

July 1981

## The Albrecht Rule and Consumer Welfare: An Economic Analysis

Roger D. Blair

David L. Kasserman

Follow this and additional works at: <https://scholarship.law.ufl.edu/flr>



Part of the [Law Commons](#)

---

### Recommended Citation

Roger D. Blair and David L. Kasserman, *The Albrecht Rule and Consumer Welfare: An Economic Analysis*, 33 Fla. L. Rev. 461 (1981).

Available at: <https://scholarship.law.ufl.edu/flr/vol33/iss4/1>

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Law Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact [kaleita@law.ufl.edu](mailto:kaleita@law.ufl.edu).

# University of Florida Law Review

VOLUME XXXIII

SUMMER 1981

NUMBER 4

## THE ALBRECHT RULE AND CONSUMER WELFARE: AN ECONOMIC ANALYSIS

ROGER D. BLAIR\*

DAVID L. KASERMAN\*\*

### INTRODUCTION

Designed to preserve competitive product pricing,<sup>1</sup> section 1 of the Sherman Antitrust Act prohibits price fixing.<sup>2</sup> Since the rule's inception, the Supreme Court has not allowed a reasonableness defense to a section 1 violation.<sup>3</sup> Instead, the court determined that competitively determined prices were reasonable and that collusively determined prices were not.<sup>4</sup> Early Supreme Court

\*Professor of Economics, University of Florida. B.A., 1964, M.A. 1966, Ph.D., 1968, Michigan State University.

\*\*Associate Professor of Economics, University of Tennessee. B.S., 1980, University of Tennessee; Ph.D., 1976, University of Florida.

The authors have received financial support from the Public Policy Research Center at the University of Florida. We have also received very helpful suggestions from Jerrold K. Guben, Robert F. Lanzillotti and Stephen Rubin on an earlier version.

1. R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE*, 24-26 (1976).

2. For a purview of early judicial treatment under the Sherman Act, see generally Note, *The Rule of Reason in Loose-Knit Combinations*, 32 COLUM. L. REV. 291 (1932). Initially, the Supreme Court interpreted section 1 of the Sherman Act by looking to the "reasonableness" of the challenged conduct in each case—known as the "rule of reason" approach. See *Chicago Bd. of Trade v. United States*, 246 U.S. 231 (1918); *United States v. American Tobacco Co.*, 221 U.S. 106 (1911); *Standard Oil Co. v. United States*, 221 U.S. 1 (1911). See also Allison, *Ambiguous Price Fixing and the Sherman Act: Simplistic Labels or Unavoidable Analysis?*, 16 HOUS. L. REV. 761, 763-66 (1979).

The language of the Sherman Antitrust Act was deliberately left vague to allow courts to develop the precise conduct to be prohibited. Section 1 provides in relevant part: "[e]very 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." *Id.* 15 U.S.C. §1 (1976).

3. Although the language of section 1 forbids all restraints of trade, many defendants in price fixing cases have asserted that the law should not apply to them because the prices they set were reasonable. See, e.g., *United States v. Joint-Traffic Ass'n*, 171 U.S. 505, 574-78 (1898) (Railroad defendant attempted to justify price fixing by claiming necessity in order to prevent industrial strife because of "cutthroat" competition); *United States v. Trans-Missouri Freight Ass'n*, 166 U.S. 290, 328 (1897) (defense similar to *Joint-Traffic* not accepted). See also *United States v. Trenton Potteries Co.*, 273 U.S. 392, 397 (1933) (Justice Stone held that since every price fixing agreement eliminates some form of competition, then price-fixing, even if reasonable, would be illegal). This argument, however, has no economic basis because competitive prices are per se reasonable.

4. Early Supreme Court opinions emphasized that free competition was sole consideration to determine Sherman Act violations. For example, in *Chicago Bd. of Trade v. United States*, 246 U.S. 231 (1918), the Court stated that "[t]he true test of legality is whether the restraint

applications of the rule focused theoretically on the market price impact of any challenged conduct.<sup>5</sup> The Court, however, did not require proof of the conduct's actual effect on market price. Rather, it merely required that enough evidence exist to sustain a reasonable inference that the challenged behavior would likely increase the market price above a competitively determined level.<sup>6</sup> In determining the sufficiency of the evidence, the Court focused on the general market situation of the product and the aggregate power of the colluding firms within that market.<sup>7</sup> Accordingly, analysis of price fixing violations centered on economic criteria.

The Court in *United States v. Socony-Vacuum Oil Co. Inc.*,<sup>8</sup> however, departed from this economic focus. In *Socony-Vacuum*, the Court held the mere attempt to charge a monopoly price to be a section 1 violation. Furthermore, the Court did not require the plaintiff to demonstrate that the defendant likely had the power necessary to effectuate monopoly prices.<sup>9</sup> The rule against price fixing, therefore, became more a part of the law of conspiracy than the law of monopoly.<sup>10</sup> Consequently, antitrust authorities<sup>11</sup> have ignored the economic aspects of price fixing. This abandonment of the economic focus of price fixing has adversely impacted on contemporary antitrust law. A particularly egregious example of the negative effects of this shift in emphasis is provided by the Supreme Court case, *Albrecht v. Herald Co.*<sup>12</sup> In *Albrecht*, the Court held that maximum resale price fixing violated section 1 of the Sherman Act.<sup>13</sup>

This article will trace briefly the rule against maximum resale price fixing

imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition." *Id.* at 238. Competitively determined prices are determined by the unfettered forces of supply and demand. Because these prices result from market forces, they are inherently "reasonable" although they may be quite high. Collusively determined prices are determined administratively by the suppliers. Although market forces admittedly influence the level of collusive prices, these forces are restrained. As a result, consumers lose the benefit of a free market.

5. See, e.g., *Dr. Miles Medical Co. v. Park & Sons Co.*, 220 U.S. 373, 407 (1911) (agreements between dealers having the purpose of destroying competition and fixing prices are void); *Addyston Pipe Steel Co. v. United States*, 175 U.S. 211, 236-38 (1899) (Sherman Act violation predicated on a finding that price competition had been practically eliminated in substantial parts of the country).

6. See, e.g., *United States v. Joint-Traffic Ass'n*, 171 U.S. 505, 577 (1898) (the consolidation of two competing railroads is a Sherman violation because it tends to raise rates) (emphasis added).

7. See, e.g., *United States v. United States Steel Corp.*, 251 U.S. 417 (1920); *United States v. American Tobacco Co.*, 221 U.S. 106 (1910).

8. 310 U.S. 150 (1940).

9. In Justice Douglas' famous footnote 59, he wrote "[t]he existence or exertion of power to accomplish the desired objective . . . becomes important only in cases where the offense charged is the actual monopolizing of any part of trade or commerce in violation of §2 of the Act. . . ." *Id.* at 226 and n.59.

10. R. POSNER, *supra* note 1, at 25. See generally, Note, *Prosecutions for Attempt to Monopolize: The Relevance of the Relevant Market*, 42 N.Y.U.L. REV. 110 (1967).

11. The antitrust laws are enforced by the Antitrust Division of the Department of Justice, and the Federal Trade Commission. Price fixing cases are usually prosecuted by the Department of Justice.

12. 390 U.S. 145 (1968).

13. *Id.* at 153-54.

and examine the current vitality of the rule as it exists presently. A simple model of derived demand will be used to demonstrate the deleterious economic effects of the current price fixing rule.<sup>14</sup> In particular, it will be shown that the prohibition against maximum price fixing works to the detriment of the consumer. Finally, attempts to circumvent the present rule will be shown to conflict with other legal theories. The economic analysis used herein will provide a persuasive argument for the Court to re-examine the utility of the prohibition against maximum resale price fixing.

#### JUDICIAL TREATMENT OF MAXIMUM PRICE-FIXING

Although the *Socony-Vacuum* case involved a horizontal conspiracy to restrict the supply and thereby raise the price of gasoline, it also applies to the setting of maximum resale prices. Justice Douglas, in a sweeping condemnation of any price fixing action, stated: "[u]nder the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal *per se*."<sup>15</sup> The language concerning depressing prices remained mere dictum until the Supreme Court's decision in *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.*<sup>16</sup> In *Kiefer-Stewart*, Seagram and Calvert, liquor producers, agreed not to sell their products to any wholesaler who refused to respect their pre-set *maximum* resale prices. Kiefer-Stewart, a liquor wholesaler, refused to accept the Seagram-Calvert restrictions. Accordingly, they were denied access to Seagram and Calvert products. Kiefer-Stewart brought suit alleging illegal price fixing under the Sherman Act. Seagram and Calvert responded by asserting that they had set maximum resale prices to counterbalance a horizontal price fixing conspiracy among its wholesale customers.<sup>17</sup> The Court, however, ruled that Seagram and Calvert's illegal conduct was not justified by proving that Kiefer-Stewart had also engaged in illegal price fixing. In reaffirming *Socony-Vacuum*, the Court noted that agreements to fix maximum resale prices restrain the exercise of independent business judgment, thereby crippling free trade.<sup>18</sup>

---

14. Areeda and Turner apparently share our opinion of this rule. Their feelings are foreshadowed, but not fully developed in 3 P. AREEDA & D. TURNER, *ANTITRUST LAW* 216 (1978). Based on the holding in *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977), Professor Posner also believes the *Albrecht* rule will not survive. See Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1, 12 (1977). Even some commentators who are generally suspicious of vertical restraints appreciate the deleterious impact of the *Albrecht* rule. See, e.g., Bohling, *A Simplified Rule of Reason for Vertical Restraints: Integrating Social Goals, Economic Analysis and Sylvania*, 64 IOWA L. REV. 461, 519-21 (1979).

