Washington Law Review

Volume 59 | Number 1

12-1-1983

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Recommended Citation
Henry N. Butler, *Restricted Distribution Contracts and the Opportunistic Pursuit of Treble Damages*, 59 Wash. L. Rev. 27 (1983).
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RESTRICTED DISTRIBUTION CONTRACTS AND THE OPPORTUNISTIC PURSUIT OF TREBLE DAMAGES

Henry N. Butler*

I. INTRODUCTION

Section 4 of the Clayton Act grants private parties the right to recover treble damages resulting from an antitrust violation.[1] The economic goal of the treble damage award is to deter antitrust violations through increasing both the probability of enforcement by rewarding private actions and the cost of getting caught.[2] Legal commentators, as well as economists, continue to debate the efficacy of the treble damage action as a means of promoting consumer welfare.[3]

It is clear that the threat of treble damage actions tends to deter all types of potential antitrust violations. The problem is that some of the behavior

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1. 15 U.S.C. § 15 (1976). Section 4 of the Clayton Act superceded § 7 of the Sherman Act, ch. 647, § 7, 26 Stat. 210 (1890).

2. The Supreme Court has emphasized the deterrence effects of the private action. Perma-Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 139 (1968) ("[T]he purposes of the antitrust laws are best served by insuring that the private action will be an ever present threat to deter anyone contemplating business behavior in violation of the antitrust laws."); Illinois Brick Co. v. Illinois, 431 U.S. 720, 746 (1977) (discussing the role of "private attorneys general" in augmenting public enforcement). *See also* Blair, *Antitrust Penalties: Deterrence and Compensation*, 1980 UTAH L. REV. 57; Polinsky & Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880 (1979). The goals of § 4 may also be stated as compensation and punishment, which are merely ex post manifestations of the goal of ex ante deterrence. For an empirical analysis of the effectiveness of treble damage actions in deterring horizontal price fixing, see Block, Nold & Sidak, *The Deterrent Effect of Antitrust Enforcement*, 89 J. POL. ECON. 429 (1981).

The recent policy debate over the use of contribution in antitrust necessarily addressed the deterrence aspects of treble damages. *See, e.g.*, Easterbrook, Landes & Posner, *Contribution Among Antitrust Defendants: Analysis*, 23 J. L. & ECON. 447 (1981); Comment, *Contribution in Private Antitrust Suits*, 63 CORNELL L. REV. 682 (1978); Comment, *Contribution in Private Antitrust Actions*, 93 HARV. L. REV. 1540 (1980); Comment, *A Case Against Contribution in Antitrust*, 58 TEX. L. REV. 961 (1980).

3. *See, e.g.*, K. ELZINGA & W. BREIT, THE ANTITRUST PENALTIES: A STUDY IN LAW AND ECONOMICS (1976); Austin, *Negative Effects of Treble Damage Actions: Reflections on the New Antitrust Strategy*, 1978 DUKE L.J. 1353; Block & Sidak, *The Cost of Antitrust Deterrence: Why Not Hang a Price Fixer Now and Then?*, 68 GEO. L.J. 1131 (1980); Parker, *Treble Damage Action—A Deterrent to Antitrust Violations?*, 16 ANTITRUST BULL. 483 (1971); Schwartz, *An Overview of the Economics of Antitrust Enforcement*, 68 GEO. L.J. 1075 (1980); authorities cited *supra* at note 2.

discouraged may be procompetitive behavior. Such a result is not consistent with the antitrust goal of promoting consumer welfare.[4] This is particularly true of actions brought by a distributor against a manufacturer with whom the distributor had signed a restricted distribution contract.[5] Although the United States Supreme Court has recognized the procompetitive aspects of some restricted distribution practices,[6] it is still possible for most of them to be attacked as unlawful restraints of trade under section 1 of the Sherman Act.[7] The analysis presented in this article addresses the narrow issue of the effects of potential treble damage actions on the behavior of contractually-related manufacturers and distributors.

Part II of this article presents the notion of opportunistic behavior, which has influenced much of the economic analysis and the Supreme

4. The Supreme Court, specifically the Burger Court, has adopted a pragmatic, efficiency oriented antitrust policy which stresses the importance of maximizing consumer welfare. *See* Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979) (legislative history of the Sherman Act "suggest[s] that Congress designed [it] . . . as a 'consumer welfare prescription' ") (quoting R. BORK, THE ANTITRUST PARADOX 66 (1978)); Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 53 n.21 (1977) ("Competitive economies have social and political as well as economic advantages . . . but an antitrust policy divorced from market considerations would lack any objective benchmarks."). *See also* Liebeler, Book Review, 66 CALIF L. REV. 1317, 1317 (1978) ("From an economic standpoint, the goal of antitrust law is to balance allocative efficiency and productive efficiency in an attempt to maximize the total wealth of society."); Easterbrook, *Is There A Ratchet in Antitrust Law?*, 60 TEX L. REV 705 (1982).

For presentation of the view that antitrust laws should be concerned with more than consumer welfare, see L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 376 (1976) ("The antitrust laws do not deal solely with problems of allocative efficiency."), and Redlich, *The Burger Court and the Per Se Rule*, 44 ALB L. REV 1 (1979). Also, for an interpretation of *Sylvania* as not precluding an antitrust doctrine based on non-economic goals, see Bohling, *A Simplified Rule of Reason for Vertical Restraints: Integrating Social Goals, Economic Analysis and* Sylvania, 64 IOWA L. REV 461 (1979).

For an analysis of the tradeoffs between efficiency and other societal goals, see Elzinga, *The Goals of Antitrust: Other Than Competition and Efficiency, What Else Counts?*, 125 U. PA L. REV 1191 (1977). Elzinga stresses that efficiency and equity are not necessarily mutually exclusive goals, but he cautions against pursuing equity when they happen to diverge: "While it may seem tolerant, even humanitarian, to call for more equity at the expense of efficiency, those who do so seldom are the ones who suffer the loss in real wealth." *Id.* at 1213.

5. Restricted distribution practices are manufacturer-imposed restrictions on competition among distributors or dealers who provide the manufacturer's goods to lower links in the production-distribution chain or to the ultimate consumer. These contractual arrangements take many forms. A common dichotomy is between price and nonprice restraints. An example of a price restriction is a resale price maintenance agreement between a manufacturer and its retailers that forbids the retailers from selling the manufacturer's products below specified price levels. Nonprice restricted distribution practices usually limit the freedom of retailers to sell the manufacturer's product outside a given area (territorial restraint), from more than one specified outlet (location restraint), to a particular class of customers (customer limitation), or to carry the products of other manufacturers (exclusive dealing). *See generally* Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution Practices: Per Se Legality*, 48 U. CHI L. REV 6 (1981).

6. *See infra* note 41 and accompanying text.

7. Section 1 of the Sherman Anti-Trust Act, 15 U.S.C. § 1 (1976), provides in part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."

Court's recent treatment of vertical nonprice restraints. The transformation of the threat of opportunism into socially-wasteful expenditures of resources is also discussed.

Part III examines the problematic role of opportunism in the distribution of goods, restricted distribution practices that aim to solve the problem, and the antitrust treatment of such restricted distribution practices. This part argues that, in terms of controlling opportunism, which is the substantive purpose of the practice, the Supreme Court's formalistic distinction between price and nonprice restraints is not useful.

Part IV examines the perverse incentives created by the current antitrust treatment of restricted distribution practices. Part IV begins with an analysis of contract law damages and the incentives to engage in opportunistic behavior through inducing breach and collecting damages when stipulated damage clauses provide for damages greater than actual damages. The analysis is then extended to the antitrust treatment of restricted distribution contracts where the threat of a treble damage action is viewed as an implicit government-mandated clause stipulating damages greater than actual damages. Thus, the incentives to engage in opportunistic behavior through the manipulation of restricted distribution contract terms are the same as under other contracts when stipulated damages are greater than actual damages. This part argues that the pursuit of treble damages in restricted distribution cases is another form of opportunistic behavior, and that the threat of such opportunistic behavior increases the costs of procompetitive distribution practices and thus decreases consumer welfare. The opportunistic pursuit of treble damages also explains why distributor and franchisee terminations are among the most actively litigated categories of antitrust actions.[8]

Part V discusses the policy implications of the analysis. Although it is clear that the perverse incentives created by the current state of the antitrust law of restricted distribution practices could be eliminated by declaring all such practices to be per se legal, the narrow scope of the analysis does not support such a sweeping recommendation. Instead, Part V recommends that when the true basis of an action is a dispute concerning a voluntary contract between vertically-related parties, the problem of the opportunistic pursuit of treble damages should be minimized by adopting a uniform rule of reason for all restricted distribution practices and by revitalizing the in pari delicto defense to antitrust actions.

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8. Bohling, *Franchise Terminations Under the Sherman Act: Populism and Relational Power*, 53 TEX. L. REV. 1180, 1212 (1975).

II. THE NATURE OF OPPORTUNISM

Reciprocal benefit is the basis of contractual interaction. Each party agrees to the contract terms in anticipation of benefiting from the other's performance.[9] The phenomenon of opportunistic behavior, or opportunism, occurs when one party to the contract recognizes that the postcontractual, preperformance manipulation of contract terms cannot always be economically retaliated against. The opportunist then performs the contract in a manner contrary to the other party's understanding of the terms, but not necessarily contrary to the written or explicit terms of their contract, in order to transfer wealth from the other party.[10] In other words, under certain circumstances, an ex ante mutually beneficial contract may be transformed into an ex post unilaterally beneficial contract through the unbridled self-interested behavior of a contracting party.[11]

Two examples illustrate the basic phenomenon of opportunistic behavior. First, consider a plaintiff's attorney in a private antitrust action. The plaintiff and the attorney have negotiated a contingency contract whereby the attorney's fee will equal one-tenth of the total damage award in the case. Suppose the attorney, who alone has become intimately involved in the case and thus cannot be replaced on short notice, has presented a very effective case so that prior to final arguments all observers agree that the plaintiff will win the case and recover a substantial treble damage award. However, immediately prior to final arguments, the attorney tells the plaintiff he or she will intentionally lose the case unless the plaintiff agrees to increase the attorney's fee to twenty-five percent. Putting aside

9. Of course, both contracting parties realize that future contingencies may cause one or the other to regret having entered into an executory contract. These risks, however, can be minimized and allocated through standard contractual rules or by customized individual agreement. *See generally* Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1271–88 (1980) (legal rules of contract facilitate the efforts of bargaining parties to minimize and allocate optimally the risks of future contingencies that may cause one or both parties to regret having entered into an agreement); Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM L. REV 554, 554–77 (1977) (discussion of the economic justification underlying the risk-allocating rules of contract).

10. *See* O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM ECON REV 356 (1980); Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 97 (1978); Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL ECON 615 (1981); Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981); Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON 233 (1979); Williamson, Wachter & Harris, *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON 250 (1975).

11. Williamson has described opportunism as "self interest seeking with guile." Williamson, *supra* note 10, at 234 n.3.

for a moment the ethical issues and the legal enforceability of the increase, it is clear that the plaintiff must meet the attorney's opportunistic demand or lose the case.

