarily static in character that allows restraints even on independent entities, but only when there is no apparent way to avoid a problem except by restraint, *i.e.*, when the restraint is essential to the existence of the business in the way that a price fix between buyer and seller is essential to almost any sale. Requiring this "impelling" circumstance directs inquiry toward the necessity of using control. Only when direct control is the only feasible way to protect a relevant interest of the producer is it permitted. For example, if no products liability insurance existed and a product created substantial, unavoidable risks of injury in the hands of some classes of customers, it might be reasonable to restrict the distributors' right to sell to such buyers. If, however, insurance could be had to protect the producer that would allow the distributor who would pay the insurance costs to sell to any customer, making the use of a restraint would no longer be necessary. It should be emphasized that this final criterion is not satisfied by mere efficiency; that a control may at some point in time produce greater sales and lower costs does not justify it. Only a more fundamental or inherent necessity of a long run nature will justify the use of such a restraint, and then only the minimum consistent with this necessity.

Criteria of this sort are critical in explaining cases such as *Schwinn*. There, for example, vertical restraints were imposed in an effort to restructure a distribution system and not primarily to create a cartel. The government's position that this was a cartel would have required treating all four methods of distribution alike. In refusing to do so, the courts clearly concluded that Schwinn had demonstrated that its restraints did not violate the first criterion. Nevertheless, the *Schwinn* Court drew a line that placed some restraints in a category of per se illegality while permitting as reasonable other restraints whose effect in terms of distribution was virtually identical. This distinction cannot be based on cartel analysis, but rather must be explained in terms of the relationship between the producer and the restrained party.[265] Such a distinction is explicable in terms of the second criterion, which would justify treating functionally independent elements differently. Further, the Court set forth certain circumstances in which the producer could impose restraints even on functionally independent businesses. These exceptions reflect both the application of the other side of the dynamic aspect of the second criterion and the static interest recognized by the third criterion.

There are a couple of disconcerting aspects to the *Schwinn* opinion. The Court's reference to the absence of price fixing on the part of Schwinn regarding the Schwinn Plan and the agency sales[266] is without rational basis, since Schwinn had total control over the price charged to the buyer. Even more disconcerting is the treatment of the consignment plan. The Court treated this latter plan as a variant of the agency sales arrangement and Schwinn Plan rather than a variant of full sale.[267] In doing this, the Court made no functional analysis of the necessity for a control relationship between producer and distributor. Since the distributor itself shipped these bikes to retailers and billed them, remitting only a net sum to Schwinn, it was acting in a functionally independent way requiring no commands from Schwinn to activate the transaction. The result is perhaps a legacy of the tests of title and risk invoked in *Simpson* which did not, it should be recalled, really test for functional control. It also appears that neither the government nor Schwinn, because of the ways each viewed the case, argued for this separation or otherwise facilitated the Court's understanding of the varied control relationships inherent in the distribution system. Given the overall result in the case and assuming the continued validity of Simpson, the best explanation of the treatment of the consignments is that the Court erred in applying its standards and would not have reached the same result if the consignment method had been properly argued.[268]

265. "[T]he position and function of the dealer in question are, in fact, indistinguishable from those of an agent or salesman of the manufacturer." United States v. Arnold Schwinn & Co., 388 U.S. at 380.

266. *Id.* at 373, 380-81.

267. *Id.* at 380-82.

268. The reference to *Simpson* in the *Schwinn* opinion refers to all three non-sale

Schwinn had aimed its primary argument at the first criterion, as had the government, and Schwinn clearly prevailed on that point. Schwinn also sought to deal with the second criterion by fitting itself into the class of powerless firms entitled to use ancillary restraints to achieve power in the marketplace. Here, Schwinn failed to convince the Court that it was a new entrant or a failing firm although it did show that its adoption of the present system stemmed from a desire to avoid a perceived threat of possible failure.[269] This was not sufficient to justify exempting its conduct from the general rule, at least where it had long since made the transition to its new system of distribution. The facts clearly disclosed that it had achieved a considerable degree of success in meeting the large chainstore competition. Since it had already obtained this degree of power, the unfettered right to maintain all controls would serve more to protect and entrench its power than to permit it to increase power at the expense of larger competitors. As a result, actual control over the resale of bikes sold to firms acting as distributors could not be justified on the basis that it had dynamic advantages in the long run struggle for power in the market.

