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Antitrust - Vertical Restraints of Territory and Customers - Section 1 of the Sherman Act

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ANTITRUST—VERTICAL RESTRAINTS OF TERRITORY AND CUSTOMERS—Section 1 of the Sherman Act—The United States Supreme Court, distinguishing between sales and agency transactions, has held that vertical territorial or customer restrictions of a manufacturer relative to a sale are *per se* violations and that restrictions incidental to an agency relation are subject to the rule of reason.

United States v. Arnold, Schwinn & Co., 388 U.S. 365, 87 S. Ct. 1856 (1967).

Faced with a highly competitive situation due to the presence in the market of mass merchandisers such as Sears, Roebuck & Co. and Montgomery Ward & Co. and its own unsatisfactory distribution system, Arnold, Schwinn & Co.,[1] a manufacturer of bicycles, undertook to streamline its marketing operations. By 1952 it had reduced the number of distributors to 22 and the number of retailers from 15,000 to 5500. While utilizing the method of franchising dealers, Schwinn did not prevent either its distributors or dealers from selling competing brands, although it did require that equal prominence and promotion be given to its products. The franchised dealer was required to purchase only from the distributor serving his area and although not expressly prohibited from selling to unauthorized wholesalers and retailers, such action would subject the dealer's franchise to cancellation. Each distributor was assigned specific territories and instructed to deal only with dealers franchised by Schwinn within that area.[2] Distribution was accomplished through: (1) sales to distributors; (2) sales to retailers utilizing an agency or consignment arrangement with distributors; (3) sales to retailers involving direct shipment from the factory to the retailer, invoicing the dealer, and paying commissions to the area distributor—denominated the Schwinn-Plan.[3]

In its suit against Schwinn and the Schwinn Cycle Distributors Association,[4] the United States charged a conspiracy to fix prices, allocate exclusive territories, and restrict merchandise to franchised dealers[5] in violation of Section 1 of the Sherman Act.[6] The district court rejected the price-fixing issue, but found that Schwinn and certain of its distributors had conspired to restrict territories with respect to products pur-

1. Hereinafter referred to as Schwinn.

2. The Supreme Court noted that Schwinn had been "firm and resolute" in insisting upon compliance with the customer restrictions. United States v. Arnold Schwinn & Co., 388 U.S. 365, 372, 87 S. Ct. 1856, 1862 (1967).

3. *Id.* at 370, 87 S. Ct. at 1861.

4. B. F. Goodrich had been an additional defendant, but was dropped from the case through a consent decree. *Id.* at 367, 87 S. Ct. at 1859.

5. *Id.*

6. 15 U.S.C. § 1 (1964).

chased from Schwinn and enjoined that practice.[7] It further held that the other marketing practices, agency, consignment, and Schwinn-Plan, were not violative of the Sherman Act.[8] On appeal the government contended that territorial and customer restrictions, regardless of whether incident to sales, agency, consignment, or Schwinn-Plan transactions, should be enjoined. The Supreme Court expanded the district court's decree and *held* that territorial and customer restrictions upon either a wholesaler or retailer are *per se* violations when incident to a sales transaction,[9] but that when similar restrictions are imposed upon agents of the manufacturer, the manufacturer retaining title, dominion, and risk of loss with respect to the product, the restrictions are illegal only if found to be unreasonable restraints upon competition.[10]

Mr. Justice Fortas, writing for the majority, relied principally upon *White Motor Co. v. United States*[11] and *Dr. Miles Medical v. John D. Park & Sons Co.*[12] in adopting a *per se* rule[13] with respect to vertical restraints upon territory or customers where the manufacturer sells and passes title to its product to the reseller. He reasoned that, if allowed, such restrictions would violate the ancient rule against restraints on alienation since the nature of such a transaction includes an agreement, combination, or understanding.[14]

The majority realized that certain benefits were derived from a market comprised of numerous independent dealers and desired their perservation, especially in the face of competition from mass merchandisers; mindful that the adoption of a *per se* rule for all vertical restrictions would accelerate the trend toward vertical integration in distribution,[15] the majority, utilizing the approach set forth in *White Motor*,[16] applied the "rule of reason"[17] to Schwinn's marketing practices involving agency, consignment, and the Schwinn-Plan. In deciding that these distribution

7. United States v. Arnold, Schwinn & Co., 237 F. Supp. 323, 343 (N.D. Ill. 1965). The United States did not appeal the price-fixing finding nor did Schwinn challenge the ruling of conspiracy. 388 U.S. at 368, 87 S. Ct. at 1860.