15. *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 223 (1940). In *Catalano, Inc. v. Target Sales, Inc.*, 446 U.S. 643, 647 (1980), the Supreme Court recently cited the *Socony-Vacuum* language with obvious approval.

16. 340 U.S. 211 (1951). See generally Comment, *The Per Se Illegality of Price Fixing—Sans Power, Purpose, or Effect*, 19 U. CHI. L. REV. 837 (1952).

17. *Id.* at 214. Justice Black noted that the Seventh Circuit felt that fixing *maximum* resale prices "promoted rather than restrained competition." *Id.* at 212.

18. *Id.* at 213.

Adhering to the *Kiefer-Stewart* reasoning, the Supreme Court held a maximum price fixing scheme illegal in *Albrecht v. Herald Co.*<sup>19</sup> In *Albrecht*, the *Globe-Democrat*, a St. Louis newspaper, assigned exclusive territories to its distributors. This practice minimized the cost of providing home delivery by eliminating duplicate effort. Because each distributor was given a territorial monopoly, the *Globe-Democrat* had the power to terminate distributors who charged more than the advertised price. Although *Albrecht*, a distributor, was aware of the maximum price limitation, he ignored it and charged a higher price. After several customer complaints, the *Globe-Democrat* warned *Albrecht* that he was jeopardizing his distributorship. Nevertheless, *Albrecht* continued to overcharge his customers. In response, the *Globe-Democrat* first competed directly with *Albrecht*, and later assigned a portion of *Albrecht's* territory to another distributor. *Albrecht* then brought suit claiming that the pricing scheme violated section 1 of the Sherman Act. Consequently, the *Globe-Democrat* terminated his route and forced him to sell his distributorship. At trial, the jury found that no Sherman Act violation had occurred. Distinguishing *Kiefer-Stewart*, the Eighth Circuit affirmed, reasoning that because the *Globe-Democrat* had granted exclusive territories, the price fixing was necessary to insure competition which would protect the public from overcharging by the dealers.<sup>20</sup> On certiorari, the Supreme Court reversed and rejected this distinction stating "the assertion that illegal price fixing is justified because it blunts the pernicious consequences of another distribution practice is unpersuasive."<sup>21</sup> Instead, the Supreme Court followed the *Kiefer-Stewart* independent judgment-free trade analysis, concluding that the maximum price fixing scheme deprived the distributor of his ability to compete freely within the market place.<sup>22</sup> Accordingly, the court held that the price fixing scheme violated section I of the Sherman Act.<sup>23</sup>

The *Albrecht* case continues to be the dispositive authority on the resale price fixing prohibition. Although the Supreme Court has had an opportunity to review and perhaps revise the rule, they have denied certiorari in a case similar to *Albrecht*.<sup>24</sup> Consequently, section 1 of the Sherman Act continues to prohibit the setting of maximum price ceilings.

#### *When Are Maximum Resale Prices Fixed?*

A supplier invariably uses maximum resale price fixing to prevent its distributors from exploiting their market power. In *Kiefer-Stewart*, wholesale distributors conspired to raise prices by establishing a minimum sales price. The manufacturers, Seagram and Calvert, sought to prevent the inevitable decline in sales that accompanies a price increase. Accordingly, they fixed the maximum price that each distributor could charge for their products. Although individually each wholesale distributor had minimal monopoly power, collec-

19. 390 U.S. 145, 153-54.

20. 367 F.2d 517, 523-25 (8th Cir. 1966).

21. 390 U.S. at 154.

22. *Id.* at 152-53.

23. *Id.* at 154.

24. See *Knutson v. Daily Rev.*, 548 F.2d 795, cert. denied, 433 U.S. 910 (1977).

tively they tried to emulate the price and output that a monopolist would select.<sup>25</sup> Maximum price fixing restrictions, however, thwarted their intentions.

*Albrecht* clearly demonstrates a supplier's rationale for establishing maximum prices. The distributor, Albrecht, was granted a complete monopoly for home delivery in his exclusive territory. The *Globe-Democrat* sought to prevent Albrecht from abusing his monopoly power. Fixing the maximum resale price of the *Globe-Democrat* accomplished that objective.<sup>26</sup>

In both *Kiefer-Stewart* and *Albrecht* the manufacturers enjoyed market power from product differentiation provided by the brand names of Seagram and Calvert, or as the only seller of an evening newspaper. The distributors also enjoyed market power through the collusion of horizontal competitors<sup>27</sup> or through exclusive territories.<sup>28</sup> Economists have recognized this as a problem of successive monopolies in the chain of distribution.<sup>29</sup> A simple model of derived demand provided in the next section will facilitate analysis of the *Albrecht* rule against maximum resale price fixing.

Before examining this economic model, it should be noted that Professor Sullivan provides an alternative interpretation of the *Albrecht* rule. He fears that maximum resale price fixing oligopolistically limits pricing, thereby preventing market entry.<sup>30</sup> For example, suppose four bakeries provide service in a local market. If their prices approached the monopoly level, new firms would enter and compete in this market until the monopoly profits disappeared.<sup>31</sup> Arguably, under some circumstances the four firms could set prices below the monopoly level but above the competitive level, and still earn some monopoly profits, while discouraging new firms from entering the market.<sup>32</sup> There are several reasons why this theory fails to apply to maximum resale price fixing. First, collusion does not appear to be necessary. One firm could simply reduce its price to the entry deterring level and thereby force the other three firms to follow suit. Second, it is not clear why the four firms can have supracompetitive

25. The relationship between the multi-plant monopoly and the cartel is developed carefully in Patinkin, *Multiple-Plant Firms, Cartels, and Imperfect Competition*, 61 Q.J. ECON. 173 (1947).

26. Professor Rosse has demonstrated that the actions of distributors like Albrecht can result in *everyone* — the subscribers, the publisher and even the distributor — being worse off. See Rosse, *Vertical Price Fixing in Newspaper Distribution: A Per Se Rule That Makes Everyone Worse Off*, (unpublished manuscript, May 1980).

27. Recall that *Kiefer-Stewart* had been conspiring with other wholesalers.

28. Under an exclusive territory scheme, each distributor has the exclusive privilege of distributing the producer's output in a specific geographic market. Consequently, there is no competition at the distribution level. In *Albrecht*, the newspaper publisher awarded exclusive territories to each of his distributors. This made each distributor a monopolist in its assigned territory.

29. See, e.g., Machlup & Taber, *Bilateral Monopoly, Successive Monopoly, and Vertical Integration*, 27 *ECONOMICA* 101 (1960) (classic discussion of successive monopoly and other important related matters).

30. L. SULLIVAN, *HANDBOOK OF THE LAW OF ANTITRUST* 211 (1977).

31. If there is no artificial barrier to entry, monopoly profits will attract entry into that industry. As long as these profits provide a return on investment above the competitive rate, the incentive for outsiders to enter remains.

32. See F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 232-52 (2d ed. 1980) (overview of the limit pricing literature with pertinent references).

profits without attracting other firms into the market. Finally, and most importantly, Sullivan's conjecture appears to be void of empirical content. The Supreme Court cases discussed herein all involved a successive monopoly situation where an economic agent with some market power unilaterally and vertically imposed fixed prices. In Sullivan's example, the horizontal conspiracy among the four bakeries presents an antitrust problem independent of vertical price restrictions. Thus, Sullivan's model fails as inapplicable to vertical price fixing.

#### A SIMPLE MODEL OF DERIVED DEMAND

Many vertical restraints involve products that are not altered physically as they move through the distribution network. Where the seller performs merely a distribution function, a so-called fixed proportions relationship exists between the input and the output. For example, for every television set sold to a retail customer there must be one television set sold by the manufacturer to the distributor. An economic analysis of this situation with and without competitive distributors will be formulated.

#### *Competition Among Distributors*

Initially, it will be assumed that distributors operate in a competitive market while manufacturers enjoy some lawful horizontal market power due, for example, to a patent.<sup>33</sup> The manufacturer sells his product to an extensive network of competitive retail distributors that, in turn, sell the product to the final consumers. The retail distributors demand the product only to the extent that final consumers demand it from them. Consequently, the distributors' demand is derived from the consumer demand. This derived demand, as the demand function, dictates the optimal price and output decision of the manufacturer. Figure 1 illustrates a relatively simple model depicting this situation.

In Figure 1,  $D_R$  represents the retail customers' demand for the final product, which shows the usual inverse relationship between price and quantity.<sup>34</sup> This model assumes the distributor's per unit (or average) cost of performing the retail function remains constant regardless of the quantity sold. Where this is the case, the marginal (or incremental) cost also remains constant and equal to the average cost.<sup>35</sup> Constant marginal costs are consistent with free entry and exit at both the retail distribution level and the competitive input markets for the retail distribution industry as a whole. In Figure 1,  $MC_R$  represents the marginal cost of retailing.

The demand for the manufacturer's product by the retail distributors is derived from the retail consumers' demand for the product.<sup>36</sup> The retail de-

33. The source of this market power is really not important, but by attributing it to a patent, attention will not be deflected to irrelevant issues. In other words, the legality of the manufacturer's market power is assumed.

34. Generally, the quantity demanded of a product is inversely related to its price. Accordingly, as price rises, a smaller quantity of the product will be demanded.