Schwinn could still argue under the third criterion that control over sales was essential. As to retail sales, since Schwinn could dismiss the retailer altogether, it had no absolute need for detailed control of its business. As for distribution to retailers, the existence of the Schwinn and the agency plans made a defense of direct control over sales very difficult. Schwinn already had two ways to sell to retailers which did not require restraints on functionally independent distributors. Its only argument for control was that it would keep independent distribution identical with its controlled distribution, an argument not of necessity but of convenience.

Thus, the *Schwinn* case, itself a distillation and recapitulation of the rules on vertical restraints found in the price-fixing cases, can be explained in large measure by use of a combination of static and dynamic economic theories, which, if they are valid, provide a logical basis for those rules. The one thing that ought to emerge above all else is that the policy basis is a complex one which will not always yield easy results.

distribution plans collectively and asserts that in all these plans the "position and functions of the dealer . . . are . . . indistinguishable from those of an agent or salesman." In such a case only if the impact is " 'unreasonably' restrictive"—which must mean more control than is inherently needed in terms of the dependent form chosen—is there a violation. The cite to *Simpson* follows. It appears that the Court meant to show by this reference that even agency could be abused, thus reinforcing the present argument that had the misuse of the consignment plan been disclosed, it would have been enjoined. *Id.* at 380.

269. *Id.* at 368-77.

To illustrate further the application of the criteria, consider the analysis they would generate in primary responsibility clauses and location clauses. Both can be defended on their efficiency or power-creating basis, thus meeting the first criterion if there is no cartel coloration. But such claims are available only if those using or benefiting from the restraint are new entrants or failing firms, firms to which power should flow because of weak market position. In general, the second criterion would reject these restraints; they can only be justified if they are permitted under the third criterion: restraints inherently necessary.

The area of primary responsibility is more easily defended on the basis of the third criterion. If its function is limited to a declaration of the area in which the distributor will devote a certain quantum of effort, both parties must have an expression of this idea so that each knows what is expected in order to continue the relationship and to plan effectively. The producer must know, in order to plan his future need for distributors, where and to what extent his goods are presently being distributed. The distributor, on the other hand, needs to know what is expected of him if the relationship is to continue. Of course, if in fact the areas of primary responsibility are also areas of exclusive responsibility, the agreement is more than that which is inherently necessary to the planning of distribution and so could fail under the third criterion. Thus, it is only the basic assignment which is permissible. It follows that a producer can require a distributor to perform within the area assigned, and dismiss it if it has failed to perform, but it may not have similar control, direct or indirect, over specific activity beyond that area. There is an exception here because a producer must have some freedom to select distributors so that it can be free to remove a distributor selling outside an assigned territory provided its reasons relate to the manner of selling and service and not the area in which sales are made. Needless to say, this may not be an easy distinction to make in specific cases.

Location clauses, as distinct from area assignments, create a more disparate analysis under the necessity criterion. If a distributor already doing business at a specified assigned location adds another location, it interferes with the producer's control over where and by whom its product is to be sold, thus potentially disrupting the producer's plan of distribution that is presumably designed to produce maximum efficiency. On the other hand, such a clause is a serious imposition on the distributor's ability to develop its business in what it regards as a rational manner. The dynamic effect of these clauses may be to keep the distributor from becoming sufficiently powerful to consider integration backward into production, using house brands, or otherwise attempting to shift economic power from the production to the distribution sector. Thus, the clauses have strong efficiency arguments for them but strong dynamic arguments against them. The real question, however, is whether they are necessary to a distribution system. The answer would appear to be that they are not.