8. 237 F. Supp. at 343.

9. 388 U.S. at 378, 87 S. Ct. at 1865.

10. *Id.* at 380, 87 S. Ct. at 1866.

11. 372 U.S. 253 (1963).

12. 220 U.S. 373 (1911).

13. For a definition of *per se* illegality see, Northern Pacific Railway Co. v. United States, 356 U.S. 1, 5 (1958). See also von Kalinowski, *The Per Se Doctrine—An Emerging Philosophy of Antitrust Law*, 11 U.C.L.A. L. REV. 569 (1964).

14. 388 U.S. at 377, 87 S. Ct. at 1865-66.

15. *Id.*

16. 372 U.S. 253, 263 (1963).

17. Chicago Board of Trade v. United States, 246 U.S. 231 (1918); Standard Oil of New Jersey v. United States, 221 U.S. 1 (1911). For an historical development see Bork, *The Rule of Reason and The Per Se Concept: Price Fixing and Market Division*, 74 YALE L.J. 775 (1965).

practices were not unreasonable, the following factors were considered controlling: that reasonably interchangeable products are readily available; that Schwinn's distributors and retailers handled competing brands; that price-fixing was not present;[18] that the marketing policies were made necessary by, and went no farther than required by competitive forces; and, that the policies preserved rather than destroyed competition.[19] A major factor considered by the Court in construing Schwinn's practices was not only the effect on *intrabrand* competition, but also the effect on *interbrand* competition. The Court reiterated that sound business motives were insufficient to satisfy the rule of reason.[20]

In *White Motor Co. v. United States*,[21] decided in 1963, the Supreme Court was faced with the same issues as presented in *Schwinn*. White Motor Co., a truck manufacturer, had imposed in its dealer contracts strictly defined territorial limits and reserved large customers to itself. These restraints clearly come within the area of *per se* illegality now adopted in *Schwinn*. In *White Motor*, the Supreme Court refused to adopt a *per se* rule applicable to vertical territorial and customer restrictions stating that it was unwilling to extend the *per se* doctrine without first assessing the market impact of such practices. The district court, granting a motion for summary judgment, had held that the restrictions were *per se* violations of the Sherman Act. In reversing and remanding the case, the Court indicated that it did not know enough of the "economic and business stuff" out of which these arrangements emerge to be certain that a *per se* violation resulted.[22] The Supreme Court concluded in *White Motor* that the legality of the restrictions could only be determined after a trial. Mr. Justice Brennan, in his concurring opinion attempted to establish guidelines for the trial court.[23] He noted that while the vertical restrictions were similar to both horizontal agreements to divide markets and resale price maintenance agreements, both of which are *per se* violations, there were significant differences such as, the unilateral nature of the restraints and the relative impact upon interbrand competition. Mr. Justice Brennan suggested that these differences made necessary an assessment of the following issues: (1) whether the restraints increase

18. The Court in *dicta* indicates it would have had little difficulty if price-fixing were involved, 388 U.S. at 375, 87 S. Ct. at 1862. *See* note 34 *infra*.

19. It should be noted, although not expressly considered by the Court as a determinative factor, that Schwinn did not improve its position in the market by the institution of the marketing practices. In 1951 Schwinn had the largest single market share with 22.5% and in 1962 it had 12.8%, 388 U.S. at 368, 87 S. Ct. at 1860.

20. *Id.* at 375, 87 S. Ct. at 1863; United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940).

21. 372 U.S. 253 (1963).

22. *Id.* at 263.