Second, suppose individual A owns a vacant lot and individual B is contemplating building a house. It is conceivable that A and B could negotiate a contract for B to rent the lot and build his house. A and B could contract for five years at the fair market value of the rent and also contract for a series of five year options to extend the lease with the rent to be negotiated. B, however, would not build on land rented for such a short time (relative to the expected life of the house) for fear that after the first five year contract expired, A would not agree to renew at the fair market value of the land and would instead raise the rent to reflect the costs to B of moving the house to another lot. That is, because of the threat of opportunistic behavior by A, B will most likely choose to avoid the potentially mutually beneficial exchange.[12] This inability of the market to process a mutually beneficial exchange is referred to as a transaction failure.[13]

The preceding examples illustrate two important general points about the nature of opportunistic behavior. First, opportunism occurs after the contract is formed and, therefore, is not a manifestation of precontractual monopoly power.[14] This is an especially important point to remember when discussing the relationship between opportunism and allegedly anticompetitive restricted practices.[15] Second, opportunism is a precontractual problem in that the potential for its occurrence may lead to transaction failures. The mere possibility that opportunistic behavior will occur after the creation of a contract is sufficient to alter the incentive structures and behavior of potential offerors and offerees.[16]

12. Another solution to this problem would be for B to purchase a lot he would like to build on. Conceptually, this is a form of vertical integration, which is the solution emphasized in Klein, Crawford & Alchian, *supra* note 10.

13. Transaction failures reflect the inability of the market to organize a mutually beneficial exchange because of the possibility of opportunistic behavior by one of the parties at the expense of the other. *See* Williamson, *Vertical Integration of Production: Market Failure Considerations,* 61 AM. ECON. REV. 112 (1971). Transaction failures are also referred to as "market failures" or the "hold-up problem." See Klein, *supra* note 10, and Caves, *Vertical Restraints as Integration by Contract: Evidence and Policy Implications,* Discussion Paper No. 754, Harvard Institute of Economic Research (1980) (copy on file with the *Washington Law Review*), for uses of alternative terminology to describe the same phenomenon. Transaction failures, or market failures, are "failures only in the limited sense that they involve transaction costs that can be attenuated by substituting internal organization for market exchange." Williamson, *supra,* at 114.

14. Muris, *supra* note 10, at 523.

15. *See infra* the discussion of the relationship between opportunism and restricted distribution practices at the text accompanying notes 21–34.

16. It is important to note that not everybody need be opportunistic in nature for a transaction or market failure to occur: "It is not necessary that all agents be regarded as opportunistic in identical

The existing literature[17] suggests five methods, other than merely avoiding the transaction, by which potential victims of opportunistic behavior can eliminate or reduce their risk of becoming victims. First, it may be possible to avoid the risk of opportunism through vertical integration. Conceptually, the use of in-house attorneys and the purchasing of the lot on which one builds a home are forms of vertical integration. Second, the potential victim may adjust the initial price to deter the occurrence of opportunism. For example, if the initial fee in the contingency fee example had been twenty percent, then the attorney's opportunistic threat would have been less credible because the attorney would have had more to lose had he or she "thrown" the case. Third, future adverse market adjustments may prevent a substantial portion of myopic opportunism. Opportunism by the attorney may be deterred by the recognition that the future value of his or her services would surely diminish as a result of this opportunistic fee manipulation. Fourth, even if the potential victim signs a relatively simple contract, he or she may rely for protection on implicit contract terms based on legal principles which do not allow the enforcement of certain types of postcontractual modifications. For example, the attorney's opportunistic extortion may not be enforceable for lack of consideration under a pre-existing duty theory. Finally, the parties can agree to and write a complete, fully specified contingent contract and rely on the courts to enforce the agreement. For example, the landowner and the homeowner in the earlier example could specify the method for determining future rent when the initial lease expires. These five methods of avoiding opportunism will not act as a complete deterrence in all circumstances. They can, however, lead to substantial reductions in the risk associated with many transactions.

Persons who recognize the existence of circumstances that might subject them to opportunistic behavior will invest resources in attempting to avoid manipulation. On the other hand, persons who recognize the potential of acting opportunistically will invest real resources in perpetrating opportunism. These joint expenditures of resources are socially wasteful. That is, the resources are invested solely for the purposes of transferring wealth, and are not devoted to any productive, or wealth-creating, purpose.[18]

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degree. It suffices that those who are less opportunistic than others are difficult to ascertain ex ante and that, even among the less opportunistic, most have their price." Williamson, *supra* note 10, at 234 n.3.

17. *See supra* note 10.

18. An activity that results in an analogous waste of resources is theft. Theft involves more than the transfer of wealth from one party to another; it also involves the investment of time and other resources by thieves in the managing of the transfer as well as the investment of resources by potential victims in avoidance of the transfer. In the absence of theft, these resources would be invested in

The threat of opportunism, moreover, results in another social inefficiency because it increases the transaction costs of exchange and thereby reduces the volume of mutually beneficial exchanges. The net result of the allocation of resources to purposes related to opportunism is a reduction in the wealth of society. The next part discusses the conventional analysis of the effects of opportunism on contractual relationships between manufacturers and distributors.

III. OPPORTUNISM AND RESTRICTED DISTRIBUTION: ECONOMICS AND LAW

Most large-scale manufacturers find it uneconomical to own the retail outlets through which they market their products. There are two major reasons for this. First, the nature of the manufacturer's product line may be such that it cannot support a chain of outlets limited to a single product line. The expense of owning and operating a chain of stores that sells only the manufacturer's product (for example, baseball gloves) may well overwhelm the potential revenue from the sale of the single product. Second, the administrative diseconomies of a dispersed, nationwide system of outlets could result in prohibitively high operating costs.[19] Thus, in an attempt to get their products to consumers at the lowest possible cost, many manufacturers of consumer goods distribute their products through contractual agreements with independently owned distributors.[20] Such a solution clearly has benefits, but it also has costs.

The particular cost of using independent distributors that is focused upon in this article is that distributors may, under some circumstances, act opportunistically to the detriment of the manufacturer. Consequently, because their distributors' best interests may not always coincide with their own best interests, manufacturers have developed contractual devices to encourage dealers to act as if they were acting in the manufactur-

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other, presumably productive uses. *See* Tullock, *The Welfare Costs of Tariffs, Monopolies and Theft*, 5 W. ECON. J. 224, 231 (1967) ("A successful bank robbery will inspire potential thieves to greater efforts, lead to the installation of improved protective equipment in other banks, and perhaps result in the hiring of additional policemen."); Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

19. The costs of these inefficiencies are reflected in a concern for controlling the behavior of self-interested employees whose goals are not necessarily the maximization of the firm's profits. *See* Williamson, *supra* note 10. A study of identical branch restaurants of a large chain, for example, revealed that restaurants run by franchisee-owners were much more profitable than those run by hired managers. Moreover, the study revealed that the profits almost always increased with a change from hired managers to owner managers, and that they almost always decreased when the change was from franchisee-owner to hired manager. *See* Shelton, *Allocative Efficiency vs. "X-Efficiency": Comment*, 57 AM. ECON. REV. 1252 (1967).

20. *See* INDUSTRY & TRADE ADMIN., U.S. DEPT. OF COMMERCE, FRANCHISING IN THE ECONOMY, 1977–1979 (1979).

ers' best interests. In this part, an example of the problems created by the self-interested opportunistic behavior of distributors at the expense of manufacturers is presented and analyzed. The analysis also includes discussions of manufacturers' contractual solutions to the opportunistic problems and the antitrust treatment of those solutions.

A. *Opportunistic Free-Riding and Transaction Failures*

The potential that opportunistic behavior will disrupt a distribution system is present whenever the consumer demand for the manufacturer's product is positively related to the provision of point-of-sale and post-sale services by the distributor. An automobile dealership is a good example of a distributor that provides these types of services.[21] The typical dealership provides an elaborate showroom, a trained sales force, large amounts of local advertising, a substantial inventory, and a parts department. It is, of course, costly for dealers to provide these services. An auto dealer (dealer X) will incur these costs only if there is a reasonable expectation that the costs will lead to a larger market share and higher profits.

The potential for opportunistic behavior on the part of dealers, however, might make the realization of a reasonable return on the investment in services a risky proposition. Consider what would happen if another dealer (dealer Y) of the same brand of automobile opened a dealership across the street from dealer X. As a result, some of the benefits of X's provisions of services would flow to Y, and X's expected return would not be realized. In the extreme situation, Y would not provide any point-of-sale or post-sale services, which would enable it to charge a lower price because of its lower costs. The rational consumer would take advantage of X's showroom services, then go across the street and purchase a car from Y. Clearly, Y would be taking a "free ride" on X's provision of services.

The transaction failure aspect of Y's intrabrand free-riding behavior is straightforward. Opportunistic behavior by Y is individually rational, but tends to cause an overall degeneration in the provision of services. Since X does not capture the benefits of providing them, it will stop providing services. Moreover, if X recognizes the potential for opportunistic free-riding, it might not provide the services in the first place. This transaction failure harms the manufacturer in that its profits are reduced because it is unable to increase sales through the provision of point-of-sale services. The manufacturer's response to the opportunism and conflict between its

21. This example is based on the facts of United States v. General Motors Corp., 384 U.S. 127 (1966). *See* 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).

distributors is to place restrictions on the distributor's actions. The distributors themselves might also seek the manufacturer's restrictions on their actions in order to allow the distributors as a group to profit from the provision of services.[22]

B. *Resale Price Maintenance, Maximum Price Fixing and Market Divisions*

Economists have analyzed several contractual solutions to the problems caused by opportunism in distribution.[23] Resale price maintenance and vertical market divisions are the most common of these problem-solving contractual arrangements. The purpose of these agreements is the suppression of intrabrand competition between dealers of the same manufacturer.[24]

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22. Because of the difficulty distributors would face in attempting to prevent the intrabrand free-riding, they might find it worthwhile to pay the manufacturer to regulate their behavior. Similar concepts related to free-riding, shirking, monitoring, and team production have played an important role in recent developments in the economic theory of the firm. *See* Alchian & Demsetz, *Production, Information Costs, and Economic Organization,* 62 AM. ECON. REV. 777 (1972). Professor Cheung gives the following example of the decision to hire regulators:

> My own favorite example is riverboat pulling in China before the communist regime, when a large group of workers marched along the shore towing a good-sized wooden boat. The unique interest of this example is that the collaborators actually agreed to the hiring of a monitor to whip them. The point here is that even if every puller were perfectly "honest," it would still be too costly to measure the effort each has contributed to the movement of the boat, but to choose a different measurement agreeable to all would be so difficult that the arbitration of an agent is essential.

Cheung, *The Contractual Nature of the Firm,* 26 J. L. & ECON. 1, 8 (1983).

23. The following discussion is limited to solutions to intrabrand free-riding in distribution. For discussion of other types of opportunism in distribution, see Klein, *supra* note 10 (analysis of the potential for opportunistic behavior by both franchisors and franchisees and how it affects contractual terms); Marvel, *Exclusive Dealing,* 25 J. L. & ECON. 1 (1982) (analysis of interbrand free-riding and the protection of property rights in information through exclusive dealing).

24. The notion that the suppression of competitive market forces can increase economic efficiency seems to be at odds with the maximum efficiency implications of the competitive model. Moreover, the Supreme Court champions unconstrained competition:

> The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions. But even were that premise open to question, the policy unequivocally laid down by the Act is competition.

Northern Pac. Ry. Co. v. United States, 356 U.S. 1, 4 (1958).