The location clause, like the exclusive territory clause, contains two commands: (1) One shall serve at a given location, and (2) one shall not serve at any other. A necessity justification is primarily served by the first command, since the producer needs to know where the distributor will operate at any time in order to know where to direct promotion, ship goods, and the like. Moreover a producer, given a set of existing outlets, will solicit new distributors based on its idea of where its outlets are. Thus, in terms of a potential new entrant into distribution, this aspect of the location clause serves to say where the producer wants an outlet. This information is basic to business planning. The second command centers on the producer's extensive control over the distributor's decisions about how and where to run its business. While such control may result in more efficient distribution, it is not essential to business relations between producer and distributor and indeed results in substantial impairment of the dynamic character of the distributor. Moreover, if, on balance, a producer finds it does not approve of its distributor's added locations and finds it undesirable to continue to deal, it is free, even without the location clause, to stop dealing. The conclusion that follows is that location clauses should be held "per se" illegal only when they go beyond telling a distributor where, at a minimum, it must sell and, instead, attempt to delineate the totality of locations at which it may resell a producer's products. Of course, a rigid location clause may well be protected by a showing that the producer or a distributor is a new or failing firm if restraint has been used in a noncartel way. This is only available, however, for so long as is reasonably necessary to let the firm achieve a position of some strength and stability in the market.

Despite the previously expressed view that the absolute location clause fails under the necessity test of the third criterion, it should be emphasized that this may depend on how costly it appears to be to forbid the use of the clause. If a court perceives the problems and costs as too great, either in general or in a specific case, it will be included to find that the restraint is inherently essential. This illustrates that the second and third criteria exist in a state of tension. If a court regards the world as dynamic and nondetermined, it will be more willing to reject necessity arguments under the third criterion. Conversely, as a court comes to believe that the presently efficient way of doing things is the only way, it will tend to find a greater number of restraints as inherently necessary. Thus, both a dynamic view of the economy and a faith in the role of law as an independent influence on the future are essential if the tension between the two is to be resolved in favor of a competitive marketplace. The degree of belief in these two elements will affect the relative impact of the second and third criteria.[270]

## IV. THE RULES ON VERTICAL RESTRAINTS: A COMMON SENSE RESOLUTION OF THE PROBLEMS IN A DYNAMIC, NON-DETERMINISTIC WORLD

A central underlying issue of all antitrust law is the extent to which the law can control economic evolution without producing great inefficiencies. If we assume that forces beyond the control of the legal system determine the most efficient form of industrial organization and that this form is unique, the legal system can, at best, play only a limited role in shaping industrial organization. But so many of our economic relationships exist not because of some fundamental necessity, but because the legal system has so directed things that such a belief has little rational basis. More-

270. As this article was about to go to press the Ninth Circuit announced its en banc decision in GTE Sylvania v. Continental T.V., —— F.2d ——, 1976-1 Trade Cas. ¶ 60848, 44 L.W. 2510, 762 TRADE REG. REP. D-1 (9th Cir. April 9, 1976). See text accompanying notes 97-102 *supra* for a discussion of the 9th Circuit's first opinion in this case. The new opinion by Judge Ely reverses the panel's decision and holds that Sylvania's location clause must be judged under a "rule of reason" standard. Four judges dissented in three separate opinions. The various opinions in this case deserve much analysis, much more than is possible at this time in this article. Suffice it to say, a primary basis for the disagreement between the majority and dissenters appears to be their differing but implicit assessments of whether the location clause was efficiency-motivated or was for the purpose of creating a cartel, (*i.e.*, application of the first criterion). The majority, believing that the restraint was efficiency based, rejected application of the *Schwinn* rule of presumptive illegality, a conclusion rejected vigorously by the dissenters. The primary basis for the majority's position would appear to be a falacious distinction between location restraints and territorial assignments reminiscent of and as valid as the *White Motor* distinction between vertical price and vertical territorial restraints. *See* text accompanying notes 183-86 *supra*. In addition, the majority fairly clearly believes that the location clause in its absolute form is essential to distribution. Thus, in terms of this article's discussion, the majority would exempt these restraints from presumptive illegality under the third criterion. Because Judge Ely does not separate the location clause into its two commands and does not explain how each command operates in an ancillary way essential to the survival of distribution, he does not seem to make a convincing case for his position in terms of the analysis of *Schwinn* offered in this article. *Cf.* text accompanying notes 100, 222-23 *supra*.

over, though the inventiveness of man is vast, necessity channels and directs it; it is the law and its sanctions that, to a large extent, create the necessity.

