



1-1-1974

Functional Discounts: A Legal-Economic Concept Permitting New Experiments in Distribution Systems

John T. Soma

Follow this and additional works at: <http://digitalcommons.law.scu.edu/lawreview>



Part of the [Law Commons](#)

Recommended Citation

John T. Soma, *Functional Discounts: A Legal-Economic Concept Permitting New Experiments in Distribution Systems*, 14 SANTA CLARA LAWYER 211 (1974).

Available at: <http://digitalcommons.law.scu.edu/lawreview/vol14/iss2/1>

This Article is brought to you for free and open access by the Journals at Santa Clara Law Digital Commons. It has been accepted for inclusion in Santa Clara Law Review by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.

FUNCTIONAL DISCOUNTS: A LEGAL-ECONOMIC CONCEPT PERMITTING NEW EXPERIMENTS IN DISTRIBUTION SYSTEMS*

John T. Soma**

It has been stated that "in today's dynamic economy, marketing, rather than production, is the most crucial aspect of the manufacturer's business; experimentation and innovation in distribution techniques are its most outstanding characteristics."¹ In response to the increase in importance of marketing over production, there has been a proliferation of new marketing techniques such as discount mass merchandising, spot television advertising, and boutique merchandising.² One method of creating the opportunity to experiment with these new marketing techniques is through the use of functional discounts. An example of a functional discount will help explain the concept. Assume a manufacturer has traditionally produced and totally packaged a product before shipping the product to a wholesaler. The manufacturer may find that it is more economical to have the wholesaler perform the final packaging. For the performance of this job or function, the manufacturer grants the wholesaler a discount.³ The discount is called a functional discount. A functional discount, therefore, is a price concession granted by the

* This article is based on the author's masters thesis in Economics. The writer wishes to acknowledge the suggestions and advice of Professors Richard Arnould, Dwight Flanders, and Thomas Friedland, Department of Economics, University of Illinois, and Professor Glen Weston, George Washington University School of Law. The author, however, bears full responsibility for the contents and conclusions of this article.

** J.D., University of Illinois, 1973; M.A., Economics, University of Illinois, 1973; Ph.D. candidate in Economics, University of Illinois; Research Assistant for the Center for Advanced Computation, Urbana, Illinois.

1. Jones, *Marketing Strategy and Government Regulation in Dual Distribution Practices*, 35 GEO. WASH. L. REV. 456 (1966).

2. See generally E. CUNDIFF & R. STILL, BASIC MARKETING 103 (2d ed. 1971) [hereinafter cited as CUNDIFF].

3. See generally Kelley, *Functional Discounts Under the Robinson-Patman Act*, 40 CALIF. L. REV. 526 (1952) [hereinafter cited as Kelley, *Functional Discounts*]; Rowe, *Price Discrimination, Competition, and Confusion: Another Look at Robinson-Patman*, 60 YALE L.J. 929 (1951); Van Use, *Functional Prices*, in CCH ROBINSON-PATMAN ACT SYMPOSIUM 89 (1947).

seller to the buyer for services performed by the buyer for the seller.⁴

Through the use of functional discounts, a manufacturer can "buy distribution" in various distribution channels by accepting different profit levels from varying classes of customers who represent these different channels.⁵ For instance, the manufacturer may simultaneously sell directly to mass discount merchandisers, spot advertise on television to create a national market for traditional retailers, and sell to newly established jobbers servicing boutique shops.

When a functional discount is granted by a seller to a buyer for services performed by the buyer for the seller, there is invariably a difference between the economic and legal interpretation of the transaction. The critical problem of functional discounts involves the discrepancies which exist in the case law between the economic and legal definitions of injury caused by functional discounts. This article will focus on distribution systems, and in particular the interplay between the economic and legal definitions of injury caused by functional discounts under section 2(a) of the Robinson-Patman Act.⁶ The article will then demonstrate that the present functional discount case law hinders, rather than encourages, new experiments in marketing structures which could increase competition across traditional channels of distribution.

4. A function can be defined as an act, operation, or service performed in the process of distributing goods or services which requires the expenditure of economic resources, and the performance of which is rewarded by some type of economic compensation. See P. CONVERSE, H. HUEGY & R. MITCHELL, *ELEMENTS OF MARKETING* 126 (7th ed. 1965) [hereinafter cited as CONVERSE].

5. C. DAVISSON, *THE MARKETING OF AUTOMOTIVE PARTS* 910 (1954) [hereinafter cited as DAVISSON].

6. 15 U.S.C. §§ 1, 13(a) (1970). The main provisions of the Robinson-Patman Act are found in section 1 of that act. However, they were originally sections "2(a)", "2(f)", etc., of the Clayton Act and thus are generally called sections "2(a)", "2(f)", etc., of the Robinson-Patman Act. The relevant provisions are:

Section 2(a). That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale . . . and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them:

Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered.
 . . .

LEGISLATIVE HISTORY OF FUNCTIONAL DISCOUNTS

While the need for functional discounts and their existence has been recognized and accepted by the economic community, little has been done to facilitate their acceptance through legislation. The House version of the Robinson-Patman Act originally included an allowance for price differentials based on functional duties.⁷ The Senate-House Conference Committee, however, eliminated all references to any functional or trade discount exemptions without explanatory comment.⁸ The primary reason for this omission was that at the time of passage of the Act, the traditional wholesaler-jobber-retailer chain of distribution was the normal method of distribution,⁹ and under this method, functional discounts were not needed. The supplier normally sold only to wholesalers based on trade discounts. Channels of distribution, however, have changed greatly since the original passage of the Robinson-Patman Act. As the *Report of the Attorney General's National Commission* stated, modern marketing structure has changed so much that "this proliferation of modern marketing units defies neat nomenclature and descriptive labels."¹⁰

In the early 1960's one-day hearings were held before the House Committee on the Judiciary (Antitrust Subcommittee) to amend the Robinson-Patman Act to allow functional discounts as a defense to price discrimination charges.¹¹ Both the Justice Department and the Federal Trade Commission, while favoring the principle of functional discounts, opposed the specific bills and they died in committee.¹² At present, therefore, there is a dearth of statutory language incorporating functional discounts into present law although the need exists to codify this modern approach to merchandising.