Suppression of competition among competitors, and the contractual or administrative devices used to effect such suppression, can never be productive among independent producers of substitute brands of a particular class of goods or services. Thus, all horizontal (interbrand) restraints are per se illegal. *See infra* list of per se illegal practices at note 36. Yet the suppression of rivalry among the distributors of the same brand of a good or service, when effected by the manufacturer, can be effi-

Resale price maintenance (RPM) agreements, which prohibit distributors from selling the manufacturer's product below a specified price, are contractually imposed by manufacturers in order to increase sales through encouraging the provision of point-of-sale and post-sale services.[25] By increasing dealers' profit margins, RPM agreements encourage dealers to make investments in services in order to attract more customers and earn even greater profits.[26] This, of course, increases the dealers' costs. However, as long as a minimum resale price is greater than a distributor's cost of distribution, the distributor will have an incentive to increase its sales by investing in the provision of value-enhancing point-of-sale services. Distributors of the same brand of a product will continue to compete with each other in the provision of services, but they will no longer compete through price-cutting and free-riding on the provision of services. Since the price is set by the manufacturer, the only way for a distributor to attract more customers who value the service is to provide it.[27]

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cient if its purpose is to reduce the prospect of opportunistic behavior. *See* Continental T.V., Inc. v. GTE Sylvania Inc. 433 U.S. 36 (1977) (discussed *infra* at text accompanying notes 44–51); Liebeler, *Intrabrand "Cartels" Under* GTE Sylvania, 30 UCLA L. REV. 1 (1982). Williamson notes, "The uncritical extension of competitive reasoning from the interfirm context to the manufacturer-distributor nexus is doubtlessly responsible for much of the confusion in the vertical restraints arena." Williamson, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PA. L. REV 953, 956 (1979).

25. The earliest contribution to this analysis was Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. L. & ECON 86 (1960).

26. For a graphical explanation of the effects of minimum price restraints on the provision of services by dealers, see Posner, *supra* note 21, at 284–85. An intuitive feeling for the effects of this type of restraint on the provision of point-of-sale services can be gathered from a consideration of the provision of services in the airline industry prior to deregulation. Regulation of airline fares and routes forced airlines to compete for customers through means other than cutting prices. The competition between the different brands of airlines took the form of differentiated customer services; for example, advertising stressed the quality of meals and the amount of leg-room. The consumer welfare implications of this type of activity are questionable because federal regulations imposed this strategy on all competitors. When unregulated competitors are free to make their own decisions (that is, to choose to compete through price cutting, provision of services, or some combination), consumer welfare is unambiguously improved by the increase in options made available to consumers. *See infra* note 27; Posner, *supra* note 21, at 285 n.10:

> The difference between the services induced by [government sponsored] dealer cartelization and those induced by the manufacturer's voluntary imposition of resale price maintenance is that in the former case the services are provided beyond the point at which their value to the consumer is just equal to their cost to the dealer.

27. There is little disagreement as to the nature of RPM and the restricted distribution practices. This is due to the development of the so-called "New Economics" of antitrust law, which has helped identify and narrow the issues relevant to policy discussions of vertical restraints. *See* Phillips, Schwinn *Rules and the "New Economics" of Vertical Relations*, 44 ANTITRUST L.J. 573 (1975). The "New Economics" is the transaction cost approach, the basic tenets of which are stated in Williamson, *The Economics of Antitrust: Transaction Cost Considerations*, 122 U. PA L. REV 1439, 1442–43 (1974). There remains, however, considerable disagreement as to the proper antitrust treatment of vertical restrictions. Much of the disagreement can be traced to long-standing differences between the "Harvard" and "Chicago" schools of economics. *Compare* Posner, *The Chicago*

Manufacturer-imposed market divisions, whether they take the form of territorial, locational, or customer limitations, also reduce dealer or distributor incentives to take opportunistic intrabrand free-rides.[28] Since each dealer is granted a spatial monopoly of the manufacturer's product, the dealer is a direct beneficiary of the increased sales that result from its provision of services. Moreover, the dealer also suffers directly any losses associated with its attempts to shirk or free-ride on the provision of services. That is, if the dealer does not provide the services demanded by the customers, then customers in the dealer's territory will choose competing brands and the dealer's sales will decline.

The effectiveness of vertical market divisions in controlling opportunistic free-riding, however, can be threatened by price competition. For example, a discounting distributor may be able to lower its prices to the extent that customers from other distributors' territories may find it worthwhile to travel to the discounters. Judicious spacing of territories by the manufacturer may solve some of the problems associated with a chronic discounter.[29] Of course, if the discounters can be identified, the manufacturer can also solve the problem by refusing to sell to them.[30] It seems clear, however, that the nature of vertical market divisions is such

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School of Antitrust Analysis, 127 U. PA. L. REV. 925 (1979), *with* Nelson, *Comments on a Paper by Posner*, 127 U. PA. L. REV. 949 (1979). Sullivan, *supra* note 4, at 376 n.1 notes:

> In general, Harvard school theorists recognize ways in which restrictions imposed by a seller on buyers for the seller's own purposes may adversely affect competition; by contrast, Chicago school theorists regard such restraints as efficiency-producing, unless the buyers are the real instigators of the restraint, in which case the arrangement is necessarily a horizontal cartel.

More specifically, some Harvard school commentators argue that the effect of intrabrand restraints is anticompetitive because they encourage socially unproductive advertising and product differentiation that insulates the manufacturer from competition. *See, e.g.*, Comanor, *Vertical Territorial and Customer Restrictions:* White Motor *and Its Aftermath*, 81 HARV. L. REV. 1419, 1422–25 (1968); Louis, *Vertical Distributional Restraints Under* Schwinn *and* Sylvania: *An Argument for the Continuing Use of a Partial Per Se Approach*, 75 MICH. L. REV. 275, 281 (1976). The Supreme Court, however, rejected that view as "flawed by its necessary assumption that a large part of the promotional efforts resulting from vertical restrictions will not convey socially desirable information about product availability, price, quality, and services." Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 56 n.25 (1977). On the other hand, the Court refused to accept the dealer services theory as the complete explanation of nonprice restraints. *Id.* at 56 ("[T]he view that the manufacturer's interest necessarily corresponds with that of the public is not universally shared . . . ."); *id.* at 58 ("[W]e do not foreclose the possibility that particular applications of vertical restrictions might justify *per se* prohibitions . . . .").

28. *See* Posner, *supra* note 21, at 285; Liebeler, *supra* note 4, at 1326.

29. *See* Posner, *supra* note 5, at 11–12.

30. Depending upon the circumstances, however, such a refusal to deal may amount to an antitrust violation. *See infra* text accompanying notes 77–79. Another problem for manufacturers is that discounters often receive their merchandise from authorized dealers' overstock instead of directly from manufacturers. This practice is called trans-shipping. For a discussion of recent developments in this area, see *Discounters, Alleging Price Fixing, Are Fighting Cuts in Their Supplies*, Wall St. J., June 21, 1983, at 37, col. 4.

that the fine tuning of the provision of services available to manufacturers through RPM is not available when vertical market divisions are used.[31]

Another threat to the effectiveness of a vertical market division strategy is the possibility that spatial dealers may charge prices so high that their quantity sold falls below the manufacturer's profit maximizing quantity.[32] In order to prevent this type of opportunistic behavior, a manufacturer may impose a maximum price on the dealer's sales. By moving the maximum price up or down, the manufacturer can control the provision of services by its spatial monopoly dealers.[33]

Each restricted distribution practice discussed above may be used by itself or in conjunction with the others. That is, they are not mutually exclusive. For example, the analysis indicates that RPM and market division are substitutes in that they can be used to accomplish the same goals. Moreover, the potential pricing difficulties associated with market divisions serve to illustrate the interconnected nature of price and nonprice restricted distribution practices.[34] In summary, it is apparent that a well

31. Posner, *supra* note 21, at 294 (Posner hypothesizes that RPM might be more efficient than vertical market division because of the greater flexibility inherent in simply adjusting prices).

32. By making dealers compete with each other for the right to an exclusive territory, manufacturers can effectively protect themselves from this type of dealer exploitation. This "competition for the field" has been proposed as a theoretical alternative to public utility regulation of natural monopolies. *See* Tullock, *Entry Barriers in Politics*, 55 AM. ECON REV. 458 (1965); Demsetz, *Why Regulate Utilities?*, 11 J. L. & ECON. 55 (1968); Crain & Ekelund, *Chadwick and Demsetz on Competition and Regulation*, 19 J. L. & ECON 149 (1976). For judicial recognition of the concept of competition for the market (or field), see United States v. El Paso Natural Gas Co., 376 U.S. 651 (1964).

33. Easterbrook, *Maximum Pricing Fixing*, 48 U. CHI. L. REV 886, 890 (1981). This type of fine tuning also has implications for cartel theories of the emergence of vertical restraints. First, maximum price fixing can be used to combat dealer cartels. *See, e.g.*, Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. 211 (1951). Second, it has been argued that today's maximum prices have a tendency to become tomorrow's manufacturer-cartel minimum price. *See* Albrecht v. Herald Company, 390 U.S. 145, 152–53 (1968). Thus, in terms of the cartel theories, the consumer welfare implications of vertical maximum price fixing are mixed. For a thorough economic analysis of vertical maximum price fixing, see Blair & Kaserman, *The* Albrecht *Rule and Consumer Welfare*, 33 FLA L. REV 461 (1981).

34. The facts of In the Matter of Adolf Coors Company, 83 F.T.C. 32 (1973), illustrate the interrelated aspects of restricted distribution practices. The case involved Coors beer, which is different from other beers in that it is not pasteurized. Because of this, deterioration in quality begins immediately after Coors is packaged. Quality, however, can be maintained through refrigeration and rapid distribution. Thus, it is easy to see that Coors had some unique quality control problems in distribution. For example, if a consumer purchased a six-pack of Coors that had spoiled, the consumer would not know whether to blame the manufacturer, the distributor, or the retailer; thus, the consumer would rationally reduce consumption of Coors. Because of the lack of information about the source of the inferior quality, individual distributors and retailers would have an incentive to cheat on quality control costs and free-ride on the Coors' reputation for quality and freshness. The costs of the inferior quality, which occasionally appeared as a result of this free-riding, would be borne by Coors and all the other distributors who suffered from reduced consumption of Coors (that is, the free riders, by definition, were not bearing the full costs of their actions). Coors needed to control these opportunistic possibilities in order to compete effectively.

Coors could have maintained its quality from production to consumption by vertically integrating

designed combination of RPM, maximum price setting, and market division can be utilized by manufacturers to maintain strict control over potential opportunistic intrabrand free-riding and thereby increase the interbrand competitiveness of the manufacturer's product line.

C. *Antitrust Analysis*

In the earliest restricted distribution case, *Dr. Miles Medical Co. v. John D. Park & Sons Co.*,[35] the Supreme Court held that RPM is per se illegal.[36] In the *Dr. Miles* case, a manufacturer of patent medicines sold

(through ownership) and performing the distribution and retailing functions itself. However, any contemplation of the costs associated with trying to own all the retail outlets for a product such as beer suggests the reasonableness of not organizing this aspect of beer production internally. Instead, Coors chose a combination of contractual agreements (contract vertical integration), a more economical substitute for ownership vertical integration, as a means of quality control. In order to discourage free-riding by its wholesalers, Coors granted exclusive distributorships (a form of vertical market division). Thereafter, any distributor who cheated on quality would be penalized by a reduction in quantity sold in its territory. Since Coors would still have to bear some of the costs created by a distributor who continued to shirk, Coors' distributors were also subject to termination on five-days notice. Given the costs of bulding a refrigerated warehouse, the threat of termination would provide distributors with a powerful incentive to comply. The quick termination clause when coupled with the large transaction-specific investment by the distributor also opens the door to opportunistic behavior by Coors. For an analysis of market force constraints on franchisors' behavior when they have the ability to terminate at will, see Klein, *supra* note 10. By granting exclusive territories, however, Coors created another potential problem—the distributors might charge a price too high for profit-maximization by Coors. Therefore, Coors imposed maximum resale prices on its exclusive dealers. Finally, to discourage free-riding and to encourage quality control measures at the retail level, Coors imposed minimum resale prices on the retailers. The total effect of these restraints was to instill an incentive structure that encouraged the provision of services in a manner very similar to the way Coors would have provided them had Coors itself integrated directly into distribution. The preceeding analysis of the Coors distribution system is from Liebeler, *Bureau of Competition: Antitrust Activities*, in THE FEDERAL TRADE COMMISSION SINCE 1970: ECONOMIC REGULATIONS AND BUREAUCRATIC BEHAVIOR 79–84 (1981).