The price system plays a significant role in identifying aspects of commerce that deserve the attention of innovative minds. To the extent that costs change, innovation aims to reduce them again. If this means vertical integration instead of independent distribution, that result is acceptable both because it is unlikely to be more costly[271] and because the would-be distributor will be able to find a place for his talents in some other area of distribution where genuinely independent distribution is possible. As a method of allocating scarce talent among activities, a legal system operating as a dynamic force creates the necessity that directs this resource toward those areas in which the greatest results are possible.

Consider how this approach deals with the problem that the Court faces in the area of vertical restraints. First, there is the ambiguity inherent in trying to separate naked and ancillary restraints in a dynamic world. The pleadings in *Dr. Miles* show that what one person might label "cost of promotion" or "advertising expenses"[272] that should be protected in the interest of efficiency, a less sanguine mind could describe as a cash offer to join or to help create a cartel. This is, of course, a form of cartel in which competition is possible.[273] Other sellers of brand name goods could offer to give larger shares to the retail cartel, driving up the price paid by the public to obtain seller loyalty. Such reverse competition, even if possible, is hardly desirable. Nor is it any particular saving grace to say that this kind of activity is likely to be self-destructive over time as inflated retail profits produce more new entries at the retail level or induce existing retailers to compete.[274] By forbidding the practice in the first place, the Court avoids all the social costs involved.

271. It is worth noting that both White Motor Co. and Schwinn were in the process of moving toward greater vertical ownership and control over distribution. White, even as it argued its case, was the owner of over half its retail outlets, and Schwinn distributed most bicycles through its Schwinn and agency plans, not through functionally independent distributors.

272. *See* Bork, *Part II* at 430-39, 453-56, 460-61.

273. This is the way in which Holmes' dissent in *Dr. Miles* makes most sense.

274. Such competitive response will depend on both entry conditions for new firms and the degree to which existing firms do not share the agreed goals. Because of the specific regulatory-type barriers to entry into retail drugs and the consistently greater homogeneity of the bulk of participants, an industry drive toward cartel was a more generally accepted goal and disruption from new forces more easily controlled than in the retail grocery industry where noneconomic barriers to entry were less and the diversity of businesses made uniformity of ambition less possible. J. PALAMOUNTAIN, THE POLITICS OF DISTRIBUTION 92-106, 255-62 (1955).

If cartels should be forbidden, however, it is first necessary to identify them, and this is difficult. McReynolds' effort in *Colgate* to redirect and clarify the *Dr. Miles* rule illustrates the problem of separating naked and ancillary restraints with a simple test. This difficulty, combined with a sense that many vertical restraint cases ultimately involve naked restraints concealed in ancillary clothing, justifies a strict view of all such restraints. Moreover, given some respect for the inability or unwillingness of counsel to reveal or courts to divine the true reason for a business practice, this approach may be more than justified.

But at least since the *Colgate* decision, the Court has recognized that producers have interests in all aspects of the distribution process including price. The interest is, in static terms, efficiency, and in dynamic terms, flexibility. To accommodate the producer's legitimate interests, the Court has elaborated on an idea which began in *Dr. Miles*, was developed in *GE*, and found final expression in *Schwinn*. If substantial control is essential in the view of the producer generally, the producer must choose as its distributive entities those types which inherently must be controlled. Control of these entities can, indeed must, be full and complete. But they must be genuine employees, agencies, or contractors, not independent elements in the distribution chain concealed under agency trappings. Both *Simpson* and the final result of General Electric's agency plan[275] demonstrate that a functionally independent distributor cannot be converted into a controlled agent merely by rewriting a contract. That aside, the Court's approach recognizes the basic difference between an independent distributor and an employee or contractor-agent as a functional difference and allows control only to the extent that the entity's functioning requires the control. As noted earlier, this is the maximum prohibition on control that the Court could write, and, while it can look strange (as in the *Schwinn* case where depending on its functional relationship with the "distributor" Schwinn can or cannot tell that "distributor" to whom it may sell), this functional approach solves the problems that inhere in setting policy in a dynamic area of commercial activity such as distribution.