35. To aid in reader comprehension, the incremental retailing cost is assumed to be constant.

36. For example, a retailer of television sets demands as many sets from his producer as

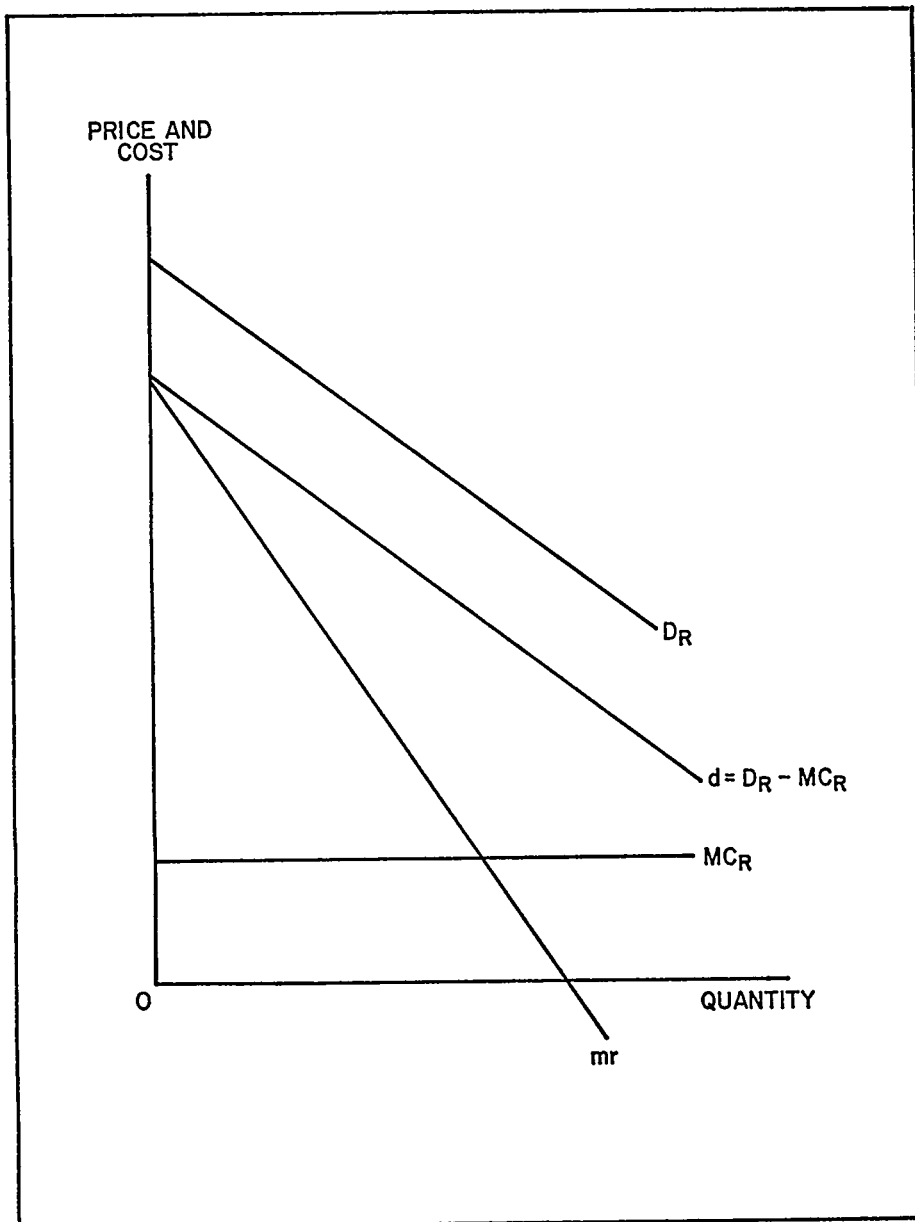


FIGURE 1

DERIVED DEMAND OF RETAIL DISTRIBUTORS FOR MANUFACTURER'S OUTPUT:  
COMPETITION IN RETAILING.

mand curve  $D_R$  shows the maximum price consumers will pay for the final good. Given the final demand  $D_R$  in Figure 1, the highest price consumers will pay minus the costs of performing the retailing function results in the max-

the retailer has customers demanding the television sets from him. Thus, the producer experiences a demand by his retailers which is derived from the demand of the retailer's customers.



imum figure that the retailers can profitably pay the manufacturer. Consequently, the retailers' maximum affordable price or derived demand is  $d$  where  $d = D_R - MC_R$ . The marginal revenue function associated with  $d$  is  $mr$ .<sup>37</sup>

The model assumes the manufacturer is interested in maximizing profits.<sup>38</sup> To accomplish this objective, the manufacturer selects an output such that his marginal production costs are equal to the marginal revenue associated with the derived demand. Figure 2 reproduces from Figure 1 the final demand  $D_R$ , the derived demand  $d$  with the associated marginal revenue  $mr$ , and the marginal cost of retailing  $MC_R$ . The manufacturer's marginal production cost ( $mc$ ) is added to the model and is assumed to be constant.<sup>39</sup> The manufacturer's optimal (i.e., profit maximizing) output results when marginal revenue equals marginal cost. In Figure 2, this is shown as  $Q_1$ , where  $mr$  intersects  $mc$ . This output will be sold at a price of  $P_1$  to the competitively organized distributors. Accordingly, the manufacturer earns a monopoly profit<sup>40</sup> on each unit of output equal to the difference between his per unit cost of production and the price:  $P_1 - mc$ . His total profit is  $P_1 - mc$  times the quantity sold  $Q_1$ .

Competition among the retail distributors will cause the price to the final customer to equal the price charged by the manufacturer plus the marginal cost of retailing. Because the vertical distance between the retail demand curve  $D_R$  and the derived demand  $d$  precisely equals the marginal cost of retailing  $MC_R$ , the final retail price shown in Figure 2 denoted by  $P_{R1}$  is a market clearing price for a quantity of  $Q_1$ .<sup>41</sup> The competitive retailers earn a competitive rate of return since their price  $P_{R1}$  just equals their costs:  $P_1$  plus  $MC_R$ .

Under the conditions specified (i.e., fixed proportions in production with competition at the distribution stage) the manufacturer extracts all the monopoly profit through the price and output decision regarding the intermediate product. That is, the final product price and quantity equal those that would

37. The relationship between demand and marginal revenue can be found in every standard treatment of microeconomics. Total sales revenue is the product of the quantity sold and the price of the product. Thus, total revenue is reflected by the product of the coordinates of the points on the demand curve. A marginal revenue function is associated with a total revenue function. Marginal revenue refers to the change in total sales revenue for a small change in the quantity sold. In other words, marginal revenue describes what happens to total revenue when the producer expands the quantity sold by a small amount. For linear demand curves, the marginal revenue function bisects the horizontal distance between the price axis and the demand curve. For a more extensive discussion, consult C. McCONNELL, *ECONOMICS: PRINCIPLES, PROBLEMS, AND POLICIES* 492-94 (7th ed. 1978).

38. Although this assumption has been challenged, most economic analysis proceeds on this assumption. Empirically, relying upon the assumption of profit maximization has not led to discordant results. For a brief survey of the literature and ample references, see F. SCHERER, *supra* note 32, at 29-41.

39. Constant marginal production costs can result from production in a single plant according to a linearly homogeneous production function which has been combined with competitive input markets. Alternatively, constant marginal production costs can result from multiplant production and competitive input markets.

40. The manufacturer is able to exploit his monopoly power to earn a higher than competitive profit, which is generally referred to as monopoly profit.

41. A market clearing price for a specific output level is the price on the demand curve that corresponds to the specific quantity. At that price, buyers will select precisely the quantity specified.