35. 220 U.S. 373 (1911).

36. *Id.* at 408.

A per se rule is simple to administer because it requires no analysis of effect or intent. The existence of the condemned practice establishes the violation: "[T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." Northern Pac. Ry. Co. v. United States, 356 U.S. 1, 5 (1958). The *Northern Pacific* holding was reaffirmed in Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 50 n.16 (1977). Practices currently categorized as per se illegal include horizontal price fixing, United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940); vertical price fixing, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911); horizontal division of markets (and other nonprice restraints), United States v. Topco Assocs., 405 U.S. 596 (1972); product-tying arrangements, International Salt Co. v. United States, 332 U.S. 392 (1947); and boycotts, Fashion Originators' Guild of America v. Federal Trade Comm'n, 312 U.S. 457 (1941).

The Rule of Reason, on the other hand, determines the legality of a restraint of trade only after inquiry into the effect and the intent of the party who imposed the restraint. The classic statement of

its drugs through a standard contractual arrangement which, by its language, created an agency agreement with the manufacturer's wholesalers and retailers. The contracts included a consignment agreement that kept title to the drugs in the manufacturer until the sales to consumers and also set retail prices at which the product could be sold by dealers. In turning aside the manufacturer's effort to enjoin breaches of its established retail prices, the Supreme Court first found that the transactions were sales (not truly agency or consignment arrangements) and then ruled that a manufacturer who sells its product to a wholesaler is not entitled to restrict its resale through interference with the purchaser's pricing decisions: "[T]hat these arrangements restrain trade is obvious."[37] Since the *Dr. Miles* decision in 1911, the Court has opened and closed several exceptions to the per se rule against RPM,[38] yet *Dr. Miles* remains the leading case.[39]

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the Rule of Reason was given by Justice Brandeis in Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918):

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

For a more recent discussion of the Rule of Reason, see National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 687–92 (1978).

37. 220 U.S. at 400.

38. Shortly after the *Dr. Miles* decision, the Court announced a broad exception to the per se rule against RPM. In United States v. Colgate & Co., 250 U.S. 300, 307 (1919), the Court upheld an RPM arrangement whereby the manufacturer was entitled to terminate unilaterally a dealer who did not adhere to the manufacturer's retail price. This exception has been all but foreclosed by the Supreme Court decision in United States v. Parke, Davis & Co., 362 U.S. 29 (1960), in which the Court held that if the manufacturer does anything more than merely announce the suggested resale price and then refuse to deal with distributors that fail to comply with that price, then the manufacturer is engaged in a per se unlawful RPM scheme. An additional exception was carved out of the *Dr. Miles* holding when, in United States v. General Electric, 272 U.S. 476 (1926), the Court adopted its suggestion in the *Dr. Miles* decision, 220 U.S. at 404–05, that a vertical price restraint would be legal if the manufacturer sold the goods directly to the consumers through agency and consignment agreements. The Court approved an RPM scheme under which the retailer was the manufacturer's agent and, instead of taking title to the products, received them on consignment. This exception was closed in Simpson v. Union Oil Co., 377 U.S. 13 (1964), which involved the termination of a service station dealer (Simpson) by a producer of gasoline (Union) when Simpson sold gasoline below the minimum price set by Union. Union had probably organized its distribution system with consignment agreements because of the Court's emphasis on the passage of title as indicated by the *Dr. Miles* and *General Electric* cases. Yet, although it could not distinguish the *General Electric* agency-consignment arrangement from the *Simpson* arrangement, *id.* at 25–31 (Stewart, J., dissenting), the *Simpson*

The Supreme Court's treatment of nonprice restricted distribution prac-

Court invalidated the vertical price restraint on the ground that Union used it as a device to "coerce" nominal agents—"who are in reality small struggling competitors"—by taking away "the only power they have to be wholly independent businessmen." *Id.* at 21.

39. Nevertheless, the Court has recently agreed to hear the appeal of a Seventh Circuit decision, Monsanto Co. v. Spray-Rite Serv. Corp., 684 F.2d 1226 (7th cir. 1982), *cert. granted,* 103 S. Ct. 1249 (1983), which involves a manufacturer's termination of a distributor (Spray-Rite) that was alleged to have been the result of a conspiracy between the manufacturer (Monsanto) and some of its distributors to fix the resale price of Monsanto herbicides. The case, therefore, should be classified as a "mixed termination" case—a case where it is alleged tht the termination is the result of a conspiracy between distributors and the manufacturer. *See, e.g.,* Piraino, *Distributor Terminations Pursuant to Conspiracies Among a Supplier and Complaining Distributors: A Suggested Antitrust Analysis,* 67 CORNELL L. REV. 297 (1982). Compare "mixed termination" cases with "dual distribution" cases—cases involving manufacturers who not only supply wholesalers but also sell their product directly to retailers in competition with the wholesalers. For analyses of dual distribution, see Brett & Wallace, Sylvania *and the Dual Distribution Dilemma,* 26 N.Y.L. SCH. L. REV. 971 (1981); Slowey, *Dual Distribution: Definition, Legislative Background and Specific Attempts at Regulation,* 48 ANTITRUST L.J. 1799 (1980).

During the period prior to the termination of Spray-Rite, Monsanto sold its herbicides through a system of distributors who were allocated areas of primary responsibility, but the vertical market division was not exclusive and the territories of distributors often overlapped. 684 F.2d at 1232. The overlapping may account for the fact that over the years Monsanto had received numerous complaints from distributors about the excessive discounting of other distributors, including Spray-Rite. *See supra* the discussion of the relationship between pricing and territorial restrictions at the text accompanying notes 29–30. Such complaints were the basis for Spray-Rite's allegations that it was terminated as a result of a resale price fixing conspiracy between Monsanto and other distributors. Monsanto, however, had not received any complaints about Spray-Rite in the year preceding the termination. Trial Record 1379–1407, *cited in* Brief for the United States as Amicus Curiae, On Petition for a Writ of Certiorari, Monsanto Co. v. Spray-Rite Serv. Corp., 684 F.2d 1226 (7th Cir. 1982), *cert. granted,* 103 S. Ct. 1259 (1983). Spray-Rite also alleged that Monsanto orchestrated a post-termination boycott which prevented Spray-Rite from obtaining Monsanto herbicides from other Monsanto distributors. Spray-Rite alleged, and the district court and the court of appeals agreed, that Monsanto maintained the boycott through cash bonus payments to distributors who participated in Monsanto's technical schools and demonstrations to dealers and customers. 684 F.2d at 1233, 1235–36. (The court of appeals based its boycott decision on Klor's Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959) and United States v. General Motors Corp., 384 U.S. 127 (1966).) The cash payments, however, appear to have been designed to encourage distributors to provide services and thus not free-ride on the services of other distributors.

Monsanto, on the other hand, claimed that it refused to renew Spray-Rite's distributorship pursuant to Monsanto's criteria for evaluating distributor performance: "(1) whether the distributor's primary activity was soliciting sales to herbicide dealers; (2) whether the distributor employed trained personnel capable of carrying out Monsanto's technical programs with dealers and farmers; and (3) whether the distributor was fully exploiting the herbicide market in its area of primary responsibility." 684 F.2d at 1232 (footnote omitted). Spray-Rite fulfilled the first criterion in that 90% of its business was devoted to herbicide sales, but 80% of those sales were another brand of herbicides, with only 16% being Monsanto's. It appears that Spray-Rite was not fulfilling the second criterion, and, in any case, it seems clear that Spray-Rite was not effectively promoting Monsanto's product vis-a-vis its competitors. *Id.* at 1232. Monsanto's termination of Spray-Rite, in spite of the fact that Spray-Rite was the tenth largest purchaser of Monsanto products, suggests that Monsanto felt that Spray-Rite was attracting its Monsanto purchasers from other Monsanto distributors through discounting and free-riding.

Since Monsanto accounted for less than 20% of Spray-Rite's business, one would not expect the termination to mean the end of Spray-Rite. In fact, subsequent to the termination, Spray-Rite continued to sell herbicides for four years. *Id.* at 1233. In 1972, however, Spray-Rite terminated opera-

tices has oscillated from the Rule of Reason to per se illegality and back to the Rule of Reason.[40] The current leading case for all types of vertical

tions, sued Monsanto, and alleged that the termination had eventually forced it out of business altogether. At trial, the district court accepted an expert witness' testimony that the termination was the cause of Spray-Rite's demise. On the basis of this testimony, the jury found that Spray-Rite had been damaged in the amount of $3,500,000. *Id.* at 1240–42. The district court entered judgment in favor of Spray-Rite and trebled the damages.

Monsanto appealed and the Court of Appeals for the Seventh Circuit held: (1) a per se illegal resale price-fixing conspiracy can be inferred solely from evidence that Monsanto received complaints from other distributors and subsequently refused to renew Spray-Rite's contract; and (2) nonprice vertical restrictions, which are normally tested under the *Sylvania* Rule of Reason, are subject to the per se rule merely because they are alleged to be part of a vertical price-fixing conspiracy.

The court of appeals did not use the *Dr. Miles* decision as the controlling precedent, but instead relied on United States v. Sealy, Inc., 388 U.S. 350 (1967). In this regard, the court appears to have been mistaken because Sealy involved horizontal, not vertical, restraints. *Id.* at 352. There was no evidence in *Spray-Rite* that Spray-Rite was terminated as a result of collusion between Monsanto distributors. The collusion, if there was any, was vertical, that is, between Monsanto and its distributors.

Therefore, the Supreme Court's decision to hear Monsanto's appeal presents an opportunity not only for the reaffirmation or overruling of the 70-year-old *Dr. Miles* per se illegality rule, but also for a coherent articulation of the relationship between price and nonprice vertical restraints. The latter is especially important in view of recent changes in the antitrust treatment of nonprice restraints. *See infra* text accompanying notes 40–48.

William F. Baxter, Assistant Attorney General, Antitrust Division, must be credited with securing the Supreme Court's granting of certiorari in *Monsanto*. *See* Brief for the United States as Amicus Curiae, On Petition for a Writ of Certiorari, Monsanto Co. v. Spray-Rite Serv. Corp., 684 F.2d 1226 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 1249 (1983). Baxter has indicated that the antitrust division, in recognition that private actions represent many of the major Supreme Court antitrust decisions, will continue to appear as amicus curiae in order to influence the precedents that shape the law. *See* Baxter, *Separation of Powers, Prosecutorial Discretion and the "Common Law" Nature of Antitrust Law*, 60 TEX L.REV 661, 700 (1982).