The functional approach facilitates the resolution of the static-dynamic tension. If the goal is to maximize the flexibility that permits the introduction of new ways of doing business, the obvious solution is to protect the freedom of the independent elements in the distribution process so that each is free to compete and change. This approach requires recognition, however, that

275. United States v. General Elec. Co., 358 F. Supp. 731 (S.D.N.Y. 1973).

the producer must be as free to integrate vertically as the independent distributor is free not to. By keeping businesses which are functionally independent elements in the production-distribution process free to act as they see fit, the prospect for keeping the cost of change low is maximized. By allowing such independent businesses at each level of distribution to decide what makes most sense to them in price, territory, etc., the chances for the fullest exploration of the greatest number of options are also maximized. Hence, restrictions on the exercise of independent business judgment should be limited to those which are absolutely necessary to the continuing relationships between such enterprises.

In permitting full control of an agent, employee, or contractor, the Court has provided an alternative for those who cannot operate in the free atmosphere of independent distribution, forcing producers and distributors alike to make choices. The recurring battle in the gasoline business, for example, in which producers seek to retain, for some purposes, employee-like controls over dealers whom, for other purposes, they regard as independent businessmen, is illustrative. The *California Stations*,[276] *Simpson*, and *TBA* cases[277] manifest a judicial intention to make real the oil companies' claims that station operators are independent businessmen by insuring that they have the freedom to control and determine their conduct in the market that is implicit in the term independent business.[278]

Another example of the dynamics of distribution is the newspaper retailing business. In the *Albrecht*[279] case, newspapers were told that they could not enforce maximum price agreements with independent delivery businesses. The fact that the newspaper they delivered was the only one in town, thus conferring on the deliverer a local monopoly in the area of his route, did not confer special privilege on the newspaper to set prices for the independent dis-

276. Standard Oil Co. (Cal.) v. United States, 337 U.S. 293 (1949).

277. *See, e.g.*, FTC v. Texaco, Inc., 393 U.S. 223 (1968); Atlantic Ref. Co. v. FTC, 381 U.S. 357 (1965).

278. One outcome of real independence is that dealers can begin to search for alternate suppliers. In a recent case in Wisconsin a group of gasoline dealers were able to get gas at significantly lower prices than their regular supplier charged when they worked collectively through a broker. Milwaukee Journal, Oct. 7, 1974, at 1. On a larger scale, the development of such buying groups could result in very substantial disruption of the existing, somewhat tattered oil ologopoly and probably engender a new competitive atmosphere in the industry.

279. Albrecht v. Herald Co., 390 U.S. 145 (1968). The message is still arriving at the present time. *See, e.g.*, Williams v. Independent News Co., 485 F.2d 1099 (3d Cir. 1973); Knutson v. Daily Review, Inc., 383 F. Supp. 1346 (N.D. Cal. 1974); Bowen v. New York News, Inc., 366 F. Supp. 651 (S.D.N.Y. 1973); Lepore v. New York News, Inc., 346 F. Supp. 755 (S.D.N.Y. 1972).

tributor. The Court did not, however, shield the delivery businesses from the pressures of dynamic change. If the newspaper decided to integrate its distribution system through the use of employee-carriers, there could be no objection even if independent businessmen lost their supply. In theory, at least, the deliverer could also integrate by developing their own source of supply, *i.e.*, a competing newspaper. Thus, the newspaper could achieve the end it desired by proper use of form so long as it changed the function of the parties as well as their formal relationship.[280]

All of this does not foreclose an attack on the restraint of non-independent entities. But such an attack would have to rest on a showing that in fact such controls either were facilitating some sort of producer-cartel arrangement, such as using only designated haulers to insure price stability, or were adversely affecting entry or other dynamic conditions. In the latter case, one would have to show that desirable static efficiency advantages did not justify the restraint or that the restraint resulted in an unlawful monopoly.