JUDICIAL HISTORY OF FUNCTIONAL DISCOUNTS

Functional discounts have been implicitly accepted in the

7. H.R. REP. NO. 2287, 74th Cong., 2d Sess. 8-9 (1936).

8. H.R. REP. NO. 2951, 74th Cong., 2d Sess. 1, 6 (1936). See also C. AUSTIN, PRICE DISCRIMINATION & RELATED PROBLEMS UNDER THE ROBINSON-PATMAN ACT 52 (2d ed. 1959).

9. In speculating as to why the functional discounts provisions were dropped from the original Robinson-Patman Act, one authority has stated that farm cooperatives did not want to jeopardize their special status in receiving discounts, and thus wanted the then present (1930's) case law to remain intact. C. EDWARDS, THE PRICE DISCRIMINATION LAW 25 n.8 (1959) [hereinafter cited as EDWARDS, PRICE DISCRIMINATION].

10. THE REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY THE ANTITRUST LAWS 204 (1955) [hereinafter cited as REPORT].

11. H.R. REP. NO. 2170, 88th Cong., 1st Sess. (1963).

12. BNA ANTITRUST TRADE REG. REP., Aug. 22, 1961, at A-6; Sept. 5, 1961, at A-1; Sept. 25, 1962, at A-7.

case law.¹³ In *Standard Oil v. FTC*,¹⁴ the major case of functional discounts, the issue of jobber classification, and thus functional discounts, never reached the Supreme Court due to procedural changes at each level of the case. While the Supreme Court has never dealt with the issue, the Federal Trade Commission recognized functional discounts in dictum in *Doubleday & Co.*,¹⁵ concluding that without functional discounts, competition and marketing efficiency is thwarted, and consumers are forced to pay higher prices. Through the use of the discounts, the seller can shift various distribution functions to his customers, thereby increasing market efficiency.

The concept of functional discounting has found approval from various sectors of the legal profession. The chief sponsor of the Robinson-Patman Act¹⁶ stated that functional discounts are implicitly included in the Act,¹⁷ and the Attorney General's Commission has also accepted the concept of functional discounts.¹⁸ Within *The Report of the Attorney General's National Committee to Study the Antitrust Laws*, however, the dissent preferred to limit functional discounts to only those distributors who resell their goods as wholesalers, on the grounds that the middleman assumes the risk, investment and costs solely to this extent.¹⁹ Economically, functional discounts exist in the

13. *FTC v. Ruberoid Co.*, 343 U.S. 470 (1952). In *Empire Rayon Yarn Co. v. American Viscose Corp.*, 364 F.2d 491 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), the court of appeals ruled that the validity of functional discounts had to be judged under section 2(a) of the Robinson-Patman Act, rather than under section 2(c). Section 2(c) would have rendered all functional discounts illegal per se due to its strict prohibition of brokerage or commission payments to any purchaser or parties related to the purchaser.

14. 41 F.T.C. 263 (1945), *modified*, 43 F.T.C. 56 (1946), *modified and aff'd*, *Standard Oil Co. v. FTC*, 173 F.2d 210 (7th Cir. 1949), *modified by FTC Commission*, January 16, 1953, *certified to 7th Cir.*, March 26, 1953, *remanded for want of jurisdiction to FTC Commission*, January 18, 1954, *reconsideration denied by FTC Commission*, January 7, 1955, *appealed*, 233 F.2d 649 (1956), *modified*, 355 U.S. 396 (1958).

15. *Doubleday & Co.*, 52 F.T.C. 169 (1955). The *Doubleday* decision also weakened the strong stand the FTC has taken on functional discounts by holding:

In our view, to relate functional discounts solely to the purchaser's method of resale [price by use rule] without recognition of his buying function thwarts competition and efficiency in marketing, and inevitably leads to higher consumer prices.

Id. at 209 (1955).

16. The true author of the Robinson-Patman Act was "Judge" Teegarden. Rep. Patman even declared "Mr. Teegarden wrote this bill . . ." *Hearings Before the House Committee on the Judiciary on Bills to Amend the Clayton Act*, 74 Cong., 1st Sess. 9, 27-28 (1935). See also F. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 12 (1962) [hereinafter cited as ROWE, 1962].

17. W. PATMAN, COMPLETE GUIDE TO THE ROBINSON-PATMAN ACT 29 (1963) [hereinafter cited as PATMAN].

18. REPORT, *supra* note 10, at 207.

19. *Id.* at 209.

market place; they are legally sanctioned because there is no direct prohibition to their use. This legal existence, however, is based on a judicial interpretation of the Act rather than specific statutory language.

LEGAL PRICE DISCRIMINATION AND INJURY

In order to understand legal price discrimination under the Robinson-Patman Act it is best to begin with the Act itself. Section 2(a) states:

That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchasers involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale . . . and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them²⁰

In essence, section 2(a) prohibits a seller from making interstate sales to two or more different customers of commodities of like grade and quality at price differences which produce a competitive injury.²¹ A prima facie case of price discrimination requires the following elements: (1) a seller; (2) in interstate commerce; (3) to two or more different purchasers; (4) of commodities; (5) of like grade and quality; (6) at a price difference; (7) which produces a competitive injury.²² The plaintiff has the burden of proving these seven elements in price discrimination cases, but once proved, the plaintiff has shown a prima facie violation of section 2(a).

Knowledge of each necessary element is essential to an understanding of functional discounts. First, one seller must make two sales. A problem typically arises when a parent corporation and its sales subsidiary offer the same commodity for sale at different prices. For example, in *Baim & Blank, Inc. v. Philco Corp.*²³ an individual retail dealer was quoted a higher price by

20. 15 U.S.C. §§ 1, 13(a) (1970).

21. See generally Blackford, *A Survey of Section 2(a) of the Robinson-Patman Act*, 41 NOTRE DAME LAW. 285, 287 (1966) [hereinafter cited as Blackford, *Survey*].