40. *Compare* White Motor Co. v. United States, 372 U.S. 253 (1963), and Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977), *with* United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967). The Supreme Court's oscillating treatment of these practices has been widely discussed. *See, e.g.*, R. BORK, THE ANTITRUST PARADOX 188–97 (1978); R. POSNER, ANTITRUST LAW 147–67 (1976); Bern & Tansey, *Proper Application of the Rule of Reason to Vertical Territorial Restraints: Debunking the "Intrabrand-Interbrand" and "Efficiencies" Deviations*, 20 AM BUS L.J. 453 (1983); Bohling, *A Simplified Rule of Reason for Vertical Restraints: Integrating Social Goals, Economic Analysis, and* Sylvania, 64 IOWA L. REV 461 (1979); Bork, *Vertical Restraints:* Schwinn *Overruled*, 1977 SUP CT REV 171; Butler & Baysinger, *Vertical Restraints of Trade as Contractual Integration: Antitrust Ramifications of a Synthesis of Relational Contracting Theory, Transaction Cost Economics, and Organization Theory*, forthcoming in 33 EMORY L.J. (1984) (copy on file with the *Washington Law Review*); Carstensen, *Vertical Restraints and the* Schwinn *Doctrine: Rules for the Creation and Dissipation of Economic Power*, 26 CASE W. RES L. REV 771 (1976); Flynn, *Commentary: The Function and Dysfunction of Per Se Rules in Vertical Market Restraints*, 58 WASH U.L.Q. 767 (1980); Gerhart, *The "Competitive Advantages" Explanation for Intrabrand Restraints: An Antitrust Analysis*, 1981 DUKE L.J. 417; Goldberg, *The Law and Economics of Vertical Restrictions: A Relational Perspective*, 58 TEX L. REV 91 (1979); Halligan, GTE Sylvania: *The Case for Overruling* Albrecht v. Herald Co., 39 OHIO ST L.J. 496 (1978); Liebeler, *Intrabrand "Cartels" Under* GTE Sylvania, 30 UCLA L. REV 1 (1982); Louis, *Vertical Distribution Restraints After* Sylvania: *A Postcript and Comment*, 76 MICH L. REV 265 (1977); Louis, *Vertical Distributional Restraints Under* Schwinn *and* Sylvania: *An Argument for the Continuing Use of a Partial Per Se Approach*, 75 MICH L. REV 275 (1976); Pitofsky, *The* Sylvania *Case: Antitrust Analysis of Non-*

market divisions is *Continental T.V., Inc. v. GTE Sylvania Inc.*,[41] which involved a disgruntled retail dealer who did not adhere to the location clause in his distribution contract. Continental T.V., the dealer, was one of many independent dealers who distributed Sylvania televisions subject to manufacturer-imposed location clauses. The problem that led to litigation began when Sylvania decided to add another dealer within a mile of the outlet operated by Continental. Sylvania's action did not violate the terms of its distribution contract and Sylvania ignored Continental's protests. Thereafter, the relationship between the parties deteriorated rapidly: Continental started selling its Sylvania inventory at an unauthorized location; Sylvania reduced Continental's credit line; Continental then refused to make payments to the company that handled Sylvania's franchise financing; and the finance company filed suit against Continental seeking recovery of the money owed and the Sylvania televisions held in Continental's inventory. The antitrust action arose through counterclaims brought by Continental alleging that the location restriction, and Sylvania's enforcement of it, violated section 1 of the Sherman Act.

The district court, relying on the Supreme Court's decision in *United States v. Arnold, Schwinn & Co.*,[42] found that Sylvania had violated the antitrust laws and assessed damages.[43] On appeal, the Court of Appeals for the Ninth Circuit distinguished the *Schwinn* decision and reversed in favor of Sylvania.[44] The Supreme Court granted Continental's petition for a writ of certiorari. In a remarkable display of candor,[45] the Court adopted a Rule of Reason approach to such restraints, and ruled in favor of Sylvania.[46] The Court's Rule of Reason analysis of the location clause consisted of an analysis of the free-rider problem inherent in the distribu-

Price Vertical Restrictions, 78 COLUM. L. REV. 1 (1978); Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981); Posner, *The Rule of Reason and the Economic Approach: Reflections on the* Sylvania *Decision*, 45 U. CHI. L. REV. 1 (1977); Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decision*, 75 COLUM. L. REV. 282 (1975); Strasser, *Vertical Territorial Restraints After* Sylvania: *A Policy Analysis and Proposed New Rule*, 1977 DUKE L.J. 775.

41. 433 U.S. 36 (1977). Although the vertical restraint in *Sylvania* was a location clause, subsequent lower court decisions have interpreted it as applying to all nonprice vertical restraints. *See, e.g.*, Clairol, Inc. v. Boston Discount Center, Inc., 608 F.2d 1114, 1123 (6th Cir. 1979) (dictum) (*Sylvania* applies to all nonprice restraints).

42. 388 U.S. 365 (1967).

43. *See* 433 U.S. at 40–41 (discussing district court holding).

44. 537 F.2d 980 (9th Cir. 1976), *aff'd*, 433 U.S. 36 (1977).

45. For a remarkable absence of candor in antitrust opinions, compare United States v. General Electric Co., 272 U.S. 476 (1926), with Simpson v. Union Oil Co., 377 U.S. 13 (1964), discussed *supra* at note 38.

46. 433 U.S. at 59 (affirming court of appeals decision in favor of Sylvania).

tion of goods by independent dealers.[47] The Court recognized location clauses as a solution to the free-riding-in-distribution problem and found that the resulting reduction in intrabrand competition was offset by the increase in interbrand competition.[48]

The Supreme Court, in the leading cases of *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.*[49] and *Albrecht v. Herald Co.*,[50] has placed vertical maximum price fixing in the same per se illegal category as RPM. Since consumers do prefer lower prices to higher prices (assuming the availability of the good or service), it appears that a contractual agreement between a manufacturer and a retailer that establishes a maximum price which the retailer cannot exceed would unambiguously increase consumer welfare. Nevertheless, in declaring vertical maximum price fixing per se illegal, the Court has chosen to value the "freedom of traders" to set prices over the possible positive impact of such practices on consumer welfare.[51] Moreover, although maximum price schemes are often used as ancillary restraints in the operation of vertical market division schemes,[52] which are subject to the Rule of Reason, the Court has refused to treat vertical maximum price fixing differently from RPM because they both involve price fixing.[53]

The preceding review establishes that current antitrust doctrines apply different standards to different types of restricted distribution practices even though the practices are implemented as solutions to the same opportunistic phenomenon of intrabrand free-riding. The practices all have the same substantive purpose. The Supreme Court recognizes the procompetitive aspects of some restraints, but treats others differently on the basis of form. Thus, from these observations alone, there appears to be a need for a consistent, coherent articulation of the antitrust relationship between price and nonprice vertical restraints. The analysis presented in

47. *Id.* at 55–57.

48. *Id.* at 58.

49. 340 U.S. 211 (1951).

50. 390 U.S. 145 (1968).

51. See Easterbrook, *supra* note 33, at 888–89, for an analysis of these cases. He points out that the Supreme Court in Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 53 n.21 (1977), rejected any antitrust doctrines that make the legality of practices hinge on the "autonomy of independent businessmen." The Court has suggested that the *Albrecht* decision is open for reexamination. *See* Group Life and Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 210, 210 n.5 (1979) (reserving judgment on the legality of an agreement to set maximum prices). *See also* Halligan, GTE Sylvania: *The Case for Overruling* Albrecht v. Herald Co., 39 OHIO ST L. REV 496 (1978).

52. *See supra* text accompanying notes 29–34.

53. *See* Albrecht v. Herald Co., 390 U.S. 145, 168–70 (Stewart, J., dissenting). Since vertical market divisions are lawful, it has been argued that maximum price fixing should be lawful as an ancillary device to a lawful vertical market division. *See* Eastern Scientific Co. v. Wild Heerbrugg Instruments, Inc., 572 F.2d 883, 885–86 (1st Cir.), *cert. denied*, 439 U.S. 833 (1978).

the next section suggests that this need is even greater than is generally recognized.

IV. RESTRICTED DISTRIBUTION CONTRACTS, TREBLE DAMAGES, AND INDUCED TERMINATIONS: ANATOMY OF A POLICY FAILURE

Restricted distribution arrangements are contractual agreements between manufacturers and their wholesalers and retailers through which the manufacturers control the distribution of their products. The contracts usually provide for unilateral termination of the wholesalers or retailers by the manufacturer should the wholesalers or retailers fail to abide by the restricted distribution contract. The terminated parties often attack the terms of the contracts as violative of the Sherman Act. In fact, distributor and franchisee terminations, and other types of disputes between suppliers and their dealers, are among the most actively litigated areas of antitrust.[54] The analysis presented in this part suggests that the reason for the proliferation of these cases is the perverse incentives generated by the interaction of the treble damage action with the current antitrust treatment of restricted distribution contracts.

A. *Penalty Clauses, Opportunism, and Induced Breach*

A recent contribution by Professors Clarkson, Miller, and Muris[55] presents an economic (or cost-benefit) analysis of the incentives to induce breach when stipulated damage clauses provide for a potential damage award greater than actual damages. Clarkson, Miller, and Muris begin their analysis with an identification of the potential benefits of stipulated damage clauses.[56] They conclude that stipulated damage clauses, which

54. *See* Bohling, *supra* note 8, at 1212.

55. Clarkson, Miller & Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351.

56. Clarkson, Miller, and Muris identify six benefits of stipulated damage clauses. First, when existing legal rules fail to provide adequate means of establishing damages from breach, stipulated damage clauses allow parties to reduce the risk of not recovering damages in the event of nonperformance. The clear benefit here is that in the absence of the damage clause, some mutually beneficial contracts may not occur. Second, parties may stipulate damages because the cost of proving damages is very high. Third, where unfavorable postcontractual events may have differential impacts on the ability of the contracting parties to perform, stipulated damages can be allocated in a manner which reflects the relative ability of parties to avoid nonperformance. Fourth, stipulated damages allow contracting parties with different preferences for risk to capitalize their preferences. For example, a risk averse purchaser may be willing to pay a slightly higher contract price in return for a stipulated damage clause that all but guarantees the supplier's performance. Fifth, similarly to the fourth benefit, contracting parties can adjust price and stipulated damages to account for their different subjective perceptions of the risk of nonperformance. Finally, stipulated damage clauses allow unknown parties

are not utilized unless their private benefits are greater than the private costs of negotiating them, enhance economic efficiency through the facilitation of mutually beneficial exchanges.[57] This leads the authors to search for a logical explanation for the common law dichotomy of enforceable liquidated damage clauses and unenforceable penalty clauses.[58] Their inquiry leads them to consider some additional costs that might accompany stipulated damage clauses.

Clarkson, Miller, and Muris identify one additional cost of stipulated damage clauses as the waste of resources devoted to inducing breach when the stipulated damages are greater than potential actual damages.[59] In a subsequent article, Muris described the misallocation as follows:

> Damage clauses stipulating an amount that exceeds the actual damages create an incentive to engage in opportunistic behavior. With the inclusion of such a clause, a promisee has more to gain from the promisor's breach than from performance, giving the promisee an incentive to expend resources in procuring a breach. These resources, plus those the promisor spends to counter the promisee's efforts, are socially wasted. As with other forms of opportunistic behavior, their only purpose is to transfer wealth. Before the clause can be condemned as opportunistic, however, the promisee must have an opportunity to induce the breach.[60]

This observation suggests that the efficiency of stipulated damage clauses is not necessarily proven by their mere existence. Moreover, Clarkson, Miller, and Muris show that the often misunderstood distinction between enforceable liquidated damage clauses and unenforceable penalty clauses is actually based on an efficiency consideration of whether the stipulated damage clause is so large as to create incentives for opportunistic behavior in the form of induced breach.[61]

(for example, new entrants in an industry) to attract risk averse customers by, in effect, offering the customers an insurance policy or performance bond. Of course, a single stipulated damage clause can be adjusted so as to provide for any combination of the benefits above. *Id.* at 366–68.

57. *Id.* at 368.

58. *Id.* at 352–57 (discussing the current tests for distinguishing liquidated damages from penalties).

59. *Id.* at 370–72.

60. Muris, *supra* note 10, at 581.

61. Some commentators object that the distinction betwen liquidated damages and penalties is unwarranted. *See, e.g.*, Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM L. REV 554 (1977) (the distinction interferes with the enforcement of important groups of beneficial stipulated damage clauses). Professors Kronman and (now Judge) Posner suggest that the Clarkson, Miller, and Muris analysis is not really an efficiency analysis:

> The refusal to enforce a penalty clause on this ground seems difficult to reconcile with efficiency. If the inclusion of the clause would create a real danger of the promisee's trying to provoke the promisor to breach, this danger will be reflected in the parties' negotiations over the contract price or other terms of the contract. If the penalty clause survives the negotiating pro-

The preceding analysis suggests that the incentives to engage in opportunistic behavior through court actions increase dramatically when the potential damage award is greater than actual damages. Since section 4 of the Clayton Act provides for damage awards greater than actual damages, the Clarkson, Miller, and Muris analysis may provide some insights into the incentive structures confronting contracting parties when one of the parties is faced with a potential antitrust action.