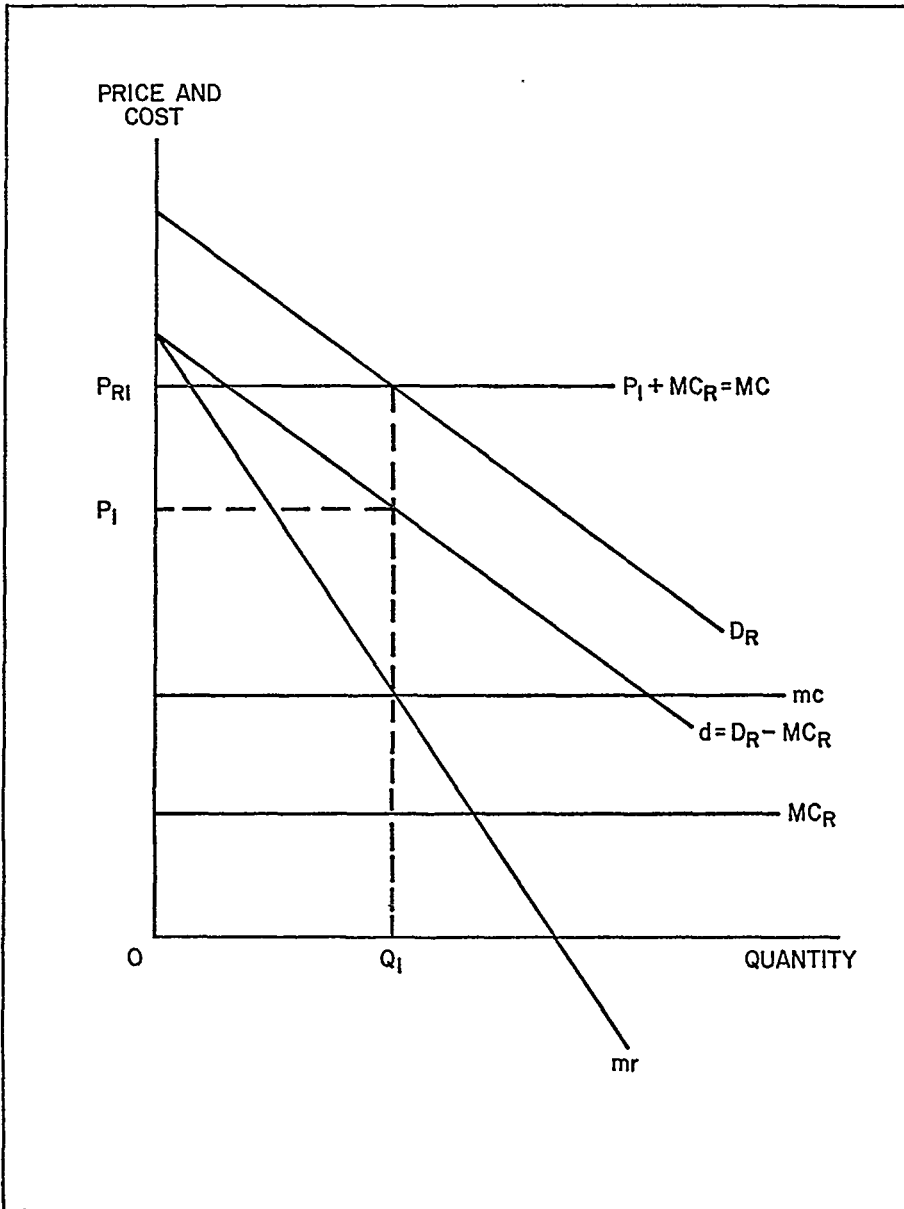


FIGURE 2

PROFIT MAXIMIZING PRICE AND OUTPUT FOR THE MANUFACTURER.

result from a vertically integrated monopoly that controlled both the manufacture and distribution.<sup>42</sup> Consequently, the manufacturer has no need for vertical control. This, however, is not always the case. For various reasons, there is often an absence of competition among distributors, creating an incentive for vertical control of some aspect of the distribution system.

42. See Machlup & Taber, *supra* note 29; Spengler, *Vertical Integration and Antitrust Policy*, 58 J. POL. ECON. 347 (1950).

*No Competition Among Distributors*

For many products, franchisees possessing some local monopoly power conduct retail distribution. In some instances, the manufacturer assigns exclusive territories to the franchisees. A classic example of this involves the distribution of newspapers.<sup>43</sup> In other cases, exclusivity is not guaranteed, but the cost structure of the franchisee's business indicates that excessive intra-brand competition among distributors would lead to failures. Therefore, the manufacturer spaces the franchisees in such a way that each one can be a viable business entity. The distribution of automobiles is an example of this.<sup>44</sup> Because financial success necessitates a substantial sales volume, a local market must be larger than a critical size or it will not support more than one dealer.<sup>45</sup> Unfortunately, this local monopoly power invites each distributor to maximize its profit by restricting output below the level that the manufacturer finds optimal.

Suppose for example, the manufacturer sells his output to final consumers through a nation-wide system of distributors. Due to the nature of the distribution function, the manufacturer establishes only one distributor in each geographic sub-market.  $D_R$  represents the retail demand for the product in Figure 3 along with the associated marginal revenue  $MR_R$ .  $MC_R$  denotes the marginal cost of retailing. If the retail distribution were competitively organized, the curve labelled  $D_R - MC_R$  would be the derived demand. The curve marginal to  $D_R - MC_R$  is labelled  $d$ , which equals  $MR_R - MC_R$ .

Since the retail distributor is a local monopolist, he will maximize profits by equating his marginal revenue with his marginal cost.<sup>46</sup> The curve labelled  $d = MR_R - MC_R$  is marginal revenue minus the marginal cost of retailing. For the distributor, marginal cost results from adding the sum of the price charged by the manufacturer to the marginal cost of retailing. Thus, the distributor selects his profit maximizing output by equating the price he has to pay to the manufacturer with the net marginal revenue  $MR_R - MC_R$ . Consequently, when the distributor has a local monopoly, the derived demand for the sub-market is  $d$ .

The manufacturer exploits his monopoly power by selecting his price and output where marginal cost equals marginal revenue. Figure 4 reproduces the curves from Figure 3, but adds the curve marginal to  $d$ , labelled  $mr$ . In addition, the diagram includes the manufacturer's marginal production cost  $mc$ . The manufacturer produces  $Q_2$  units of output for this market and charges  $P_1$  per unit. This price and output generates profit for the manufacturer of  $P_1 - mc$  per unit. Thus, his total profit is  $P_1 - mc$  times  $Q_2$  units of output.

The distributor's marginal cost ( $MC$ ) equals the price he pays to the manufacturer ( $P_1$ ) plus the marginal cost of retailing ( $MC_R$ ). The distributor max-

43. See notes 19-29 and accompanying text, *supra*. (Albrecht discussion).

44. See generally B. PASHIGIAN, THE DISTRIBUTION OF AUTOMOBILES: AN ECONOMIC ANALYSIS OF THE FRANCHISE SYSTEM (1961).

45. For example, it is not in the interest of General Motors to have so many competing dealers that each is on the brink of financial ruin.

46. In other words, the profit maximizing quantity is found at the intersection of marginal revenue and marginal cost.

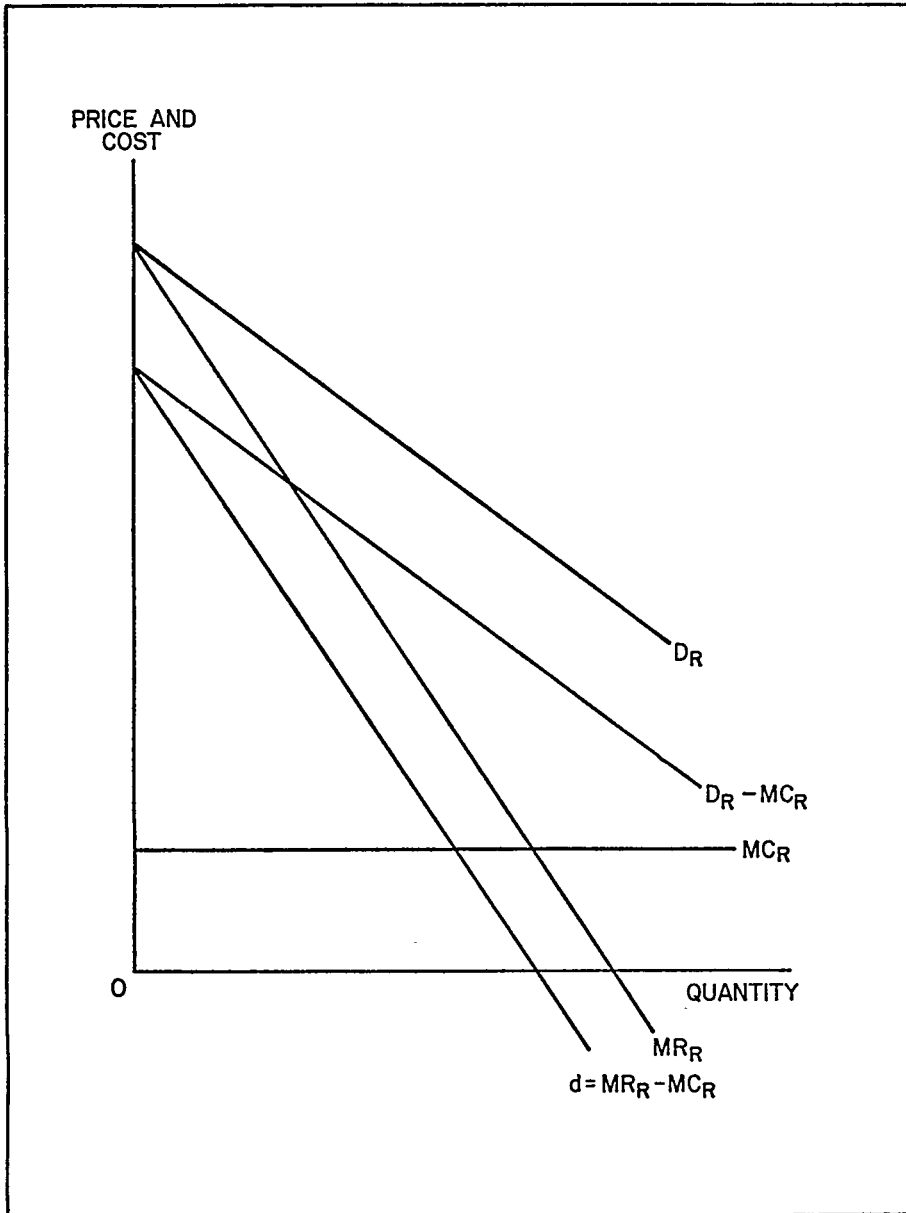


FIGURE 3

DERIVED DEMAND OF RETAIL DISTRIBUTION FOR MANUFACTURED OUTPUT:  
LOCAL MONOPOLY IN RETAILING.

imizes his profit by equating this marginal cost ( $P_1 + MC_R$ ) to his marginal revenue ( $MR_R$ ). Consequently, the distributor sells  $Q_2$  units of output to retail customers at a retail price of  $P_2$ . By earning excess profits of  $P_2 - MC$  per unit of output times the number of units sold the distributor benefits from his status as a local monopolist.