22. *Id.*

23. 148 F. Supp. 541 (E.D.N.Y. 1957). See *Klein v. Lionel Corp.*, 237 F.2d 13 (3d Cir. 1956); *Chicago Sugar Co. v. American Sugar Refining Co.*, 176 F.2d 1 (7th Cir. 1949); *Frank Miles v. Coca-Cola Bottling Co.*, 1973-2 CCH TRADE

Philco's sales subsidiary than Philco was offering to a large purchaser. Despite the ownership of the subsidiary by Philco, the court dismissed the complaint because the sales of the subsidiary were not attributed to the parent.²⁴

Second, the interstate commerce requirement of the Robinson-Patman Act requires that one of the two sales creating the price discrimination occur in interstate commerce.²⁵ By contrast, the Sherman Act and Clayton Act only require that the transaction affect interstate commerce.²⁶ The classic case dealing with the commerce requirement is *Standard Oil Co. v. FTC*,²⁷ in which Standard Oil contended that the storage and sale of gasoline in the same state deprived the gasoline of any interstate characteristics. The Supreme Court rejected this argument and instead applied a "flow of commerce" theory. Since the gasoline had been refined in Indiana before shipment to Michigan for distribution, the Court held that the movement of the gasoline across state lines constituted a "flow of commerce", and thus, had fulfilled the interstate commerce requirements of the Robinson-Patman Act.²⁸

Third, the two different purchasers requirement is simple: there must be two or more independent legal entities purchasing the commodity. The price at which an independent subsidiary sells a commodity will not be attributed to its parent.

Fourth, the products sold must be commodities. This requirement has assumed significance by confining the scope of section 2(a) to tangible property.²⁹ In *General Shale Products*

CASES ¶ 74,675, at 94,966 (E.D. Wis. May 18, 1973); *FTC v. Edelmann & Co.*, 51 F.T.C. 978 (1955).

24. The sale requirement excludes commercial arrangements such as leases and consignments. See *Students Book Co. v. Washington Law Book Co.*, 232 F.2d 49 (D.C. Cir. 1955), *cert. denied*, 350 U.S. 988 (1956); *Gaylord Shops, Inc. v. Pittsburgh Miracle Mile Town & Country Shopping Center, Inc.*, 219 F. Supp. 400 (W.D. Pa. 1963). The two sales forming the price differential must be relatively contemporaneous in time. *Atlanta Trading Corp. v. FTC*, 258 F.2d 365 (2d Cir. 1958).

25. Section 1 of the Clayton Act defines "commerce." 15 U.S.C. § 12 (1970). The relevant provision states that "'Commerce', as used herein, means trade or commerce among the several States and with foreign nations . . ."

26. D. BAUM, *THE ROBINSON-PATMAN ACT: SUMMARY AND COMMENT* 11-13 (1964).

27. 340 U.S. 231 (1951).

28. *FTC v. Standard Oil Co.*, 355 U.S. 396 (1958). See generally *Moore v. Mead's Fine Bread Co.*, 348 U.S. 115 (1954); *Littlejohn v. Shell Oil Co.*, 1973-2 CCH TRADE CASES ¶ 74,645, at 94, 834 (1973) (jurisdictional requirements of Robinson-Patman Act mandate at least one interstate sale); *Hiram Walker, Inc. v. A & S Tropical, Inc.*, 407 F.2d 4 (5th Cir. 1969), *cert. denied*, 396 U.S. 901 (1969); *Abramson v. Colonial Oil Co.*, 390 F.2d 873 (5th Cir.), *cert. denied*, 393 U.S. 831 (1968); *Food Basket, Inc. v. Albertson's, Inc.*, 383 F.2d 785 (10th Cir. 1967); BNA ANTITRUST TRADE REG. REP., October 17, 1969, at B-1.

29. See, e.g., *Fleetway, Inc. v. Pub. Serv. Interstate Transp. Co.*, 72 F.2d

v. *Struck Construction Co.*,³⁰ a discriminatory price for bricks was included as part of a construction bid. The United States Court of Appeals for the Sixth Circuit held that the price of bricks was inseparable from the total bid, and as an indivisible factor in the bid was thus not a commodity. In general, price quotations which combine tangible elements with major intangible elements (services) are not commodities within the meaning of section 2(a).³¹ Advertising has also been held not to be a commodity under section 2(a).³²

Fifth, the two commodities sold must be of like grade and quality. The legislative history of both the Clayton Act and the Robinson-Patman Act fails to clarify the meaning of the phrase "like grade and quality."³³ The early interpretation of like grade and quality was based on an examination of the physical properties of the two goods.³⁴ Later, nonfunctional differences in appearance (such as minor changes in the rib design of spark plugs) were accepted as differences in "like grade and quality."³⁵ The Supreme Court in *FTC v. Borden Co.*,³⁶ however, followed the earlier interpretation, and held that the substance of the products must be different if the product was to fall outside the scope of the Robinson-Patman Act. In *Borden*, the Federal Trade Commission charged that the price differential between Borden's premium brands and private brands violated section 2(a). Borden responded by saying that customer preference, promoted by Borden's advertising of its premium brands, constituted a legal dif-

761 (3d Cir. 1934), *cert. denied*, 293 U.S. 626 (1935); *Gaylord Shops, Inc. v. Pittsburgh Miracle Mile Town & Country Shopping Center, Inc.*, 219 F. Supp. 400 (W.D. Pa. 1963). Representative Patman offered the following interpretation of the word "commodities":

[T]he word is ordinarily used in the commercial sense to designate any moveable or tangible thing that is produced or used as the subject of barter. This is the definition of the word 'commodity' used in the application of the Robinson-Patman Act.

PATMAN, *supra* note 17, at 33.

30. 132 F.2d 425 (6th Cir. 1942), *cert. denied*, 318 U.S. 780 (1943).

31. THE WHITE HOUSE TASK FORCE REPORT ON ANTITRUST POLICY (*The Neal Report*), BNA ANTITRUST TRADE REG. REP., May 27, 1969 (Special Supplement), recommended that the Robinson-Patman Act be extended to cover services [hereinafter cited as *Neal Report*].

32. *Columbia Broadcasting System, Inc. v. Amana Refrigeration, Inc.*, 295 F.2d 375 (7th Cir. 1961), *cert. denied*, 369 U.S. 812 (1962).

33. See generally Cassady & Grether, *The Proper Interpretation of "Like Grade and Quality" Within the Meaning of Section 2(a) of the Robinson-Patman Act*, 30 S. CAL. L. REV. 241 (1957); Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 YALE L.J. 1 (1956).

34. *Boss Mfg. Co. v. Payne Glove Co.*, 71 F.2d 768 (8th Cir. 1934), *cert. denied*, 293 U.S. 590 (1934).

35. *Champion Spark Plug Co.*, 50 F.T.C. 30 (1953). See REPORT, *supra* note 10, at 158; ROWE, 1962, *supra* note 16, at 63.