B. *Induced Termination: The Opportunistic Pursuit of Treble Damages*

The typical scenario for private antitrust actions against restricted distribution practices involves a terminated distributor's allegation that the manufacturer severed their relationship because the distributor did not adhere to explicit or implicit illegal contract terms, that is, it is often alleged that the manufacturer enforces the illegal provisions through threat of termination.[62] Since most restricted distribution contracts are drafted in a manner that precludes valid contract claims, antitrust law is often viewed as a vehicle for recouping the losses (which are really unrealized gains from trade) that result from the termination.[63] Moreover, the treble damage and attorney's fees provisions of section 4 of the Clayton Act may make the antitrust action more attractive to the aggrieved distributor than a contract action.

The relationship between the incentives to engage in opportunistic litigation through a contract action involving a penalty clause—where stipulated damages are greater than actual damages—and through an antitrust action—where potentially recoverable damages are triple actual dam-

> cess, that is presumably because the benefits to the promisee exceed the costs to the promisor. However costly a contract containing a penalty clause may be, all of the relevant costs are fully borne by the contracting parties and therefore all will be taken into account in the negotiations. Only if it is believed that the parties will fail to assess these costs correctly is there a basis for intervention; the basis, however, is paternalism rather than efficiency.
>
> However, Clarkson et al. argue that if the courts refuse to enforce penalty clauses where the danger of induced breach is substantial, they save contracting parties the costs of having to specify that their penalty clauses are not to be enforced where such a danger is present or to add provisions designed to reduce the danger.

H. KRONMAN & R. POSNER, THE ECONOMICS OF CONTRACT LAW 225 (1979). Their objection to the conclusion of the Clarkson, Miller, and Muris analysis is well-taken, but it is not the purpose of this article to resolve the issue. Both the Kronman & Posner and the Clarkson, Miller & Muris approaches are in agreement as to the incentives to breach, which is the important matter from this article's perspective.

62. A threat of termination for failure to comply with an illegal restriction is itself illegal. *See supra* note 38 (discussing United States v. Parke, Davis & Co., 362 U.S. 29 (1960)).

63. *See* Bohling, *supra* note 8, at 1181–82; Horton, *Legal Remedies of a Distributor Terminated Pursuant to a Contractual Provision of Termination Upon Notice*, 3 CREIGHTON L. REV. 88 (1970); Zeidman, *The Rule of Reason in Franchisor-Franchisee Relationships*, 47 ANTITRUST L.J. 873, 897 (1979).

ages—is straightforward. The fundamental and common characteristic of the actions is that the basis of the dispute is a voluntary (and previously mutually beneficial) contract. A fundamental distinction, however, concerns the source of the excessive damage (that is, potential damage award greater than actual damage) clause. The penalty clause is voluntarily included in one mutually beneficial contract, while the threat of an antitrust treble damage action is an implicit, government-mandated term in the other mutually beneficial contract. Regardless of the source of the damage clause, under either contractual agreement, the promisee-distributor may have the incentive to induce breach or termination by the promisor-manufacturer.

Distributors can induce their termination by cheating on the restricted terms of the contract. For example, they can refuse to provide the agreed-upon services or sell below the recommended price. The termination of the contractual relationship is the manufacturer's means of retaliating against a distributor's opportunistic free-riding. However, since termination is often viewed as evidence of anticompetitive behavior which subjects the manufacturer to the antitrust laws,[64] the induced termination may lead to a treble damage action. Thus, it is clear that both induced breach and induced termination (which is usually a valid contractual response to a breach by the distributor) represent the same type of opportunistic pursuit of excessive damages.[65]

It is important to recognize that the opportunistic manipulation by a promisee-distributor may not result in the termination of the distributor.[66] For example, because of the excessive damage clause, the promisor-manufacturer may be wedged into a situation where the best outcome it can realize is somewhere between the precontractual expected outcome and the excessive damage award. If the distributor desires to maintain the relationship after it has manipulated the terms in its favor, then it may be possible to do so as long as the postcontractual manipulation stays within a well defined range.[67] As long as the distributor's opportunistic behavior costs the manufacturer less than the treble damage award, which the manufacturer would have to pay if it terminated the distributor, then the man-

64. *See supra* note 62.

65. Manufacturers, of course, recognize the presence of the threat of opportunism and make adjustments to it. The resulting market adjustments are discussed *infra* at text accompanying notes 84–89.

66. *See* Goldberg, *The Law and Economics of Vertical Restrictions: A Relational Perspective*, 58 TEX L. REV 91, 97–103 (1979) (discussing exit barriers).

67. The postcontractual bargaining range in the real estate example in the text *supra* accompanying notes 11–13 was determined in part by the cost of moving the house to another lot. For other examples of the determination of bargaining ranges, see Klein, Crawford & Alchian, *supra* note 10, at 298–99; and Muris, *supra* note 10, at 322–23.

ufacturer may be forced into a situation where its distribution costs are minimized by continuing the relationship with the distributor.[68] This postcontractual manipulation of terms is the essence of opportunistic behavior.

C. *"Heads-I-Win, Tails-You-Lose" Protection for Distributors*

The threat of opportunistic litigation has the clear potential for causing transaction failures. However, it is important to remember that such a transaction failure—deterrence to the use of restricted distribution practices—is precisely the result desired by those who think that the practices are unambiguously anticompetitive. On the other hand, most scholarly research suggests that it is impossible for vertical restrictions to have any anticompetitive effect unless the manufacturer has substantial market power.[69] Moreover, the Supreme Court has recognized the procompetitive role of nonprice restrictions in controlling opportunistic free-riding behavior.[70]

Even though in *Continental T.V., Inc. v. GTE Sylvania Inc.*[71] the Court recognized the importance to consumer welfare of controlling opportunistic behavior in vertical relationships, the current state of the antitrust treatment of restricted distribution practice remains especially conducive to opportunistic court actions. The dichotomy in legal treatment of price and nonprice vertical restraints is a direct cause of the potential for the most severe types of opportunism. Price and nonprice restricted distribution practices can be utilized to accomplish almost identical goals, but vertical nonprice restraints are subject to a Rule of Reason analysis

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68. The analysis in the text is not complete. First, the reason the distributor does not exploit the manufacturer to the point where the manufacturer is indifferent to termination or continuing the relationship must be explained. There are two potential answers to this problem. One is that the distributor may be able to earn a greater profit through continuing the relationship under the manipulated terms than through capturing the treble damage award and therefore does not appropriate all the gains from the relationship. The other explanation is that the distributor is constrained by fear that the market value for its services will be diminished should it be identified as an opportunist. *See supra* text accompanying note 17.

Second, the opportunistic behavior of one distributor also affects other distributors and, thus, the manufacturer's entire distribution system. Consequently, the greater the disruption caused by an opportunistic distributor, the more likely the manufacturer will discipline it. Such strategic behavior also plays a crucial role in many predatory pricing theories. *See, e.g.*, Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284 (1977).

69. *See, e.g.*, Easterbrook, *supra* note 4, at 708 ("No serious scholar believes today that resale price maintenance or any other vertical restriction is harmful to competition in the absence of substantial market power, and several believe that these practices are harmless even with market power.").

70. *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 55–57 (1977); *supra* text accompanying notes 47–48.

71. 433 U.S. 36 (1977).

while vertical price restraints are illegal per se.[72] Consequently, a manufacturer using lawful nonprice restraints may be subject to opportunistic manipulation should it ever discuss resale price with its distributors.

The problem is that a manufacturer and a distributor may come together for lawful purposes and, as a result of an innocent discussion of general pricing policy, the manufacturer suddenly finds itself threatened by an antitrust violation. Consider Judge Posner's description of the problem:

> It is unrealistic to expect the manufacturer that uses location clauses and outlet restrictions in order to limit free riding to be indifferent to the dealer that circumvents the intent of the clauses by discounting. As soon as the manufacturer's files contain any correspondence or memoranda documenting its concern, however, it has delivered powerful evidence of per se illegal resale price maintenance into the hands of prospective plaintiff's lawyers. Any effort, beyond mere exhortation, to terminate, penalize, threaten, or even investigate the discounter may suffice to complete the plaintiff's case under existing—which is to say expansive—interpretations of the meaning of "agreement" under Section 1 of the Sherman Act. Once a dealer is identified as a chronic discounter, he may even be able to violate lawful provisions of the dealership agreement with impunity, because the enforcement of *any* provisions against it may be deemed to have been motivated by its discounting. The taint of price fixing may invalidate the entire system of restricted distribution.[73]

In other words, the harsh treatment of one type of vertical restraint opens up the possibility of opportunistic manipulation of the provisions of lawful restraints.

The problem of opportunistic behavior in the form of antitrust suits should not be blamed entirely on the differences in the legal treatment of price and nonprice restraints. Even in the absence of a per se rule against vertical price fixing, the distributor is often in a position to engage in opportunistic legal action. Consider a distributor which voluntarily signs a restricted contract with a manufacturer and assumes that the restricted clause is subject to the Rule of Reason.[74] If the arrangement proves profit-

72. *See supra* text accompanying notes 35–48.

73. Posner, *supra* note 5, at 12 (footnote omitted). Posner supports his analysis by reference to two lower court cases (Cernuto, Inc. v. United Cabinet Corp., 595 F.2d 164 (3d Cir. 1979), and Eiberger v. Sony Corp. of America, 459 F. Supp. 1276 (S.D.N.Y. 1978), *aff'd in part and rev'd in part on other grounds*, 622 F.2d 1068 (2d Cir. 1980)) where "the court indicated that nonprice restrictions in distribution can constitute per se illegal price fixing if they are intended to limit discounting." Posner, *supra* note 5, at 13. *See also* the discussion of Monsanto Co. v. Spray-Rite Serv. Corp., 684 F.2d 1226 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 1249 (1983), *supra* note 39.

74. The uncertainty of precedents under the Rule of Reason undoubtedly accounts for some of the opportunism that is about to be described. A related, but not analogous, scenario, which hinges on the uncertainties of litigation, is the so-called "new antitrust strategy":

able for the distributor, then there are no problems. However, if the arrangement does not fulfill the distributor's profit expectation, the distributor can violate the contractual terms in hopes of earning a larger return. Should the manufacturer object to the distributor's breach of the contract and terminate the distributor,[75] the distributor sues for treble damages. That is, if the restraint is not successful, the opportunistic distributor has the incentive to seek a larger return through breaching the contract and, possibly, inducing termination.[76] The termination is viewed as an effort to enforce an illegal conspiracy. This type of arrangement has been referred to as "heads-I-win, tails-you-lose" protection of the distributor.[77]

D. *Perverse Incentives*

The distributor's position becomes especially enviable when it is realized that the extra profits earned while cheating on the restricted distribution contract will be used in establishing the damages (lost expected profits) that result from the termination. Since the increased profits resulting from cheating may be eventually trebled in an antitrust action, the incentive to cheat is even greater than suggested by the preceding analysis. Professors Elzinga and Breit have identified an analogous situation involving damages resulting from collusive behavior:

> By "perverse incentives effect" we mean that a private party neglects to modify his behavior when the damage done to him by the monopolistic firm

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> Under the "new" antitrust strategy, management intentionally exploits the private suit to achieve noncompensatory objectives. Treble damage complaints are now filed in an attempt to intimidate defendants into modifying their conduct in a way favorable to the interests of the plaintiff. The objective of the strategy is to cause the defendant to "soften" the vigor of its competitive tactics. The plaintiff assumes that a risk-conscious defendant will acknowledge the ambiguities of antitrust precedent, recognize the uncertainty of the outcome and, as a result, will avoid taking the chance of exacerbating potential damages by continuing the alleged illegal conduct. Faced with this prospect, the defendant typically gives the plaintiff various "business advantages" (such as supply contracts) in lieu of a monetary settlement.