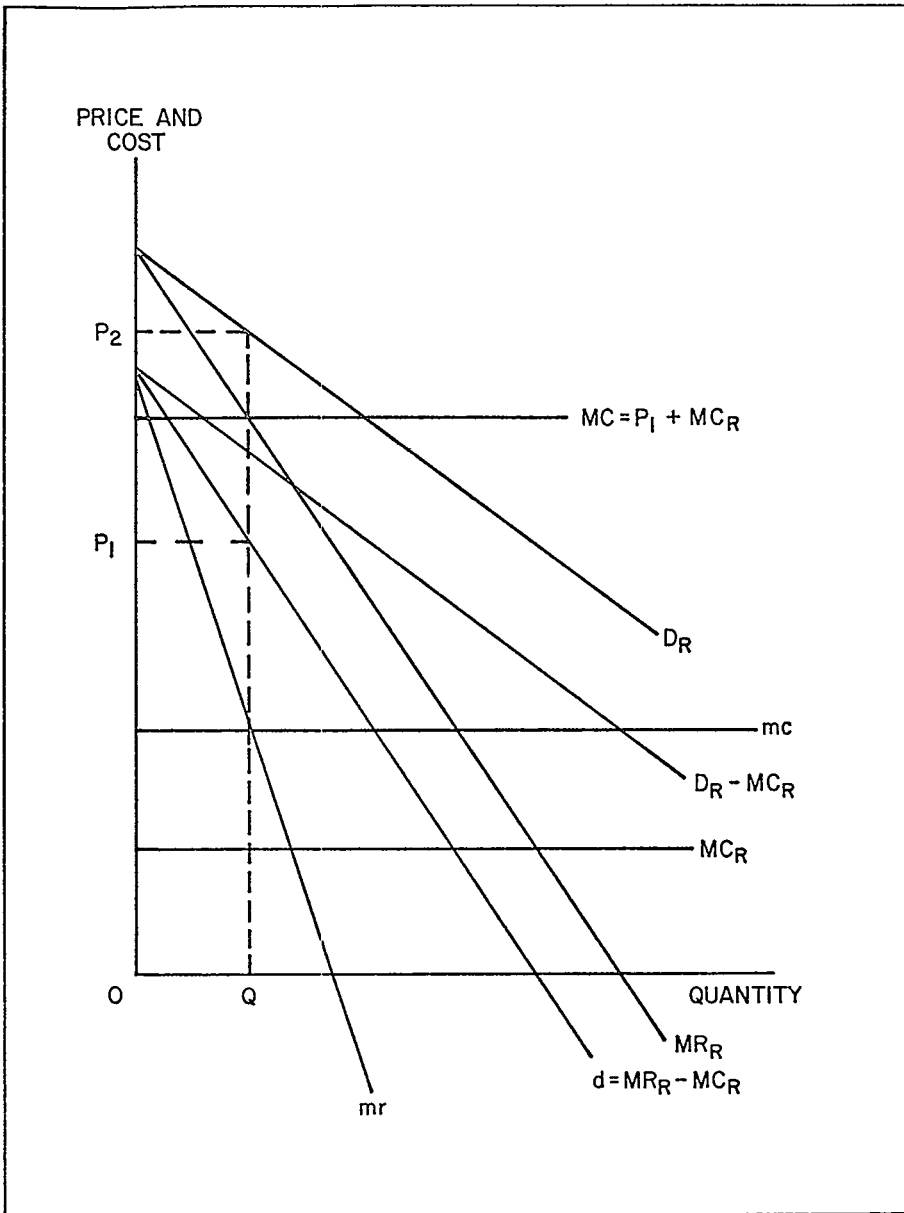


FIGURE 4  
PROFIT MAXIMIZATION: SUCCESSIVE MONOPOLY.

*A Comparison Of Industry Profits*

A comparison of two situations demonstrates the adverse effects of successive monopoly on the manufacturer's profits. First, the results developed above will be compared with the graphical models. This will be followed with an examination of a numerical example. Figure 5 combines the results of Figures 2 and

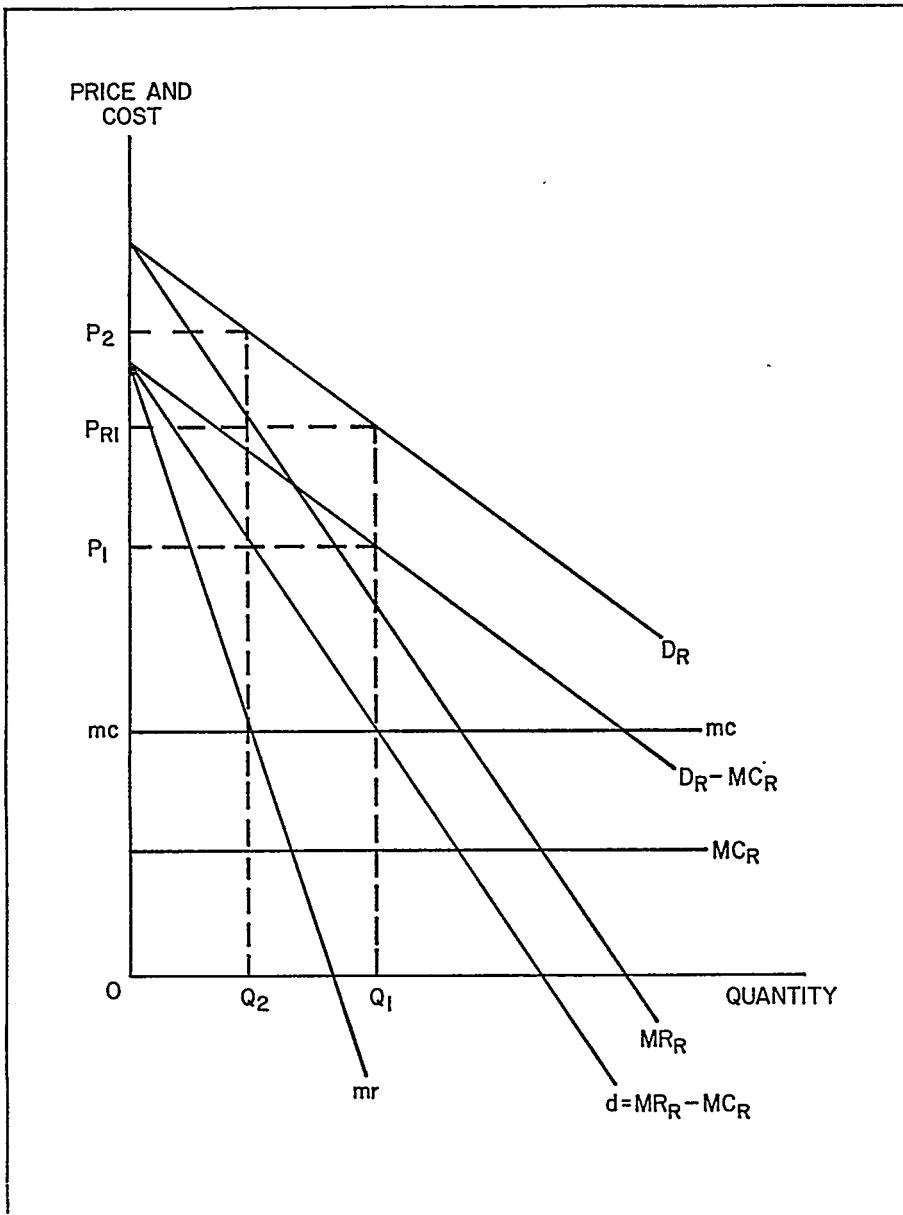


FIGURE 5

COMPARISON OF PRICE AND OUTPUT FOR TWO CASES.

4. It is evident that the successive monopoly at the production and distribution stages reduces output from  $Q_1$  to  $Q_2$  and raises the price to the consumer from  $P_{R1}$  to  $P_2$ . The manufacturer's excess profits are reduced from  $P_1 - mc$  times  $Q_1$  to  $P_1 - mc$  times  $Q_2$ . At the same time, the excess profits at the distribution stage go from zero to  $P_2 - MC$  times  $Q_2$ . It can be numerically shown that total profits of the manufacturer and of the distributor are lower with a successive

monopoly than with a monopoly of manufacturing and competitive distribution.<sup>47</sup>

*A Numerical Example.* A numerical example of how this process operates helps to make these results more tangible. Suppose that the retail demand function is given by

$$P_R = \$100 - 2Q,$$

the marginal cost of retailing is

$$MC_R = \$10,$$

and the marginal cost of production is

$$mc = \$50.$$

When retailing is competitive, the derived demand facing the manufacturer is

$$P = P_R - MC_R,$$

or

$$P = \$90 - 2Q.$$

For the manufacturer, the marginal revenue function is

$$mr = \$90 - 4Q.$$

Given the marginal cost of production (MC) of \$50, equating marginal cost and marginal revenue yields the optimal output of ten units. Substituting this quantity into the derived demand obtains the manufacturer's optimal price to the retailer: \$70. Substituting this quantity into the retail demand function produces a price to the retail customer of \$80. Notice that the retail price exactly equals the manufacturer's price plus the per unit cost of retailing. Consequently, the retailer earns no profit. The manufacturer earns a profit of  $\$70(10) - 50(10) = \$200$ . Table 1 summarizes these results.