36. 383 U.S. 673 (1966).

ference even though the products were identical in substance. Borden was unsuccessful in its attempt to include customer preference in the "like grade and quality" requirement of the Robinson-Patman Act. Thus, after *Borden*, if the substance of the products is similar, the "like grade and quality" requirement will be satisfied, and mere changes in patterns or design for consumer preference will not suffice.

Sixth, there must be a price difference. The Supreme Court in *Anheuser-Busch, Inc. v. FTC*³⁷ defined price discrimination as a price differential in two sales of products of like grade and quality. In the late 1950's Anheuser-Busch cut its price for beer in the St. Louis market area while maintaining a higher price in its other national markets. As a result of the lower price in St. Louis, Anheuser-Busch's share of the St. Louis market rose from 12 to 39 per cent. The Supreme Court ruled that any price difference constituted price discrimination if the other requirements of the Robinson-Patman Act were fulfilled.

In *Anheuser-Busch*, the Court noted that "price discrimination within the meaning of that provision [section 2(a)] is merely a price difference."³⁸ If a price difference constitutes price discrimination, then price uniformity results in no legal price discrimination. This uniform price rule, as it has been termed, exempts any seller from Robinson-Patman liability if the seller charges every purchaser the same price. Decisions by both the Federal Trade Commission³⁹ and the courts⁴⁰ prior to the *Anheuser-Busch* decision suggest that a uniform price would exempt a seller from legal liability under the Robinson-Patman Act.⁴¹

Seventh, the price differential must produce a competitive injury. The Robinson-Patman Act was originally designed to preserve competition at the customer level. To accomplish this goal, three separate levels of injury were originally included in the Act. The relevant provision of section 2(a) states that,

37. 363 U.S. 536 (1960). See also *Sano Petroleum Corp. v. American Oil Co.*, 187 F. Supp. 345 (E.D.N.Y. 1960); REPORT, *supra* note 10, at 217 n.274; ROWE, 1962, *supra* note 16, at 99.

38. 363 U.S. at 549.

39. *Bird & Son, Inc.*, 25 F.T.C. 548, 553 (1937).

40. *FTC v. Staley Mfg. Co.*, 324 U.S. 746, 757 (1945) (suggestion that a uniform price to all delivered points would not be illegal under the Robinson-Patman Act); *Klein v. Lionel Corp.*, 138 F. Supp. 560 (D. Del.), *aff'd*, 237 F.2d 13 (3d Cir. 1956).

41. See generally REPORT, *supra* note 10, at 217 n.274; ROWE, 1962, *supra* note 16, at 99; Comment, "The Tyranny of Labels"—A Study of Functional Discounts Under the Robinson-Patman Act, 60 HARV. L. REV. 571 (1947) [hereinafter cited as *Tyranny of Labels*].

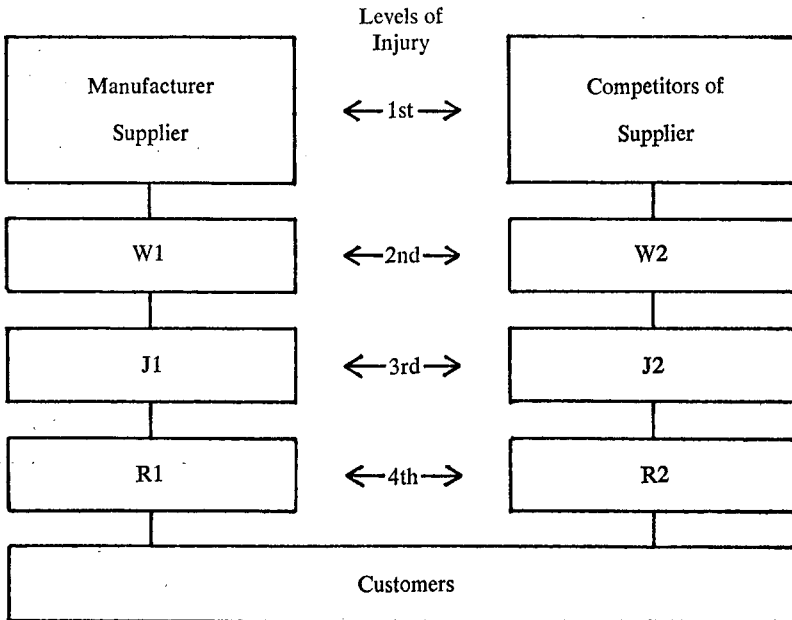
where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or *with customers of either of them*⁴²

a violation of the Act will be found. There are, then, several levels of injury: the primary injury occurs between the supplier and his competitors; the secondary level injury occurs among the buyers of the suppliers; and the tertiary level injury occurs among the customers of the buyers from the supplier.⁴³

Before 1969, these three levels of injury were accepted by most authorities.⁴⁴ The notable exception was Frederick Rowe,⁴⁵ who stated in 1962 that "this esoteric doctrine [referring to ter-

42. 15 U.S.C. §§ 1, 13(a) (1970) (emphasis added).

43. A diagram will be helpful to explain the levels of injury concept.



Symbols: W = Wholesaler; J = Jobber; R = Retailer.

Note: W1, J1, R1 are granted a discriminatory price as compared to W2, J2, R2.

Supplier competes with other suppliers and sells to wholesalers.

The levels of injury are then: the first or primary injury occurring between the supplier and his competitors; the second level or secondary injury occurring between the competing wholesalers (W1 and W2); the third level or tertiary injury occurring between the jobbers (J1 and J2); and finally, the fourth level injury occurring between the retailers (R1 and R2).

44. See, e.g., Dam, *The Economics and Law of Price Discrimination: Herein of Three Regulatory Schemes*, 31 U. CHI. L. REV. 1 (1963) [hereinafter cited as Dam]; PATMAN, *supra* note 17, at 65.

45. ROWE, 1962, *supra* note 16, at 200.

tiary injury] appears of dubious validity today."⁴⁶ In *Perkins v. Standard Oil*,⁴⁷ the Supreme Court included "fourth level" injuries in the Robinson-Patman Act.⁴⁸ In this case, Clyde Perkins, an independent wholesaler-retailer of gasoline, alleged that Standard charged its own independent subsidiaries and another independent wholesaler-retailer less than the price Perkins was charged. As a result of this price discrimination, Perkins was forced to sell his gas stations to a competitor of Standard at a substantial loss. The district court held for Perkins, but the Tenth Circuit Court of Appeals reversed the district court because the injury occurred at the "fourth level", and was therefore not prohibited by section 2(a) of the Robinson-Patman Act. The controversy in *Perkins* over the levels of injury originated in the phrase "with customers of either of them." The Supreme Court reinstated the district court verdict for Perkins on the grounds that section 2(a) covered a "fourth level" injury. Based on *Perkins*, if the causal chain from price discrimination to injury remains unbroken, then *anyone* injured in the chain of distribution may recover from the firm responsible for the discriminatory pricing regardless of the number of distribution links.