23. On remand the case terminated in a consent judgment. United States v. White Motor Co., 1964 Trade Cas. ¶ 71,195 (N.D. Ohio 1964).

interbrand competition; (2) whether the restraints are necessary for the manufacturer's survival in the market; (3) whether the restraints go farther than is reasonably necessary; and, (4) whether reasonable alternatives are available. With respect to the customer restrictions, Mr. Justice Brennan indicated that they would be much more difficult to justify. The Court in *Schwinn*, after adopting the *per se* rule relative to sales, utilized the first and third of Mr. Justice Brennan's issues in *White Motor*, in concluding that the rule of reason was satisfied with respect to agency, consignment, and Schwinn-Plan transactions. In addition the Court noted the ready availability of alternate products and the practice of Schwinn's distributors and dealers to market competing brands. It is submitted that while the Court in *Schwinn* has adopted a *per se* rule relative to vertical restraints in sales, the rationale of the *White Motor* decision remains useful. The factors set forth by the Supreme Court in both cases continue to furnish a basis upon which to judge marketing practices now in use.

Mr. Justice Stewart, joined in dissent by Mr. Justice Harlan, although agreeing with the Court's basic "rule of reason" approach, disagreed with the distinction made between sales and agency transactions.[24] Believing that the majority had misinterpreted the lower court's opinion, he compared the conduct proscribed by the district court to a horizontal conspiracy of distributors with participation therein by the manufacturer similar to that involved in *United States v. General Motors Corp.*[25] He asserted that the lower court was simply following the precedent set by *Timken Roller Bearing Co. v. United States.*[26] Mr. Justice Stewart also felt that the majority had, in effect, repudiated *White Motor.*[27] He further challenged the Court's reliance on *Dr. Miles Medical*[28] because it was decided on common-law principles, although there was *dicta* to the effect that the conduct would also have violated the Sherman Act,[29] and contended that the use of the rule against restraints on alienation does not reflect the realities of marketing policies with mass advertising and vertically integrated manufacturing-distribution systems. He concluded that the outcome should not be based upon whether an arrangement is denominated a *sale* or *agency* and that this ignores a basic precept that *substance* rather than *form* is controlling.[30]

While the Court's reasons for making the distinction between sales and agency transactions remains largely unarticulated, it is submitted

24. 388 U.S. at 389, 87 S. Ct. at 1871.

25. Where dealers requested that General Motors refuse to sell its automobiles to discount houses; General Motors acceded to the request and this conduct was held to be a horizontal conspiracy in violation of Section 1 of the Sherman Act, 384 U.S. 127 (1966).

26. 341 U.S. 593, 71 S. Ct. 971 (1951).

27. *See* note 11 *supra.*

28. 220 U.S. 373 (1911).

29. *Id.* at 409.

30. 388 U.S. at 393, 87 S. Ct. at 1873; Simpson v. Union Oil Co., 377 U.S. 13 (1964).

that the Court was seeking to strike a balance between the public policies against restraints on alienation of chattels[31] and basic antitrust policies of maintenance of competition through a multiplicity of small independent business units.[32] In striving for this balance the middle ground chosen by the Court does violence to neither of these policies, although it is probable that the decision will adversely affect modern franchising.[33] The distinction between sales and agency transactions could actually be said to foster both policies since it preserves the restraint on alienation policy and frees the independent wholesaler and retailer from the fetters of manufacturer-imposed vertical restraints. From the point of view of the manufacturer, however, the elimination of the restrictions may not be desirable and it must, therefore, choose between forward integration and an agency relation as permitted by the *Schwinn* decision. It is submitted that such an attempt at an agency relation should be undertaken with due regard for the factors which the Court considered controlling in allowing vertical restraints in *Schwinn*, but always mindful that the adoption of an agency pattern may not be justified in every circumstance.[34] At the very minimum therefore, the *Schwinn* decision seems to necessitate a reappraisal by manufacturers of their marketing systems.[35]

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31. For a discussion of this policy, see, Chaffee, *The Music Goes Round and Round: Equitable Servitudes on Chattels*, 69 HARV. L. REV. 1250 (1956); Chaffee, *Equitable Servitudes on Chattels*, 41 HARV. L. REV. 945 (1928).

32. The Court here recognizes the overlapping policy aspects of the Clayton Act, 15 U.S.C. § 12 *et. seq.*, 44, and the Sherman Act. Timberg, *Territorial Exclusives*, 29 A.B.A. ANTITRUST SECTION 233 (1965); McLaren, *Territorial Restrictions, Exclusive Dealing, and Related Sales Distribution Problems Under the Antitrust Laws*, 11 PRAC. LAW. No. 4:79 (1965).