This can be contrasted to the successive monopoly case. Recall that the derived demand in this case equals the marginal revenue of the preceding case. Thus, the derived demand is now

$$P = 90 - 4Q$$

and the corresponding marginal revenue curve is

$$mr = 90 - 8Q.$$

The retail demand, the marginal cost of retailing, and the marginal production cost are all assumed to remain constant. Equating marginal production cost with the new marginal revenue yields the optimum output of five units. Substitution into the derived demand reveals that the manufacturer will continue to charge the retailer \$70 per unit. Substitution into the final demand function shows that the smaller output now sells at retail for \$90 per unit.

The retailer's total revenue is \$450 while his total costs are only \$400. Thus, the retailer now earns a positive profit of \$50, but the manufacturer's profits fall. His revenue is \$350 while his costs are \$250. Accordingly, his profits are reduced to \$100. Note that total industry sales fell from 10 units to 5 units and the price to the consumer rose from \$80 to \$90. Total industry profit fell from \$200 to \$150 and the manufacturer and retailer share the smaller amount. In this case, the manufacturer's quest for higher profits coincides with the consumer interest in lower prices.

---

47. Simply by looking at the areas in the graph this result is obvious but it is also general for all situations where demand is linear and cost is constant. A mathematical proof is available from the authors upon request.

TABLE 1  
COMPARISON OF COMPETITIVE AND MONOPOLISTIC  
RETAILING

	Competitive Retailing	Successive Monopoly
Retail demand ( $D_R$ )	$P_R = 100 - 2Q$	$P_R = 100 - 2Q$
Marginal cost of retailing ( $MC_R$ )	$MC_R = \$10$	$MC_R = \$10$
Marginal cost of production (mc)	$mc = \$50$	$mc = \$50$
Derived demand (d)	$P = P_R - MC_R$ $= 90 - 2Q$	$P = 90 - 4Q$
Marginal revenue (mr)	$mr = 90 - 4Q$	$mr = 90 - 8Q$
Optimal output	$Q = 10$	$Q = 5$
Price to retailer (P)	$P = \$70$	$P = \$70$
Price to consumer ( $P_R$ )	$P_R = \$80$	$P_R = \$90$
Profit:		
to retailer	- 0 -	\$ 50
to manufacturer	\$200	\$100

#### THE ROLE OF MAXIMUM RESALE PRICES

It should be fairly obvious that the manufacturer will oppose a profit reduction below his maximum level. He may respond to this by establishing maximum resale prices. If the manufacturer establishes a maximum resale price of  $P_{R1}$ , the distributor's marginal revenue curve coincides with  $P_{R1}$  for all outputs between zero and  $Q_1$ . This prevents the distributor from restricting output below  $Q_1$  because the distributor's marginal cost will equal his marginal revenue at  $Q_1$  units of output. Unfortunately, as exhibited earlier, current judicial precedent unwisely prohibits the setting of maximum resale prices.

Fixing maximum resale prices restores the price and quantity that would result from competition at the distribution stage, therefore resulting in lower prices and greater consumption for the retail customer. Thus, an antitrust policy prohibiting maximum resale prices harms the consumer.<sup>48</sup> Furthermore, it protects the franchisee, whose interest in excess profits is not a legitimate concern of the antitrust laws.<sup>49</sup> Such a policy thwarts the manufacturer's efforts to combat the successive restriction of output which inexorably follows the successive monopoly market structure. As a result, prevailing antitrust law has the perverse effect of diminishing consumer welfare rather than promoting it.<sup>50</sup>

48. For a persuasive argument that consumer welfare is the *sole* legitimate goal of the antitrust laws, see R. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 50-89 (1978). *Contra*, Sullivan, *Economics and More Humanistic Disciplines: What are the Sources of Wisdom for Antitrust?*, 125 U. PA. L. REV. 1214 (1977).

49. See notes 95-103 and accompanying text, *infra* for an argument that consumer welfare is the only legitimate concern of the antitrust laws.

50. Consumer welfare is clearly diminished when prices rise because fewer products are



At this point, it is appropriate to recognize that maximum resale prices are usually not contrary to the expectations of the distributor. In the *Albrecht* case, for example, the franchise agreement provided that each distributor could charge no more than the price that the publisher advertised for home delivery.<sup>51</sup> Consequently, the distributor could not legitimately claim to have made an investment based upon the belief that he would be free to set prices as he saw fit. Thus, no serious question of fairness to the distributor requires resolution.

In *Kiefer-Stewart*, the wholesaler was not really a franchisee.<sup>52</sup> Nonetheless, both Seagram and Calvert instituted their maximum resale price policy after Kiefer-Stewart began distributing their products. In this instance, however, Seagram and Calvert responded to collusion at the wholesaling stage, which changed the market structure to one of successive monopoly. In other words, the wholesaler's collusion created a monopoly upon price and output.

In principle, the simple model developed above applies to the more complex case of multiple products. For example, many retail food franchises distribute multiple products.<sup>53</sup> The success of these operations depends in part upon maintaining fairly uniform quality standards among franchisees and maintaining relative prices *vis-a-vis* competitive products. Because neither the franchisors nor the franchisees benefit from any weakening in consumer confidence caused by disparate prices,<sup>54</sup> the franchisors have an interest in the prices charged by each franchisee. This interest springs from two sources: first, the successive monopoly problem discussed above, and second, the potential spillover effect one franchisee's pricing behavior has on the sales of other franchisees. For example, it is financially important to all Burger King franchisees that a consumer's expectations are fulfilled when visiting any Burger King restaurant. If one franchisee disappoints such expectations, the effect of this franchisee's actions carries over to other franchisees. Because the franchisor loses profit as a consequence, he has a continuing interest in the behavior of his franchisees.

#### RELEVANCE OF INDEPENDENT BUSINESSMAN ARGUMENT

The traditional concern with vertical price fixing involves the independence of the downstream businessman. For example, Professor Sullivan argues that the per se illegality of maximum price fixing is consistent with a social interest in protecting every opportunity a small firm has for independent decision making.<sup>55</sup> This policy is based upon the assumption that the efficient allocation of resources attributed to the competitive market can only be achieved if the

---

consumed. The *Albrecht* rule prohibits a manufacturer from preventing its distributors from raising prices thereby reducing quantity.

51. 390 U.S. at 147.

52. 340 U.S. 211.

53. For example, McDonald's, Burger King and Kentucky Fried Chicken distribute multiple products.

54. For example, a Burger King customer has an idea of what quality sandwich he will receive when he orders a Whopper. He also has an idea of the approximate price. Just as extreme quality variation can upset consumer acceptance, so can unusual price variation.

55. L. SULLIVAN, *supra* note 30, at 210-12.

independence of each economic agent is guaranteed. In particular, Sullivan argues that if demand for a product increases, independent businessmen should be able to raise the price of that product.<sup>56</sup> When price is free to respond to an increased demand, the higher price and greater profits for existing firms will invite outsiders to invest in that industry. As a result, resources will flow into the industry.

While Professor Sullivan's intentions are admirable, his analysis is premised upon the existence of a competitively structured environment. In *Albrecht*, however, each distributor had an exclusive territory, making it impossible for outsiders to invest resources in distribution.<sup>57</sup> In this environment, preserving the franchisee's independence permits him to raise prices with impunity. On the other hand, permitting the franchisor to set maximum prices provides the same check on pricing excesses that a competitive market structure normally provides. An examination of the structure of a particular industry invariably reveals that the fixing of maximum resale prices occurs in response to successive monopoly and its exploitation.<sup>58</sup> Consequently, Professor Sullivan's policy proscriptions are inapplicable to maximum price fixing situations.<sup>59</sup>

A recent Supreme Court decision, *Continental T.V., Inc. v. GTE Sylvania, Inc.*,<sup>60</sup> provides some insight into the Court's current attitude toward the policy of business independence. In *Sylvania*, the legality of location clauses in vertical distribution agreements was at issue. Sylvania had adopted a selective distribution policy with "elbow room" for distributors provided they sold only from approved locations. After a disagreement concerning the distribution policy,<sup>61</sup> Sylvania terminated Continental as a dealer. Continental brought suit claiming that Sylvania's location restriction constituted an unlawful restraint of trade in violation of section 1 of the Sherman Act. The Court, however, rejected the belief that the Sherman Act purports "to prohibit restrictions on the autonomy of independent businessmen" without analyzing the impact of such restrictions.<sup>62</sup> Consequently, the Court retreated from a non-economic view of cases involving non-price restrictions. Nevertheless, it is apparent that the scope of this retreat does not include economic analysis of vertical price restrictions.<sup>63</sup>

In *Kiefer-Stewart*<sup>64</sup> and *Albrecht*,<sup>65</sup> the Court expressly endorsed the fran-

56. *Id.* at 212.

57. 390 U.S. at 145. See notes 19-23 and accompanying text, *supra*.

58. The economic logic examined in this article compels this result.

59. His concern, however, is well founded for horizontal price fixing cases.

60. 433 U.S. 36 (1977). For a thorough analysis of *Sylvania* and its impact on antitrust law, see generally Pitofsky, *The Sylvania Case: Antitrust Analysis of Non-Price Vertical Restrictions*, 78 COLUM. L. REV. 1 (1978). See also Dunfee, Stern & Zelek, *A Rule of Reason Decision Model After Sylvania*, 68 CAL. L. REV. 13 (1980).

61. *Id.* at 39-40. Continental did not want to respect Sylvania's location clause. When Continental changed locations over Sylvania's objection, Sylvania terminated Continental.

62. *Id.* at 53 n.21.