The competitive injury must be substantial.⁴⁹ If there is a discriminatory price granted to a purchaser of buttons which are used in the manufacture of shirts, there will probably be no competitive effect because the cost of buttons is only a small fraction of the total cost of a shirt. An example of this theory occurred in *Minneapolis-Honeywell Regulator Co. v. FTC*,⁵⁰ where the United States Court of Appeals for the Seventh Circuit held that Honeywell's price discrimination had no substantial effect on competition at the secondary level, because prices on Honeywell's temperature controls constituted only a small part of the

46. *Id.* at 196.

47. 395 U.S. 642 (1969).

48. See note 43 *supra*.

49. *Secatore's, Inc. v. Esso Standard Oil Co.*, 171 F. Supp. 665 (D. Mass. 1959), held that a manufacturer was not obligated to sell to retail distributors at lower prices than to direct-buying customers. The court reasoned that a distributor could not compete for sales to direct-buying customers by receiving an equal price (uniform price rule), and consequently, could not be injured by a discriminatory price favoring the direct buying customers! The Seventh Circuit has also held that the two firms receiving discounts must be in competition with each other. *Chicago Sugar Co. v. American Sugar Refining Co.*, 176 F.2d 1 (7th Cir. 1949).

50. 191 F.2d 786 (7th Cir. 1951), *cert. denied*, 344 U.S. 206 (1952). See also *American Oil Co. v. FTC*, 325 F.2d 101 (7th Cir. 1963), *cert. denied*, 377 U.S. 954 (1964), in which a reduction of prices during a 17-day gas war was also held not to have a substantial effect on competition; *FTC v. Uarco Co.*, [1963-65 CCH TRANSFER BINDER] TRADE REG. REP. ¶ 16,807 (FTC 1964), in which an occasional off-list sale to six customers was held not to have a substantial effect on competition.

total cost of a furnace. On the other hand, the Seventh Circuit also has held that if the price of corn starch used for the production of candy varied even one percent, the anticompetitive effects were both real and significant.⁵¹

Once an initial determination of substantial competitive injury is made, a distinction can be drawn between first-line injury and second, third and fourth-line injury. In the first-line injury, there must be injury to competition, whereas in second, third or fourth-line injury it must merely be shown that harm to competitors has occurred.⁵² The first category of injury can be seen in *Moore v. Mead's Fine Bread*.⁵³ In *Moore*, the plaintiff and defendant were the only two bakeries in a small New Mexico town. The defendant subsidized his price cutting through other interstate sales. Since the defendant's discriminatory acts harmed his only competitor, the defendant's action necessarily must have harmed *competition*, and constituted a violation of section 2(a) of the Robinson-Patman Act.

The second category of lower level injuries is exemplified in *FTC v. Morton Salt Co.*,⁵⁴ where harm to competitors rather than to competition occurred. Morton Salt operated a dual distribution system which used yearly quantity discounts. The larger discounts were available only to carload purchasers, and only five chain stores qualified for the largest discount. Justice Black reasoned that smaller grocery stores competing with the five large chain stores were injured because small grocery stores could not qualify for the larger discounts, implying that in this second category, the plaintiff need only show harm to competitors.

The Supreme Court, in *Utah Pie Co. v. Continental Baking Co.*,⁵⁵ weakened the injury to competition requirement. In *Utah Pie*, the plaintiff entered the Salt Lake City frozen pie business by undercutting prevailing market prices by 15 to 20 percent. As a result of this lower price, Utah Pie captured 67 percent of the market. Three national suppliers responded by reducing their prices in Salt Lake City by 10 to 15 percent below their national prices. The Supreme Court labeled the response of the three national suppliers a "drastic" price cut, and allowed plaintiff to recover against the three defendants although plaintiff's sales,

51. See generally *FTC v. Ruberoid Co.*, 343 U.S. 470 (1952); *FTC v. Corn Products Refining Co.*, 34 F.T.C. 850 (1942), *modified*, 144 F.2d 211 (7th Cir. 1944), *aff'd*, 324 U.S. 726 (1945).

52. See Blackford, *Survey, supra* note 21, at 298 n.19.

53. 348 U.S. 115 (1954). See also *Lloyd A. Fry Roofing Co. v. FTC*, 371 F.2d 277 (7th Cir. 1966).

54. 334 U.S. 37 (1948).

55. 386 U.S. 685 (1967).

profits, and net worth had increased during the period of defendants' discriminatory pricing, and plaintiff's prices were at all times lower than defendants'. Based on *Utah Pie*, it appears that the stringent definition of harm to competition has been lessened by the Supreme Court to the point where any discriminatory price will be held to injure competition in some manner thereby fulfilling this element of section 2(a). The *Neal Report*,⁵⁶ however, in its proposed revision to the Robinson-Patman Act would specifically reverse the holding in *Utah Pie*.

Before price discrimination can occur under the *Neal Report's* proposed modification of the Robinson-Patman Act, the plaintiff must prove both that a significant disparity exists between the areas served by the discriminator and the smaller competitor, and that the discriminator's lower price was less than reasonably anticipated long-run average costs.

There are two elements of legal injury in a price discrimination case. First, all seven requirements of a prima facie case of price discrimination under section 2(a) must be proved, and second, the disfavored buyer must have suffered some economic harm such as lower profits or reduced sales during the time of the alleged price discrimination. Since the *Utah Pie* decision, the extent of injury required to sustain an action may merely be lower profits and sales than would have existed had there been

56. The relevant portion of the *Neal Report's* proposed change to the Robinson-Patman Act is section 2(b):

A discrimination shall be held to have the effect described in subsection (a) (subsection (a) prohibits price discrimination) only where:

(iii) The person granting the discrimination is in competition with others serving significantly more limited areas (territories or classes of customers which are relevant lines of commerce), the discrimination is restricted to one or more such limited areas (representing a small part of the total area served by the person granting the discrimination), the consideration exacted in such limited areas is less than the reasonably anticipated long-run average cost of serving those areas (including capital costs), and the discrimination imminently threatens to eliminate from such a limited area one or more competitors whose survival is significant to the maintenance of competition in that area.