Austin, *supra* note 3, at 1353. This strategy differs from the opportunistic scenario of this article in one crucial aspect: the basis of the initial relationship described by Austin is coercive, whereas the basis of restricted distribution practices is voluntary. The scenarios are consistent in that they both relate to intimidation through threat of antitrust action.

75. It might not be in the manufacturer's best interests to terminate the cheating distributor. *See supra* text accompanying notes 71–73.

76. A similar scenario would involve a distributor entering into a restricted distribution contract with a manufacturer because the contract with the restricted clause was better for the distributor than no contract at all. After the contract is formed, the distributor may wish to avoid the restricted clause while maintaining the distributorship relationship with the manufacturer. The distributor's lawyer may suggest attacking the bargained-for clause as an antitrust violation. Distributors have successfully utilized this strategy. *See, e.g.*, the discussion of Perma Life Mufflers, Inc. v. International Parts, Inc., 392 U.S. 134 (1968), *infra* at text accompanying notes 98–101.

77. Handler, *Reforming the Antitrust Laws*, 82 COLUM. L. REV. 1287, 1362 (1982).

> exceeds the cost to him of avoiding that damage or that the consumer modifies his behavior in order to increase the damage done to him by the anticompetitive activity. Unless a consumer bears the cost of purchasing from a firm with market power, for instance, he has less motive to be a careful shopper and seek out competitive substitutes. In other words, the incentive to minimize his damages is weakened or disappears. He will not attempt to alter his customary purchasing practices to avoid being overcharged because he believes reparations will be forthcoming should he be found dealing with an antitrust violator. Moreover, the possibility of receiving more than the actual amount of damages magnifies the perverse incentives effect, since an individual has an incentive not only to neglect seeking out substitutes or finding ways of avoiding damages, but also even to suffer damages in order to benefit from the collection of threefold the amount of damages actually sustained. This incentive would exist whenever the expected value of the reparations is greater than the amount of the damage.[78]

There is a fundamental distinction between the behavior described by Elzinga and Breit and the behavior described in this article. Elzinga and Breit are describing the rational response of victims of collusive anticompetitive behavior. This article addresses the rational behavior of an opportunistic perpetrator of an antitrust violation where the true basis of the treble damage action is a mutually beneficial contract to which the allegedly-injured party had voluntarily agreed. The perverse incentives described by Elzinga and Breit are also present in this article's scenario.

Another perverse incentive of the interaction of treble damage actions with restricted distribution practices concerns their relationship to the public policy underlying section 4 of the Clayton Act—the deterrence of violations of the antitrust law.[79] Since under current antitrust doctrines it is possible for a distributor to agree to a contract that includes a restricted clause and then later bring suit seeking treble damages,[80] it seems reasonable to suspect that some distributors enter into restricted agreements with that escape strategy in mind.[81] That is, it is plausible that the current state of the law not only encourages the suit but also encourages distributors to seek contractual terms that amount to the violations. When the terms of voluntary contracts can be used by one of the parties to the contract as evidence of an antitrust violation, perverse results should not be unexpected. This observation helps explain why such cases dominate antitrust litigation.[82]

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78. K. ELZINGA & W. BREIT, *supra* note 3, at 84.

79. *See supra* note 2.

80. The scenario is not symmetrical. Manufacturers do not sue their distributors for antitrust violations.

81. Consider the negotiating position of the distributor in the example, *supra* note 76.

82. Bohling, *supra* note 8, at 1212.

The preceding analysis suggests that the Supreme Court's liberalization of the antitrust treatment of nonprice restraints may not have resulted in an actual expansion of alternatives available to manufacturers. This is so because restricted distribution practices now subject to the Rule of Reason may still be deterred by the threat of opportunistic court actions by distributors who allege a violation of a related per se illegal practice. This perverse result is as destructive to the efficient distribution of goods as other types of transaction failures.[83] The fact that the judicially recognized transaction failure (intrabrand free-riding) is the result of an imperfection in the market does not dictate that it should be of more concern to policy makers than the opportunistic-court-action type of transaction failure that is the result of an inconsistent antitrust policy.

E. Market Adjustments to the Threat of Opportunistic Litigation

The potential for opportunistic treble damage actions by its distributors is something a manufacturer must consider when establishing a distribution system. In other words, the potential costs (or risks) of an antitrust action must be included in the cost-benefit calculations that underlie a manufacturer's decisions about whether to utilize certain types of restraints.[84] Unlike excessive stipulated damage clauses, which are negotiated and may be left out of a contract, the potential treble damage action is a government-mandated implicit term of all restricted distribution agreements.[85] The antitrust penalty cannot be deleted by the contracting parties and the threat of the penalty surely influences the negotiating process and the terms of the restricted distribution contract.

The threat of postcontractual opportunistic behavior is socially wasteful because manufacturers try to avoid being victimized by investing resources in precontractual searches for and investigations of potential distributors. Information about the reliability of distributors is a scarce commodity and, thus, is costly to obtain.[86] Because of their uncertainty

83. For example, see the problems associated with intrabrand free-riding, *supra* at text accompanying notes 21–22, and interbrand free-riding, references cited *supra* note 23.

84. For an analysis of the risk allocating role of contracts, see authorities cited *supra* note 9.

85. The Kronman-Posner objection to the Clarkson, Miller, and Muris characterization of the liquidated damages-penalty clause distinction as an efficiency-generating response is based on recognition of the fact that stipulated damage clauses are the result of a voluntary contract. *See supra* note 61. The distinguishing feature of the treble damage clause is that it is not negotiable, and thus a distinction between the problems of opportunism under the threat of treble damages and those when the threat is absent may be justifiable on efficiency grounds.

86. *See, e.g.*, G. STIGLER, *The Economics of Information*, in THE ORGANIZATION OF INDUSTRY 171 (1968). For interesting applications of the economic theory of information and uncertainty, see Darby & Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. L. & ECON. 67 (1973);

about the reliability of distributors, manufacturers would invest resources in obtaining distributor-specific information even if the possibility of opportunistic court action were foreclosed. This is because distributors also have the opportunity to engage in other types of opportunism in distributing the manufacturer's products.[87] The point is that the threat of opportunistic antitrust litigation leads manufacturers to invest even greater amounts of their resources in preventing the opportunistic pursuit of treble damages by distributors.

Manufacturers' information-gathering processes, however, will generate a significant degree of market discipline over opportunistically-inclined distributors. A distributor, whose record of opportunism is discovered by manufacturers, will find the demand for, and market value of, its services diminished. The market consequences of opportunistic behavior thus may deter distributor opportunism. Nevertheless, because of the information costs to the manufacturers of discovering the attributes of distributors, and the large potential payoffs to opportunistic dealers,[88] the market adjustments will not reduce the occurrence of opportunistic litigation to a de minimis level. Moreover, in evaluating the effects of this scenario on consumer welfare, it must be remembered that it is the mere possibility of the occurrence of opportunism, not the actual occurrence of opportunism, that leads to the socially wasteful investment of resources.

It is possible that in many situations manufacturers may rationally avoid the use of efficiency-enhancing restricted practices in order to avoid the threat of opportunistic court action. For example, if a manufacturer's next best alternative to distribution through independent dealers controlled by restricted distribution contracts is vertical ownership integration, then the manufacturer must compare the net benefits of the alternative distribution schemes. If the threat of opportunistic antitrust actions swings the balance from a restricted distribution system to vertical integration, then the manufacturer will choose vertical integration. Such a result warrants two comments. First, since vertical integration is the second best alternative, it is clear that the antitrust policy has caused an inefficient allocation of resources. Second, the vertical integration alternative will have an impact on the transfer-payment terms of restricted distribution contracts. That is, all distributors will bear a portion of the manufacturer's costs associated with bearing the risks of opportunistic behavior by

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and Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA L. REV 630 (1979). *See also infra* note 89.

87. *See supra* Part IIIA.

88. Treble damage awards in restricted distribution cases are nontrivial. *See, e.g.*, Monsanto Co. v. Spray-Rite Serv. Corp., 684 F.2d 1226 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 1249 (1983), discussed *supra* note 39 (actual damages of $3.5 million, trebled to $10.5 million).

a few distributors since the risk of opportunism lowers the value of their services and there exist alternatives to their services. Thus the possibility of opportunistic behavior by some distributor not only injures manufacturers, but also injures all distributors regardless of whether or not they are inclined to act opportunistically.[89] Distributors as well as manufacturers stand to gain from a change in policy.

V. POLICY IMPLICATIONS

The preceding analysis demonstrates that the costs of the private enforcement system greatly outweigh any positive effects which might flow from the deterrence of restricted distribution practices. The costs are directly attributed to the internal inconsistency of an antitrust policy that allows certain types of restraints because of their efficiency-enhancing possibilities but also allows for treble damage actions against the perpetrators when there is the slightest hint of the use of a per se illegal practice that naturally accompanies the lawful practice. One straightforward solution to this policy failure would be to declare all restricted distribution practices to be per se illegal. However, adoption of such a policy would not be consistent with the consumer welfare standard. Another straightforward solution would be to declare all restricted distribution practices to be per se legal.[90] Although consistent with the general presumption that restricted distribution practices are procompetitive, such a sweeping policy recommendation is not justified by the narrow scope of the preceding analysis. Accordingly, this part presents two policy recommendations aimed at solving the specific problem identified.

A. *Uniform Treatment of Price and Nonprice Restrictions*

The formalistic distinction between price and nonprice restricted distribution practices is not only unjustifiable in terms of economics, it is also a major culprit in the facilitation of court-enforced postcontractual manipulation. The complementary uses of price and nonprice restrictions make it

89. The analysis presented is suggested by the economic theory of adverse selection which states, in its most basic form, that the costs arising because of uncertainty with respect to the quality of a certain category of goods will be borne by the higher quality goods in the category. For example, uncertainty with respect to quality in the used car market lowers the demand price of high quality cars. Original investigations of this principle are described in Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 141 (1963); and Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

90. *See* Posner, *supra* note 5 (giving other theoretical and practical reasons for declaring all restricted distribution practices per se legal). *See also* Liebeler, *supra* note 24 (making theoretical and practical arguments for removing all intrabrand or intrafirm practices from antitrust scrutiny).

important to subject both types of restraints to the same standards of legality.[91] Since most economists accept the procompetitive analysis of restricted distribution practices, the equalization of the antitrust treatment should be achieved through a liberalization of the rules governing vertical price fixing. Thus, vertical price restraints should not be per se illegal.

The removal of vertical price restrictions from the per se illegality category and adoption of a uniform Rule of Reason for all restricted distribution practices would serve to reduce the plaintiff-distributor's probability of establishing an antitrust violation and thereby reduce the distributor's ability to manipulate opportunistically the terms of the clearly lawful aspects of the vertical relationship. The major impact of such a move would be the lessening of the degree of risk associated with using nonprice distribution restrictions, which the Supreme Court has conceded may have procompetitive effects.[92] The threat of opportunistic antitrust actions based on vertical price fixing theories has surely served to clog the communication lines between manufacturers and their territorial distributors.[93] The removal of this threat would allow for the utilization of vertical restraints to their full efficiency-enhancing potential because manufacturers could balance the costs and benefits of the strategy without having to worry about inadvertently slipping into a per se illegal practice.