63. *Id.* at 51 n.18. "As in *Schwinn*, we are concerned here only with nonprice vertical restrictions. The *per se* illegality of price restrictions has been established firmly for many years and involves significantly different questions of analysis and policy. . . ." *Id.*

64. 340 U.S. at 213.

65. 390 U.S. at 152-53.

chisee's decision making autonomy respecting the price that he charged. This pricing freedom, however, results in reduced output and higher retail prices. Therefore, it is evident that judicial concern for the welfare of franchisees contravenes the paramount concern of consumer welfare. Because the actual effect of the independent businessman argument is contrary to the promotion of consumer welfare, the argument must be deemed irrelevant on philosophical grounds.<sup>66</sup> Furthermore, the existence of an alternative to the setting of maximum prices makes the argument irrelevant on more pragmatic grounds. Although more cumbersome than price fixing, the manufacturer can obtain the same result through the use of sales quotas. The examination of any simple demand diagram reveals that at any specified price a unique quantity clears the market.<sup>67</sup> Similarly, at any specified quantity, only one price will clear the market. This simple observation can be extended to the earlier analysis.

Figure 5 shows that to achieve maximum profits, the manufacturer needs an output of  $Q_1$ . Rather than limit the resale price to  $P_{R1}$ , he can simply require the franchisee to sell a specified quantity. By establishing the performance standard at an output of  $Q_1$ , the manufacturer achieves his desired result. Thus, while the performance standard affords the franchisee complete pricing discretion, he can meet this standard only by charging a price of  $P_{R1}$  (or lower). Consequently, his pricing discretion is mostly illusory. Therefore, the view that merely forbidding maximum resale price fixing preserves a franchisee's independent business judgment is nothing more than a fiction which should be dispensed with.<sup>68</sup>

It is arguable that because both approaches achieve the same result, it is irrelevant that one is forbidden. Although this economic equivalence may appear to obviate the need to abolish the rule against maximum price setting, performance standards encounter difficulties in enforcement which detract from its usefulness. Whenever a franchisee/franchisor dispute arises, it appears as a David and Goliath confrontation. Society's natural sympathies flow to the franchisee. In the automobile industry, for example, this apparent imbalance of power resulted in protective legislation for the franchisee.<sup>69</sup> Similarly, gasoline retailers are protected by statutes specifying the conditions necessary

---

66. This follows because the philosophy of antitrust law is the promotion of consumer welfare. See, e.g., *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 497-98 (1939).

67. See notes 41-42 and accompanying text, *supra*.

68. In franchise situations, the franchisor has an obligation to guarantee certain product standards. If he fails this obligation, the trademark protection may be lost. No one has seriously objected to a franchisor's imposition of quality standards. However, quality deterioration is an alternative means of raising price. For example, if a quarter-pounder with cheese is supposed to sell for \$1.00 but the franchisee wants to charge \$1.40, the franchisee could cut the size of a quarter-pounder to three ounces and hold the price at \$1.00. The effect would be the same in both instances. Franchisors are permitted to control this aspect of the price and product. In a newspaper setting, the publisher can insist that the papers be delivered no later than a certain time. Thus, quality deterioration can be prevented. It is clear that important business decisions are not left to independent businessmen. Consequently, one can hardly point to a consistent policy position regarding the desirability of independence.

69. Automobile dealers are protected by the Dealer's Day in Court Act. 15 U.S.C. §§1221-1225 (1976).

for dealer termination.<sup>70</sup> Therefore, performance standards furnish an inadequate alternative to maximum price fixing.

#### INCENTIVE FOR VERTICAL INTEGRATION

Prior analysis has revealed that through optimal pricing the upstream firm can extract all the monopoly profit inherent in the market, provided, however, downstream sales are made at a price equal to marginal and average cost. If this does not occur at the downstream stage, the altered prices reduce the upstream firm's profits. This can be seen clearly in Figure 5. With competitive pricing at the downstream stage, the upstream monopolist's profits are  $(P_1 - mc)Q_1$ . In contrast, where a successive monopoly exists the upstream monopolist's profits are only  $(P_1 - mc)Q_2$ , a great deal smaller.<sup>71</sup> This offers the upstream firm an obvious incentive to vertically integrate forward, that is, perform the distributor's function himself.<sup>72</sup>

The manufacturer, by performing the distribution function, can ensure the distribution stage price equals his optimal price plus the average cost of distribution. Thus, vertical ownership integration provides the same profit that the upstream monopolist would obtain either from fixing maximum resale prices or from setting performance standards for a downstream monopolist.<sup>73</sup> In all three cases, the final price-output configuration is of greater public benefit than that provided by unbridled successive monopoly. Therefore, economically equivalent business practices should receive equivalent antitrust treatment.

In order to minimize the antitrust problems, a manufacturer should begin operations by performing both the manufacturing and distribution functions. Due to capital requirements, however, ownership integration may not be feasible at the firm's inception. Although vertical integration by contract is an alternative,<sup>74</sup> judicial decisions prohibit one key contractual stipulation: the setting of maximum resale prices.<sup>75</sup> Unable to set maximum resale prices, the

70. Gasoline retailers are protected by the Petroleum Marketing Practices Act. 15 U.S.C. §2801 (1976).

71. See generally Machlup & Taber, *supra* note 29.

72. Given the linear demand curves and constant marginal and average cost, it can be shown that  $Q_2$  is precisely one-half of  $Q_1$ . Consequently, successive monopoly halves the upstream firm's profits. This result follows from the geometric relationship between the curves labelled *d* and *mr*. A proof is available from the authors upon request.

73. A supplier has an incentive to impose vertical control through fixing maximum resale prices whenever a successive monopoly situation exists. If antitrust law forecloses this option, the firm may proceed with ownership integration. We should inquire whether this is the intent of public policy. When certain vertical controls were condemned by the Supreme Court in *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), Schwinn replaced some of its franchised distributors with owned outlets. The economic result turned out the same. Thus, we should wonder about the sensibility of an unnecessary reorganization of their distribution system.

74. Blair & Kasserman, *Vertical Control with Variable Proportions: Ownership Integration and Contractual Equivalents*, 46 S. ECON. J. 1118 (1980) (establishes the economic equivalence of several contractual alternatives to ownership integration).

75. See notes 15-24 and accompanying text, *supra*.

manufacturer may turn to performance standards. This strategy provides similar results and is reasonably safe from antitrust challenge.

Performance standards may produce other problems. One of the difficulties encountered in setting performance standards occurs where the standards are set subsequent to the original franchise agreement. For example, a firm may plan to specify maximum resale prices. Later, after realizing the illegality of this practice, the firm will impose economically equivalent performance standards. This, however, poses difficulty because such a change in the business relationship could easily appear inequitable. Undoubtedly, the downstream firms would resist the imposition of performance standards which operate to reduce their profits. As a result, the manufacturer may decide to integrate forward by engaging in dual distribution.<sup>76</sup> Dual distribution, because it has attracted the attention of the antitrust authorities,<sup>77</sup> may present hazards for the franchisor. The *Sylvania* court recognized the logic of this analysis as it pertains to non-price vertical restrictions:

We also note that *per se* rules in this area may work to the ultimate detriment of the small businessmen who operate as franchisees. To the extent that a *per se* rule prevents a firm from using the franchise system to achieve efficiencies that it perceives as important to its successful operation, the rule creates an incentive for vertical integration into the distribution system, thereby eliminating to that extent the role of independent businessmen.<sup>78</sup>

It is not clear why the Court persists in maintaining the *Albrecht* rule,<sup>79</sup> which, in encouraging vertical integration, produces the exact result the Court anticipated in *Sylvania*.

Total vertical integration is also hazardous since the upstream monopolist must refuse to deal with his former distributors.<sup>80</sup> Because vertical integration is legal, any refusal to deal incident to vertical integration should also be legal.<sup>81</sup> This, however, does not appear to be consistent with the case law.

The Supreme Court first considered the refusal to deal issue in *United States v. Colgate & Co.*<sup>82</sup> In that case, Colgate required its distributors to resell Colgate products at specified prices. Colgate refused to deal with a distributor who persistently altered his prices. The Supreme Court stated explicitly that in the absence of a monopoly purpose, the Sherman Antitrust Act allows a private business to choose freely with whom it will deal.<sup>83</sup> Unfortu-

76. Dual distribution occurs when a manufacturer distributes his product through both independent distributors and his own distribution centers.

77. See Regulators, *Justice Takes Aim at Dual Distribution*, BUS. WEEK July 7, 1980, at 24. Under the leadership of Sanford M. Litvack, the Antitrust Division of the Department of Justice was prepared to prosecute criminal cases which involve dual distribution. *Id.* Consequently, dual distribution should not be undertaken lightly.

78. 433 U.S. at 54 n.26.

79. See notes 19-24 and accompanying text, *supra*.

80. This follows because the output which maximizes profit does not change.

81. For a more general discussion of these matters see 3 P. AREEDA & D. TURNER, *supra* note 14, ¶728.

82. 250 U.S. 300 (1919).