Neal Report, supra note 31, at 18. The comment is as follows:

Subsection (b)(iii) deals with instances of "primary line" injury in similarly stringent fashion. Where the claim is that the discrimination is adversely affecting a competitor of the discriminator, there is the distinct possibility that the competitor is really seeking relief from competition. Accordingly, it is desirable that the scope of liability be narrowly circumscribed. This is accomplished by requiring that there be a significant disparity between the areas served by the discriminator and the smaller competitors; that the discrimination be limited to a small part of the discriminator's area of operation; that the lower price be less than reasonably anticipated long-run average costs; and that the discrimination threaten the imminent adverse effects upon competition described in connection with subsection (b)(iii). Among other things, this revision would clearly reverse the result in *Utah Pie Co. v. Continental Baking Co.*, 87 S. Ct. 1326 (1967) [386 U.S. 685].

no discrimination. It is possible that the rationale of *Utah Pie* will be limited, based on the Court's finding of clear predatory intent and by the factual context of national firms competing against one small local firm. The decision in *Honeywell* still appears to be viable,⁵⁷ and thus the disfavored purchaser probably must suffer at least something greater than the injury sustained in *Honeywell*, where the price discrimination was found to constitute only a small portion of the total cost of the product.

STATUTORY DEFENSES TO FUNCTIONAL DISCOUNTS

The seller in a price discrimination action may rely on the cost justification defense found in section 2(a) of the Robinson-Patman Act. The relevant provision states:

. . . PROVIDED, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered⁵⁸

In the study of cost justification, one should realize that as a firm performs additional functions it also incurs additional costs. Only after a careful examination of both the cost incurred and the discount offered for the performance of these functions, can one determine if a buyer or seller is discriminating in its pricing policies.

The burden of proving a cost justification defense rests on the seller charged with price discrimination,⁵⁹ who may only include those cost savings which he achieves by having part of his distribution function performed by other firms.⁶⁰ Actual costs, however, are easier to prove than hypothetical costs. Therefore, this requirement adds an additional obstacle to the cost justification defense because it is easier to prove an independent buyer's actual cost than the estimated cost savings created internally by

57. See *Continental Baking Co. v. Old Homestead Bread Co. & Interstate Breads Corp.*, 1973-1 CCH TRADE CASES ¶ 74,433 (10th Cir. 1973) (construction of a plant which was operated at only 50% capacity and which only showed a profit at the end of the damage period combined with an increase in prices after a competitor went out of business was sufficient to show predatory intent); *Minneapolis-Honeywell Regulator Co. v. FTC*, 191 F.2d 786 (7th Cir. 1951), *petition for cert. dismissed*, 344 U.S. 206 (1952).

58. 15 U.S.C. §§ 1, 13(a) (1970).

59. See Adelman, *The Consistency of the Robinson-Patman Act*, 6 STAN. L. REV. 3, 8 (1953); Murray, *Cost Justification Under the Robinson-Patman Act: Impossibility Revisited*, 1960 WIS. L. REV. 227, 228 [hereinafter cited as Murray, *Cost Justification*].

60. *FTC v. Purolator Products*, 65 F.T.C. 8 (1964); E. KINTNER, A ROBINSON-PATMAN PRIMER 142 (1970) [hereinafter cited as KINTNER, PRIMER]; PATMAN, *supra* note 17, at 25.

the seller having an independent buyer perform some of the seller's duties. Nevertheless, the cost justification rule provides that the seller is justified only in passing on cost savings that it saves internally by having others perform some of its functions.

The economic premise of the cost justification defense is that a seller should not be forced by law to charge an artificially high price to a low-cost buyer if the seller can prove that the buyer is actually a low-cost buyer.⁶¹ Therefore, the cost justification defense should include all expenses incurred by a buyer or seller in the performance of any functions pursuant to the particular sale in issue. The factors to consider in determining just compensation are the objective measurable costs in an accounting sense coupled with the subjective measurable factors in an economic sense. The first category includes all accounting costs incurred by the buyer or seller. A fair rate of return on invested capital should also be included in this category as well as a reasonable economic profit for the entrepreneur.

Additionally, several subjective measurable factors still exist in economic theory. These factors are more difficult to measure in a legal and accounting sense, yet still constitute economic costs. The first factor to consider is the desire for a supplier to insure that his plant runs at capacity, and for the buyer to insure that he has a steady supply of the particular commodity for large orders. The economics of scale which may occur when a firm either integrates downstream or upstream should also be included in the cost justification defense.⁶² A third factor to be considered is that the entrepreneur must be given an appropriate return for assuming risks. The preceding factors are not easily measured by accountants, thus creating a reluctance on the part of courts to recognize or mention them, let alone include them in a cost justification analysis. In pure economic theory, each of the previously discussed factors should be considered by the courts when applying the cost justification defense in functional discount cases. Only by considering all of these factors can one ascertain whether economic discrimination has in fact occurred.

Examining the cost justification defense as a whole, it appears that the present judicial and administrative interpretation deserves both praise and criticism.⁶³ The defense often fails in court because it is used as an excuse after a supplier is caught selling at a discriminatory price.⁶⁴ The Federal Trade Commis-

61. KINTNER, PRIMER, *supra* note 60, at 25.

62. See note 89 and accompanying text *infra*.

63. Murray, *Cost Justification*, *supra* note 59, at 233.

64. Although not impossible, it is extremely difficult to recreate the proper

sion in its administrative enforcement of the Robinson-Patman Act seldom accepts the cost justification defense.⁶⁵ *The Report of the Attorney General's Committee to Study the Antitrust Laws* suggested that the phrase "due allowance" found in section 2(a) be broadened to insure that the most honest estimates used by businessmen in functional discounts be accepted.⁶⁶ This suggested change has not been followed by either the Federal Trade Commission or the courts. Another suggestion is to lessen the procedural burden of proof required of a seller attempting to use the cost justification defense. The *Neal Report* recommended a revised cost justification defense which would have accepted reasonable estimates on cost savings as part of the cost justification defense.⁶⁷

NON-STATUTORY DEFENSES TO FUNCTIONAL DISCOUNTS

In addition to a cost justification defense the seller has several non-statutory defenses to functional discounts. Under these non-statutory defenses, a seller charged with price discrimination may defend his actions by showing a lack of one of the seven elements required to prove legal price discrimination. The most com-

distribution setting based on the previously collected non-distribution accounting data in order that the the distribution costs be properly determined.