It should be recognized that the Court's approach does not mandate that all restraints on functionally independent businesses be eliminated. If the restraint is being employed by a new entrant or failing firm or the restraint is inherently required, it is lawful. Once again this serves to solve the problem of providing the appropriate protection for both the dynamic and the static interests.

The protection afforded new entrants or failing firms has obvious dynamic implication. There is, of course, no reason why a new entrant or failing firm could not be trying to create a cartel just as much as an established firm. If in fact a cartel is all that is being created, the fact that its creators are new or failing firms will not save the restraints. It will, of course, be difficult to separate the cartel from the efficiency cases, but in light of the dynamic interest in stimulating entry in order to fragment power and the limited duration of the restraint, this is a burden worth undertaking. Realistically, the probability is much higher that the restrictions are part of a joint venture among firms in need of each other's assistance to compete effectively than it is that a cartel is being formed. The circumstances in these cases produce a strong argument for the ancillarity of the restraint and, therefore, the restraint should be more readily accepted as a socially desirable

280. Of course, where the effect of such changed control is to foreclose actual competitors, the change may still be objectionable since, if we can regard a situation involving unlawful monopoly as unreasonable monopoly, the method of monopolization ceases to be relevant in the usual cases. *Cf.* Lepore v. New York News, Inc., 346 F. Supp. 755 (S.D.N.Y. 1972).

part of a dynamic process by which distribution channels are developed. Moreover, this argument does not confer indefinite immunity; at some point the participants must be freed from the restraints they have set up. Hence, even if an error is made in a specific case, it will not create a perpetual cartel nor will it transfer to or entrench power in those already powerful. The social costs of error in dynamic terms will therefore not be great. In addition, even if the producer does not fall within the dynamically favored class, it can still defend essential restraints on functionally independent businesses as inherently necessary. There are some irreducible elements in the continuing producer-distributor relationship which require definition and explication. This explication can only occur in the form of an understanding between producer and distributor that, to be sensible and fair, must in some degree impose duties on each party in a manner that can convey the understanding to others. When such agreements are fundamental to business transactions, it is the task of contract and commercial law to regulate their content in general and the task of antitrust only to correct their abuses.

Finally, in a non-deterministic, dynamic world, there is the policy question of whether and to what degree monopolistic competition is to be favored over pure competition and concomitantly, how much the legal system will or can do to perfect either form of competition. The choice between monopolistic and pure competition is not clear-cut. Each condition has certain socially desirable aspects and either becomes more desirable as it approaches its perfect form. None of these choices are absolute. Perfection is always relative in the real world of nondetermined, dynamic change; both pure and monopolistically competitive sectors will exist in the economy. Policy must therefore focus on more or less monopolistic competition, more or less perfect in character. Moreover, policy here involves an overview of many different but interrelated legal threads from tax and trademark to antitrust. Overall, it is clear that the legal system has accepted product differentiation as valid and created many legal devices to make it possible. While as an absolute proposition it is doubtful that there are many lasting advantages in newly differentiated soaps, toothpastes, or cars, it does appear that in our economic world, investors require some sort of assurance that their company has something unique to offer. Because of the existing state of competition in a broad range of markets entry is much easier if based on some differentiation. And, of course, that differentiation may be accomplished, at least in part, through distribution activity.

The three criteria for evaluating restraints perform well in separating the cases in which the differentiation, and its resultant effect on power, is desirable from those in which it is not. By rejecting cartels based on differentiated products, the first criterion eliminates a kind of differentiation that has neither immediate nor prospective social value. The second criterion encourages new entrants to use distribution restraints to differentiate in order to take power from existing producers of differentiated substitutes. This both facilitates the success of the entrant and speeds existing firms' adjustment toward a perfect equilibrium position, requiring them to respond with innovation if they would retain power. Finally, the third criterion limits the maximum degree to which an established firm can retain power by use of restraints. This means that the firms will adjust toward equilibrium more rapidly if the world is static and new entry will be easier if the world is dynamic.