B. *The In Pari Delicto Defense*

Uniform treatment of complementary or substitute vertical restrictions may solve some of the problems associated with induced terminations and treble damage actions. It will not, however, eliminate the use of real resources to prevent or to facilitate the occurrence of opportunistic behavior.[94] As long as any vertical restricted practice is potentially illegal under a Rule of Reason analysis, opportunistic behavior through court action by a distributor will be a possibility that must be accounted for by manufac-

91. The facts of Monsanto Co. v. Spray-Rite Serv. Corp., 684 F.2d 1226 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 1249 (1983), as discussed *supra* note 39, illustrate the interactive, complementary nature of price and nonprice restricted practices. The *Spray-Rite* case thus provides an excellent forum for the Supreme Court to declare a uniform Rule of Reason.

92. *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 55–57 (1977) (acknowledging procompetitive aspects of nonprice distribution restrictions); and *supra* text accompanying notes 47–48.

93. The free flow of information between a manufacturer and its distributors is a necessary condition for the operation of an efficient distribution system. *See* P. AREEDA, ANTITRUST ANALYSIS 388 (2d ed. 1974).

94. *See supra* text accompanying notes 74–77. The fundamental problem is the inability of the Supreme Court to develop a coherent Rule of Reason for vertical restrictions, and the risk that procompetitive (or neutral) practices will be declared anticompetitive and illegal. The implicit assumption of the discussion in the text is that vertical restraints should be presumed procompetitive. *See supra* note 69.

turers. The most straightforward solution to this problem, as mentioned earlier, would be for the Supreme Court to declare all restricted distribution practices per se legal. However, it would be unrealistic to expect the Court to take such a step. On the other hand, an intermediate change in policy through the revitalization of the in pari delicto defense would solve the problems of opportunistic treble damage actions.

The in pari delicto defense,[95] which represents a moral judgment that a party should not be allowed to gain from the party's own misconduct, is a common law doctrine that is applied to illegal executory contracts. Where the duties of the parties to the illegal executory contract have been at least partially fulfilled and one party sues for damages or continued performance, the court will bar the suit if the defendant establishes that the plaintiff is in pari delicto. In other words, if the plaintiff is also to blame for the formation of the illegal contract, which is clearly the case if the contract is voluntary,[96] then recovery will be barred. The in pari delicto defense is similar to the illegality defense. Where an executory contract has not been executed, illegality is a complete defense to a suit seeking damages or performance. The courts will not enforce the illegal bargain. If the contract has been executed, the illegality defense is called in pari delicto.

The application of in pari delicto to antitrust treble damage actions involving restrictions on distribution, while analogous in terms of substance, is not as straightforward as in strict contract law. Although an illegal contract is the true basis of the action under both antitrust and contract theories, there is a potential difficulty in that the plaintiff in the antitrust action is the party who actually breached the restricted distribution contract. Since the plaintiff in the antitrust action was terminated by the manufacturer for violating some provision of the restricted distribution contract, the antitrust suit is not a contract action.[97] However, once it is

95. For discussion of the in pari delicto defense, see Handler, *supra* note 77, at 1359 (1982). *See also* SULLIVAN, *supra* note 4, at 785.

96. All contracts are voluntary. Asserting that the bargaining power of the manufacturer resulted in the distributor being forced to accept onerous terms, *see infra* text accompanying notes 99–102, misses the essential point that other terms in the contract compensate the distributor for accepting the "onerous" terms. Moreover, the use of antitrust laws to strike onerous terms from a contract, *see supra* note 76, destroys the delicate equilibrium generated by the bargaining process and results in uncompensated transfers to distributors from manufacturers.

97. There is some evidence that the statutory right to recover damages is based on a tort theory. Senator Teller suggested a tort basis under the Sherman Act damage remedy when he described the Act as an attempt "to abate . . . a sort of public nuisance." 21 CONG. REC. 2612 (1890). Courts also have treated Section 4 as a kind of tort remedy. *See, e.g.*, Story Parchment Co. v. Paterson Parchment Paper Co., 282 U.S. 555, 563 (1931); Soloman v. Houston Corrugated Box Co., 526 F.2d 389, 392 n.4 (5th Cir. 1976); *see also* Easterbrook, Landes & Posner, *supra* note 2, at 331 ("For purposes of remedy, a private treble damages action under the federal antitrust laws is a tort action.") The contributory negligence defense in tort law is analogous to the in pari delecto defense in contract law.

realized that the in pari delicto defense is available to the distributor in the guise of an antitrust counterclaim or affirmative defense if the manufacturer sues for damages or performance of the illegal restricted contract (rather than merely terminating the relationship), then it seems that a symmetrical utilization of the in pari delicto defense should be available to the manufacturer-defendant in antitrust actions.

The leading case on the use of the in pari delicto defense in antitrust treble damage actions is *Perma Life Mufflers, Inc. v. International Parts Corp.*[98] In *Perma Life Mufflers*, a group of franchise dealers had accepted contracts to sell Midas mufflers and had contracted to sell the mufflers at prices set by the franchisor and to not deal with any Midas competitors. Of these restrictive terms, the Supreme Court noted: "Petitioners [the dealers] apparently accepted many of these restraints solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity."[99] The opportunistic franchisee dealers, who wished to take the benefits of their bargains without the burdens, alleged that Midas, its parent International Parts, and two other subsidiaries unlawfully conspired to restrain competition under section 1 of the Sherman Act and section 3 of the Clayton Act and had forced them to accept the onerous terms of the franchise agreements.

The Supreme Court apparently viewed the dealers as victims of a superior economic force that had bound them to unfair and ill-advised bargains. The oppressed dealers, according to the Supreme Court, were entitled to relief under the antitrust laws which, in effect, allow the federal courts to rewrite their contracts for them. Of the in pari delicto defense, the Court held, in effect, that the role of private attorneys general in enforcing the antitrust laws was more important than denying recovery to a plaintiff who is "no less morally reprehensible than the defendant."[100] Thus, under current antitrust doctrine, court-enforced postcontractual op-

98. 392 U.S. 134 (1968).

99. *Id.* at 139.

100. *Id.* The Court emphasized the deterrence effects of the private action:

> [T]he purposes of the antitrust laws are best served by insuring that the private action will be an ever-present threat to deter anyone contemplating business behavior in violation of the antitrust laws. The plaintiff who reaps the reward of treble damages may be no less morally reprehensive than the defendant, but the law encourages his suit to further the overriding policy in favor of competition.

Id The Court ignores the costs to society when real resources are devoted to private enforcement of antitrust laws This use of resources becomes very important when the proscribed practice also has potential procompetitive features. That is, if the proscribed practice has only a small anticompetitive effect, then the resources devoted to enforcement of the law may lead to an overall reduction in wealth. In this regard, per se illegal or per se legal rules may both be preferable to the Rule of Reason. This is so because the more precise the law, the less likely the suit will be tried. *See, e.g.*, Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD 257, 271 (1974).

portunistic behavior in the form of the private suit for treble damages is alive and well.[101]

The rejection of in pari delicto as an antitrust defense has not only distorted the relative bargaining powers of distributors and manufacturers to the point where some manufacturers may not utilize otherwise efficient restricted practices, it may also account for the large amount of private antitrust litigation that has dominated the antitrust caseload.[102] A proper utilization of the in pari delicto defense would have many of the same beneficial effects as establishing a uniform Rule of Reason. Moreover, it would elminate the threat of opportunistic treble damage actions in all antitrust cases where the true basis of the action is a voluntary contract.

This recommendation is consistent with Professor Handler's suggestion that a reasonable balancing approach would be to allow the in pari delicto defense in instances of equal fault but not allow it to "preclude suits for injunctive relief against the defendant's continued wrong doing where the plaintiff has voluntarily ceased to participate in the challenged agreement."[103] Since government attacks on these practices would still be available, the reduction in private enforcement actions would not interfere with the public policy goals of the antitrust laws.[104] Also, under the approach advocated here, unfairly treated franchisees and distributors would, of course, still be allowed to pursue private contract remedies.[105]

101. Consider Professor Handler's discussion of the relationship between contracting parties and treble damages:

> An effort to reconcile the competing policies of the antitrust laws and the in pari delicto doctrine is long overdue. The rejection of in pari delicto as a defense subverts the very goals of the antitrust laws. Justice Black's formulation, if applied literally, would require a court to grant a plaintiff treble damages where both parties are equal participants in an unlawful scheme without even compelling plaintiff to cease the very illegality of which he is complaining .... Moreover, Justice Black also encouraged illegal conduct by plaintiff, by offering a "heads-I-win, tails-you-lose" protection if plaintiff violated the antitrust laws—if the conspiracy is successful, plaintiff profits from the illegality; if it is unsuccessful, it sues for treble damages. The policies of the antitrust laws and the in pari delicto doctrines are thus *not* entirely inconsistent.

Handler, *supra* note 77, at 1362.

102. *See* Bohling, *supra* note 8.

103. Handler, *supra* note 77, at 1363. This situation differs from the situation discussed *supra* note 97.

104. Professor Austin, after identifying the perverse incentives of the so-called "new antitrust strategy," suggests that "serious consideration should be given to turning over to the government exclusive responsibility for enforcing the antitrust laws." Austin, *supra* note 3, at 1372. This article does not advocate such a sweeping recommendation for three reasons. First, the analysis in this article does not justify such an approach. Second, adoption of a uniform Rule of Reason and the utilization of the in pari delicto defense can be accomplished through court action, while Austin's recommendation would surely require legislative action. Finally, it is not clear how the government would select which cases to prosecute. *See, e.g.*, Faith, Leavens & Tollison, *Antitrust Pork Barrel*, 25 J. L. & ECON. 329 (1982).

105. Goldberg, *supra* note 66, at 127–29, also suggests that antitrust law is not necessary to protect franchisees and distributors. However, he feels that contract law has not yet evolved to the

Finally, the in pari delicto defense would surely allow for a more productive utilization of the resources that are currently devoted to the opportunistic pursuit of treble damages. The net result would be an increase in consumer welfare.

IV. CONCLUDING COMMENTS

This article has examined the economic incentives generated by the interaction of the current state of the antitrust law of restricted distribution practices with the treble damage award. It identified the incentives and ability of distributors to breach voluntary restricted distribution contracts by cheating on the restrictive terms of the contract, thereby inducing their own termination by the manufacturer. Since the termination is often viewed as evidence of an unlawful restraint of trade, distributors have incentives to pursue treble damages through inducing the termination. This observation goes a long way towards explaining why distributor terminations have been among the most actively litigated areas of antitrust. The main point of the article, however, is that the threat of such opportunistic postcontractual pursuit of treble damages by distributors reduces manufacturers' incentives to implement procompetitive distribution strategies. That is, the ex ante incentives generated by the threat of postcontractual manipulation results in inefficiencies as reflected in higher costs of negotiating and managing the distribution of goods and services. Moreover, the analysis of the threat of treble damage actions suggests that the recent liberalization of the law of restricted distribution practices will have little procompetitive impact.

The article suggests that this policy failure can be remedied through the adoption of two specific recommendations. First, the Supreme Court should adopt a uniform antitrust treatment for all restricted distribution practices. Second, the in pari delecto defense should be available to antitrust defendants. The second recommendation would clearly solve the policy failure, but the first recommendation, which would lessen the extent of the problem, appears to be closer to realization because the Supreme Court currently has a restricted distribution case scheduled for argument. The policy failure identified in this article should ultimately be viewed as another theoretical justification for declaring all restricted distribution practices per se legal.

point where it can successfully resolve disputes between distributors and manufacturers or between franchisors and franchisees without simply dissolving the contract and awarding damages. He suggests that treble damages should not be awarded in disputes of that nature.