65. A statistical compilation of the cost justification defenses used in recent cases may be found in Rowe, *The Federal Trade Commission's Administration of the Antitrust Discrimination Law—A Paradox of Antitrust Policy*, 64 COLUM. L. REV. 426 (1964).

66. REPORT, *supra* note 10, at 174.

67. The *Neal Report*, *supra* note 31, at 20, proposed the following cost justification statute:

(d) It shall be a defense to a charge of discrimination that the lesser exaction of consideration makes an appropriate allowance for differences in the cost of manufacture, distribution, sale, or delivery resulting from the differing methods or quantities involved in the transactions in question. An allowance is appropriate where the difference in consideration does not substantially exceed the difference in cost; where the difference in consideration does not exceed a reasonable estimate of the difference in cost; or where the difference in consideration is the result of a reasonable system of classifying transactions which is based on characteristics affecting cost of manufacture, distribution, sale or delivery, under which differences in consideration between classes approximate differences in cost. If a system of classification is held to be unlawful, the court or agency so ruling should indicate either (i) that the seller's customers are so similar in pertinent characteristics that no system of classification would be valid or (ii) that a system of classification described by the court or agency may properly be employed in lieu of the one held to be unlawful.

THE REPORT OF THE PRESIDENT'S TASK FORCE ON PRODUCTIVITY AND COMPETITION (*The Stigler Report*), BNA ANTITRUST TRADE REG. REP. No. 413 (1969), agreed with the *Neal Report* in substance, but the *Stigler Report* did not criticize the present Robinson-Patman Act as openly. After a 15-month survey, a Special Subcommittee of the House Small Business Committee concluded that the criticism of the Robinson-Patman Act in the *Neal* and *Stigler Reports* was unwarranted. H.R. REP. No. 91-1617, 91st Cong., 2d Sess. (1969).

mon element alleged to be missing is an effect on competition. There are several possible defenses to avoid the effect on competition requirement: (1) the buyers are in distinct markets which do not overlap; (2) there is no substantial effect on competition from the price discrimination; (3) the buyer could have purchased the product at the alleged discriminatory price from the defendant firm or competing firms (the availability defense); or (4) there has been a break in the causal chain between the alleged discrimination and the possible adverse competitive effect.

The first defense is simply that the two purchasers are not competitors because they are in distinct markets, and consequently, the favored buyer does not receive an unfair competitive advantage over the non-favored buyer.⁶⁸ There is no effect on competition, and therefore, no possible injury to competition. A second possible defense is to state that the effect on competition is negligible. The *Honeywell Regulator*⁶⁹ case is an example of this situation. As Honeywell's price discrimination on furnace controls constituted only a small part of the total cost of a furnace, it did not substantially affect competition and therefore was not subject to section 2(a) censure.

The availability defense requires that the injured plaintiff have had the opportunity to purchase the product at the allegedly discriminatory price, but chose not to exercise the option.⁷⁰ The reasons a buyer might not purchase at an allegedly lower discriminatory price might include the fact that he did not want to buy in large volumes which were available to all purchasers on equal terms, or that he might not have known of other available sources from competing sellers. Although the principal issue in *Perkins v. Standard Oil*⁷¹ was the extension of recoverable injury from the third to the fourth level, *Perkins* also considered the availability defense. This defense arose in the context of non-price discrimination between branded dealers and private label customers such as Perkins.⁷² During price wars, Standard Oil subsidized its branded dealers but failed to give comparable assistance to its private label customers. The branded dealers were also given credit card privileges, painting, advertising, and maintenance allowances. The Ninth Circuit held that Standard was

68. See *National Nut Co. of Calif. v. Kelling Nut Co.*, 61 F. Supp. 76 (N.D. Ill. 1945).

69. 191 F.2d 786 (7th Cir. 1951), *petition for cert. dismissed*, 344 U.S. 206 (1952).

70. The *Neal Report*, *supra* note 31, at 18, would codify the availability defense in its proposed revision to the Robinson-Patman Act.

71. 395 U.S. 642 (1969).

72. See Von Kalinowski, *Availability as a Defense to Private Label Marketing*, 39 A.B.A. SEC. ANTITRUST 841 (1970).

required to grant these same allowances to Perkins, and that Standard's failure to do so violated section 2(a). The Supreme Court concurred on this issue noting that "the Court of Appeals found that Standard's liability for the harm done Perkins by the favorable treatment of the branded dealer was beyond dispute."⁷³

Perkins, therefore, implicitly discussed the problem of availability, and it appears that if price concessions and other non-price allowances are available to all customers who qualify, then the causal chain from price discrimination to competitive injury will be broken.⁷⁴ Availability from a separate source should also break the causal chain between price discrimination and competitive injury.⁷⁵ The *Attorney General's Report* stated that a competitive price reduction should not be "singled out as responsible for 'injury' if alternative means of access to goods at the lower price are in any event available to the buyer."⁷⁶ Thus, a seller should not be held to have violated section 2(a) if the seller insures that all price and non-price allowances are functionally available to all customers who qualify.⁷⁷

A break in the causal chain is the fourth method of avoiding the element of an affect on competition. In *Thomas E. Belliston v. Texaco, Inc.*,⁷⁸ a recent case dealing with the break of the causal link, Texaco granted Flinco two price discounts: one-half cent per gallon for picking up the gasoline from an American refinery and four cents per gallon for maintaining and providing services for some of its retail stations. Although all branded dealers had the same retail pump price, the alleged price difference came from the bonus plans offered at the Flinco-Texaco branded stations. The plan provided customers a saving of approximately 2¢ per gallon when buying from Flinco. Belliston alleged that it was injured by the bonus program offered by Flinco's stations because the program originated from Texaco's four and one-half cent price discount granted to Flinco.

73. 395 U.S. at 645.

74. *FTC v. Fred Meyer, Inc.*, 390 U.S. 341 (1968) (supplier granting advertising allowances is required to make them available on equally proportional terms to all competing purchasers).

75. *ROWE*, 1962, *supra* note 16, at 193.

76. *REPORT*, *supra* note 10, at 164-65.