33. For a general discussion of franchising see, Chadwell and Rhodes, *Antitrust Aspects of Dealer Licensing and Franchising*, 62 NW. U.L. REV. 1 (1967); Averill, *Antitrust Considerations of the Principle Distribution Restrictions in Franchise Agreements*, 15 AM. U.L. REV. 28 (1965).

34. Use of a consignment arrangement as a means of price-fixing has been held a *per se* violation. *See* Simpson v. Union Oil Co., 377 U.S. 13 (1964). Union Oil Co. placed gasoline with its dealers on consignment and attempted to fix the retail price, threatening dealers with cancellation of their lease for failure to comply. Simpson refused to follow Union's prices and his lease was cancelled. The Supreme Court held that a Sherman Act violation resulted, concluding that substance rather than form controlled. Union Oil Co. relied upon the rationale of United States v. General Electric Co., 272 U.S. 476 (1926), wherein a consignment arrangement was upheld as a means of fixing prices on patented articles. The Court in General Electric did not restrict its holding only to patented articles, 272 U.S. at 488, 47 S. Ct. 196, but in *Simpson*, Mr. Justice Douglas distinguished *General Electric* factually and restricted it to its special facts—patented articles, 377 U.S. at 23. The *Simpson* decision is criticized in Handler, *Recent Antitrust Developments—1964*, 63 MICH. L. REV. 59 (1964).

35. Recent cases having vertical overtones, but which were decided on other principles are, United States v. Sealy, Inc., 87 S. Ct. 1847 (1967) (Sealy, wholly owned by 30 of its 40 licensees, imposed territorial restraints upon its trademark licensees. The Court held that a *per se* violation resulted because Sealy was a joint venture and the restrictions were in the nature of a horizontal conspiracy.); United States v. General Motors

Such a reappraisal may portend difficulties for at least some manufacturers. A small manufacturer may find it difficult to obtain reliable and responsible resellers when he is in competition with more powerful suppliers or vertically integrated firms. Potential dealers may be reluctant to risk their own capital without such guarantees as are now prohibited by the *Schwinn* decision.[36] Such dealers may be willing to sacrifice some of their independence to protect their investments and thus be inclined to accept an agency relationship. However, establishing an agency relation requires a capital outlay which could well be beyond the resources of many small manufacturers. A potential market entrant will find it necessary to absorb the costs of setting up a distribution system which is permitted by *Schwinn*.[37] It would appear, therefore, that while the Court recognizes the problem, the attempted solution is inadequate. Their solution both tends to decrease the ability of small firms to effectively compete and increases market entry barriers. It is submitted that a reexamination is necessary and this should include reconsideration of the use of the rule of reason.

Dennis P. Mankin

CONFLICT OF LAWS—JURISDICTION—Minimum Contacts—The outer limits of constitutionally valid jurisdiction are not exceeded by asserting jurisdiction over a service corporation doing business solely in a foreign state, if such corporation does a negligent act in the foreign state which causes injury in the state of the forum.

Roche v. Floral Rental Corporation, 95 N.J. Super. 555, 232 A.2d 162 (1967), *appeal docketed*, No. —, N.J. Sup. Ct. (1967).

The third party defendant, J.C. Truck Equipment Company (hereinafter referred to as J.C.), respondent on appeal, had moved to set aside the service of the lower court on the ground that the court lacked in personam jurisdiction over J.C. This appeal was taken from the granting of that motion.

On May 6, 1963, plaintiff's decedent was killed when his car collided

Corp., note 25 *supra*; Susser v. Carvel Corp., 206 F. Supp. 636 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965) (Treble damage action by franchisees against the franchisor of trademarked ice cream outlets in which the practices of exclusive dealing, tying arrangements, and restricted supplier provisions were examined.).

36. See, Jordan, *Exclusive and Restricted Sales Areas Under the Antitrust Laws*, 9 U.C.L.A. L. REV. 111 (1962); Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795 (1962).

37. It is not clear the extent to which the *Schwinn* decision continues the exemption for new market entrants from the *per se* rule. 388 U.S. at 375, 87 S. Ct. at 1863. *Compare*, White Motor Co. v. United States, 372 U.S. 253, 263 (1963).