Thus, the three criteria, based on a nondeterministic view of the realities of the economic world balance static and dynamic interests, permitting the resolution of a variety of issues in a way that is both theoretically desirable and practically operational. This does not mean, however, that the resulting rules are free from fault. The derivation of this analysis rests on an explanation of what the Court has done, not what it has said it was doing. Thus, although these criteria seem to underlie the plethora of rules in vertical restraint law, the Court has neither articulated them nor made clear the underlying policy problems presented by any attempt to resolve the tension between static and dynamic approaches to vertical restraints, in particular, or to antitrust law in general. As a result, application of the rules to new situations is frequently muddled as neither the lawyer nor the judge has an understanding of the basic policy issues involved or the way in which the Court has resolved them.

This failure is especially significant with respect to the role of ancillarity in antitrust analysis. The issue of ancillarity surfaces fitfully in the cases. The government is normally opposed to the idea because it tends to make rule of reason problems out of cases in which an absolute rule is desired. Defendants, who are more interested in very specific results than in elaborating a broad ideal, usually use ancillarity analysis to justify whatever trade practice is under attack. This suggests that all trade practices could be so justified.

The problem in dealing with ancillarity is that neither the court nor the litigants can ever be quite sure whether the defense is allowable under a given Supreme Court case. A better articulation of the rules would minimize the problem but, at this point, the Court and commentators have too few categories at their disposal with which to perform this task. Having only per se or rule of reason classifications means that once a court is sure, as a general matter, that no broad inquiry is warranted in an area, it can only label the result a per se rule. Consequently, the per se category acquired, in addition to its rules on naked restraints, a collection of special rules with respect to the illegality of restraints, such as vertical restraints, which might be ancillary but whose ancillarity is irrelevant because the parties have failed to meet the threshold criteria. An analysis of ancillarity in vertical restraints in dynamic terms, showing that such restraints could create economic power, would have provided a basis from which to explain why relatively absolute rules might be required; but such analysis has not been made in the cases. Thus a more sophisticated classification of antitrust prohibitions has not occurred. Of course, the Court handles vertical cases at the rate of one every few years, and therefore may not have the volume of cases to develop its own analysis to any degree.

A deemphasis of the third criterion in favor of the second is, with respect to the substance of the criteria, the better approach because it is more consistent with the dynamic, nondeterministic world in which business operates. To the extent that courts believe that a particular restraint is inherently necessary, they will and should allow it. But in reaching a conclusion of necessity, courts must be leery of the claims of business. When a restraint is examined, it will probably appear essential, but the inquiry must focus on the dynamics of change and the consequences of terminating the restraint. The value judgment as to what costs and inconveniences a business should be asked to bear in the short run for the long run benefit of the economy is hard to make. While courts should be deferential; they may be too deferential and fail to look critically at the necessity for and the alternatives to a restraint. In *Schwinn*, the Supreme Court created a high hurdle for defenders of restraints to leap. Given a strong faith in the innovative capabilities of business, it should have been put no lower, and perhaps higher. Unfortunately, many cases have lowered it and have not been reversed. This trend, if continued, will substantially reduce the dynamic value of the rules on vertical restraint.

As in Horatio's philosophy, so, too, in the static economic theory of distribution: there are many things undreamed. When these undreamed, dynamic aspects intrude upon the analysis, the apparent simplicity of the issues vanishes. But as the simplicity of the theory is exposed, the basis and operation of vertical restraint law becomes more intelligible. The problem, both before and after *Schwinn*, is to explain the basis of these rules so that they can be sensibly applied. Only by integrating dynamic perceptions of how an economy works into an explanation and evaluation of those rules can they be made sensible or defensible.