83. "In the absence of any purpose to create or maintain a monopoly, the [Sherman Anti-

nately, the *Colgate* decision may apply to an upstream monopolist attempting to engage in total vertical integration because such a firm refuses to sell to former distributors,<sup>84</sup> and intends to create a monopoly at the downstream stage.<sup>85</sup>

*Photovest Corp. v. Fotomat Corp.*,<sup>86</sup> demonstrates the generality of the successive monopoly problem. In 1967, Fotomat obtained the rights to a drive-through kiosk film processing and retailing concept. Thus, Fotomat maintained a monopoly for a rather narrowly defined product.<sup>87</sup> In 1968, Fotomat granted a "block" franchise to Photovest covering the entire Indianapolis metropolitan area. Consequently, Photovest was a local monopolist within the assigned territory. Fotomat then collected its monopoly profit from Photovest through a tying arrangement.<sup>88</sup> The franchise agreement permitted Photovest to buy its processing from outside franchisor-approved sources. When Photovest took advantage of this option, however, Fotomat began to operate directly in the Indianapolis market. Photovest then brought suit alleging that Fotomat was in violation of section 2 of the Sherman Act for attempting to monopolize the area photo processing drive-through market.<sup>89</sup>

To this point, the situation can be summarized. Fotomat, the franchisor, wanted to exploit its monopoly power through a tying arrangement. Photovest, the franchisee, exploited its local monopoly power through product pricing. According to the earlier analysis, this exemplifies a successive monopoly.

If Fotomat was successful in supplanting Photovest and performing the retail function itself, one layer of monopolistic restriction would be removed. Consequently, retail prices should fall and output expand, a result clearly in the consumer's interest. Interestingly, the result is no different when Photovest wins.

Photovest has local monopoly power but its costs are high because Fotomat is extracting monopoly profit through its processing charge. However, since Fotomat cannot compel Photovest to buy its processing, Photovest should buy competitively priced processing thereby removing one layer of monopoly

trust Act] does not restrict the long-recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal." *Id.* at 307.

84. Areeda and Turner reach a similar conclusion in their review of price and supply squeeze cases. None of the other cases reviewed changes this conclusion. 3 P. AREEDA & D. TURNER, *supra* note 14, at 235.

85. Since the purpose is to create a monopoly, the proviso in the *Colgate* rule does not apply. See note 83 *supra*.

86. 606 F.2d 704 (7th Cir. 1979), *cert. denied*, 445 U.S. 917 (1980).

87. The Seventh Circuit's analysis of the relevant market followed the traditional *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962), indicia of submarkets. It found that the drive-thru retail photo processing business constituted a relevant sub-market. 606 F.2d at 713-14.

88. In Blair & Kasserman, *Vertical Integration, Tying, and Antitrust Policy*, 68 AM. ECON. REV. 397, 397-400 (1978), the writers demonstrated that tying arrangements and vertical integration are economically equivalent ways for an upstream monopolist to extract all of the monopoly profit that is available.

89. Photovest's allegation of a §2 violation of the Sherman Antitrust Act was vindicated by the Seventh Circuit. 606 F.2d at 721.

power. This, again, results in lower retail prices and higher output. Either result — ownership integration by Fotomat or competitive input prices for Photovest — leads to the same retail price and output configuration because a unique price and output combination exists which maximizes profit in the Indianapolis market. Consequently, there is no need to explicitly consider consumer welfare because either result removes a layer of monopoly power.<sup>90</sup>

Both Supreme Court and lower court decisions suggest problems in vertically integrating to avoid existing franchisee problems.<sup>91</sup> Consequently, the firm that cannot start out as a vertically integrated entity may encounter serious stumbling blocks to subsequent achievement of the desired firm structure.

#### POLICY IMPLICATIONS

Both Justices Stewart and Harlan, writing separate dissents in *Albrecht*, explained the economic effect of fixing maximum resale prices.<sup>92</sup> Nevertheless, the Court insisted upon a mechanical application of the *per se* rule against price fixing even though maximum price fixing invariably occurs in successive monopoly situations.<sup>93</sup> Application of the *Albrecht* rule to this particular market structure results in a pyramiding of monopolistic output restrictions in the vertical distribution chain, which, in turn, causes declining output and raises consumer prices. Assuming that consumer welfare is the paramount concern of antitrust laws, *Albrecht*, as Stewart noted, clearly “stands the Sherman Act on its head.”<sup>94</sup> Therefore, the Supreme Court should, at the earliest opportunity, reconsider *Albrecht*.

Considerable scholarly research supports the assertion that consumer welfare is of paramount concern in antitrust legislation despite some Supreme

90. The astute reader will recognize a bit of hyperbole here. If Fotomat won, there would be monopoly at the retail level. Since Photovest won, Fotomat can engage in dual distribution and compete with Photovest at the retail level. Under some conditions this could lead to an erosion of Fotomat's monopoly power. This, however, deflects our attention from the central point regarding successive monopoly.

91. See notes 86-90 and accompanying text, *supra*. In *Speed Auto Sales, Inc. v. American Motors Corp.*, 477 F. Supp. 1193 (E.D.N.Y. 1979), American Motors began competing with one of its franchisees. The franchisee alleged a §2 Sherman Act violation. *Id.* at 1196-98. The district court dismissed the case observing that a manufacturer is entitled to change his franchising policies without violating the antitrust laws. *Id.* In *Byars v. Bluff City News Co.*, 609 F.2d 843 (6th Cir. 1979), however, the court remanded a similar case for explicit consideration of Bluff City's reasons for refusing to deal with Byars. *Id.* at 864. By merely changing its franchising policy, Bluff City found itself facing antitrust charges. Thus, the implications for upstream firms are not perfectly clear.

92. 390 U.S. at 156. Justice Harlan distinguished price floors from price ceilings. Price floors were considered invariably harmful because they lessened competition, therefore mandating the *per se* rules application. On the other hand, price ceilings should not be afforded “*per se*” treatment because they did not tend to lessen competition. *Id.* at 158-59 (Harlan, J., dissenting). Justice Stewart maintained that the maximum price rule actually furthered the purpose of antitrust law, because it protected homeowners from Petitioner's territorial monopoly. *Id.* at 168 (Stewart, J., dissenting).

93. *Id.* at 151-52.

94. *Id.* at 170.

Court language to the contrary.<sup>95</sup> Thorelli, for one, has produced an impressive history of the Sherman Act.<sup>96</sup> He offers extensive quotes from Senator Sherman's defense of his bill showing clearly Sherman's deep concern for the consumer.<sup>97</sup> Thorelli's review of the legislative history led him to conclude that Congress advocated more competition. Moreover, "[t]here can be no doubt that the Congress felt that the ultimate beneficiary in this whole process was the consumer. . . ."<sup>98</sup>

Letwin, an astute economic historian, notes that one of the various trust abuses which led to passage of the Sherman Act<sup>99</sup> was consumer victimization caused by high prices. Finally, Bork has analyzed the purpose of the antitrust laws from two perspectives.<sup>100</sup> The first perspective is the declared legislative intent, which, according to Bork's analysis of the legislative history, clearly indicates that Congress' exclusive purpose was the promotion of consumer welfare.<sup>101</sup> Furthermore, the courts were not to balance consumer welfare against social values.<sup>102</sup> The second perspective is the legislative intent which can be inferred from a structural analysis of the statute. This, too, reveals an overriding concern for consumer welfare.<sup>103</sup> The work of Thorelli, Letwin, and Bork is compelling: the antitrust laws originally purported to protect and promote consumer welfare. The *Albrecht* rule clearly does not do so.

#### CONCLUSION

The lingering distinction between vertical price and nonprice restrictions makes little sense. As Bork pointed out, "vertical restraints are, in economic terms, all of a piece. They should be either all illegal *per se* or all unqualifiedly lawful."<sup>104</sup> When the Court upholds one vertical restraint while condemning its economic equivalent, it is forced into a kind of logical inconsistency. Nonetheless, the rule of reason treatment advocated in *Sylvania* for non-price vertical

95. For example, in *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962), the Court decided that Congress was willing to sacrifice efficiency as evidenced by higher costs and prices in order to preserve "small, locally owned businesses." One distinguished commentator, however, has pointed out that there is "no credible support for the statement in *Brown Shoe* that Congress appreciated the possible efficiency cost of attempting to preserve fragmented industries and consciously resolved the competing considerations in favor of decentralization." Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1326 (1965).

96. H. THORELLI, *THE FEDERAL ANTITRUST POLICY* 164-234 (1955).

97. *Id.* at 180-85.

98. *Id.* at 227. Thorelli goes on to point out that the *immediate*, as opposed to *ultimate*, beneficiary was probably the small businessman. *Id.*

99. Letwin, *Congress and the Sherman Antitrust Law: 1877-1890*, 23 U. CHI. L. REV. 221, 235 (1956).

100. R. BORK, *supra* note 48, at 50-71. A more detailed treatment is provided in Bork, *Legislative Intent and the Policy of the Sherman Act*, 9 J.L. ECON. 7 (1966).

101. R. BORK, *supra* note 48, at 61.

102. *Id.* at 66. "The legislative histories of the antitrust statutes, therefore, do not support any claim that Congress intended the courts to sacrifice consumer welfare to any other goal." *Id.*

103. *Id.*

104. Bork, *Vertical Restraints: Schwinn Overruled*, 1977 SUP. CT. REV. 171, 173.



restraints is a positive step. Surely such treatment should extend to fixing maximum prices, although it could go further.

An upstream monopolist will attempt to impose maximum resale prices when faced with a successive monopoly situation. The manufacturer is motivated not by altruism, but by profits. In this case, however, the interests of the manufacturer coincide with the interests of the consumer. Therefore, whenever the industry structure is one of successive monopoly, the judiciary should permit constraints on downstream pricing discretion.<sup>105</sup>

---

105. The same analysis applies to patent and copyright licensors. If the licensor is permitted to restrict the licensee's pricing discretion, it will be possible to prevent a successive monopoly situation from surfacing.