77. See *Aubrey D. Hanson v. Pittsburgh Plate Glass Indus., Inc.*, 1973-1 CCH TRADE CASES ¶ 74,564 (5th Cir. 1973) (availability defense was applicable); *Continental Baking Co. v. Old Homestead Bread Co.*, 1973-1 CCH TRADE CASES ¶ 74,433 (10th Cir. 1973) (availability defense inapplicable); *Mueller Co. v. FTC*, 323 F.2d 44 (7th Cir. 1963). The availability defense found in section 2(d) may be applicable to section 2(a) if the terms of the discount were truly available to all prospective purchasers. *Contra*, *Fowler Mfg. Co. v. Gorlick*, 415 F.2d 1249 (9th Cir. 1969). See generally Millstein, *The Status of "Availability" Under Section 2(a) of the Robinson-Patman Act*, 42 N.Y.U.L. REV. 416 (1967).

78. 455 F.2d 175 (10th Cir. 1972), *cert. denied*, 408 U.S. 928 (1972).

Texaco argued that this price concession was used up by Flinco in performing services, and thus the causal chain from discriminatory price concession to competitive harm was broken.⁷⁹ This break was allegedly caused because the value of the discount was consumed by the customer receiving the discount in the performance of the "functions." The trial judge rejected Texaco's theory of a break in the causal chain and sent the Robinson-Patman Act claim to the jury. The jury awarded Belliston three hundred thousand dollars, which the court then trebled. The United States Court of Appeals for the Tenth Circuit, however, reversed on interstate commerce grounds, stating that all of the sales had occurred in Utah even though Texaco pumped the crude gasoline from Colorado into Utah before refining. In response to Belliston's petition for certiorari, Texaco's brief in opposition asserted,

There was no evidence that any such differences in net price produced any injury to competition but, on the contrary, evidence that the distributor discount was exhausted by wholesaling expenses and a reasonable return on investment⁸⁰

The United States Supreme Court denied certiorari, precluding Texaco from asserting a break in the causal chain argument as a defense to its use of functional discounts.⁸¹ Although rejected by the Tenth Circuit, this argument still may be viable and accepted by other circuits.

ECONOMIC PRICE DISCRIMINATION AND INJURY

The factors involved in the economic definitions of price discrimination and economic injury vary considerably from their legal

79. See generally *Dean Milk Co. v. FTC*, 395 F.2d 696 (7th Cir. 1968), in which the plaintiff failed to prove that his injuries were directly attributable to defendant's discriminatory pricing policy rather than to consumer preferences and technological changes; *Borden Co. v. FTC*, 381 F.2d 175 (5th Cir. 1967), in which there was no proof that a private label price differential caused the competitor any injuries; *American Oil Co. v. FTC*, 325 F.2d 101 (7th Cir. 1963), cert. denied, 377 U.S. 954 (1964), in which price reductions during a 17-day gas war were attributable to price reductions already in effect by other major oil companies; *Anheuser-Busch v. FTC*, 289 F.2d 835 (7th Cir. 1961), in which one competitor experienced quality problems and a change of ownership, while another competitor actually increased sales by 14 percent; *Alexander v. Texas Co.*, 165 F. Supp. 53 (W.D. La. 1958), in which the injury was caused by plaintiff's own high price policy.

80. Respondent's Brief in Opposition to Certiorari at 9, *Belliston v. Texaco, Inc.*, 455 F.2d 175 (10th Cir. 1972), cert. denied, 408 U.S. 928 (1972). Flinco provided the following services to its stations: (1) maintenance for all of its stations; (2) hired salesmen to take orders from its dealers for products offered; (3) supplied technical advice whenever needed; (4) provided money to pay for needed technical improvements, and (5) provided an accounting service to its dealers.

81. *Belliston v. Texaco, Inc.*, 455 F.2d 175 (10th Cir. 1972), cert. denied, 408 U.S. 928 (1972).

counterparts. It is therefore necessary to study the economic definition of price discrimination and economic injury to understand fully the impact of functional discounts on the marketplace. The concept of marginal cost is essential to an understanding of economic price discrimination. In economic terms, marginal cost is simply the added cost expended by a firm to produce one additional unit of the product in question.

Economic price discrimination occurs when the ratio of price to marginal cost is unequal as a result of the sales of two or more similar goods.⁸² More specifically, economic price discrimination has occurred when the price of the first good sold (P_1) divided by its marginal cost (MC_1) does not equal the price of the second good sold (P_2) divided by the second good's marginal cost (MC_2). Stated in a formula, if after the sale of two identical products, $P_1/MC_1 \neq P_2/MC_2$, economic discrimination has occurred.

An example of price discrimination is the price differential between hardbound books selling for \$6 and paperback books selling for \$2. The binding presumably does not make up the difference, and so those paying for the hardbound book are paying a discriminatory price. Price differences, however, do not necessarily mean price discrimination. Thus, a wholesaler is charged less on an item per item basis than a retailer because the wholesaler buys in greater quantities. On the other hand, price equality may also be price discrimination. In the case of college classes, students in a large beginning class taught by an instructor pay the same tuition as students enrolled in a small class taught by a full professor. The students in the small class taught by the professor obviously cost the college more than those students taking the introductory course taught by the instructor.

Four economic conditions must exist for a seller to successfully price discriminate.⁸³ First, there must be two or more identifiable classes of buyers. Second, these classes of buyers must be capable of being separated into distinct markets at a reasonable cost. Third, the buyers' elasticities of demand must be appreciably different. Fourth, there cannot be any close substitute products. When these necessary conditions are present, a seller may follow an economically discriminatory pricing policy such that $P_1/MC_1 \neq P_2/MC_2$. The result of the discriminatory pricing policy is a misallocation of goods among buyers due to

82. G. STIGLER, *THE THEORY OF PRICE* 209 (3d ed. 1966) [hereinafter cited as STIGLER, *THEORY OF PRICE*].

83. *Id.* at 210.

the inequality between the price/marginal cost ratios.⁸⁴

From an economic perspective, it is the inequality of ratios that is necessary for economic injury to exist. In a theoretical sense, the method of determining the degree of discrimination is first to find the price level as if no discrimination existed. Then, assuming that the marginal costs are the same in both the discriminating situation and the non-discriminating situation, one must compare the differences in ratios to determine the extent of injury.

The determination of economic price discrimination is further confused by readjustments which an injured buyer makes in the market. If the economic discrimination is permitted to continue, the injured buyer can respond in several ways. First, the buyer might seek out alternative sources of supply. Assuming that this option is unavailable, the injured buyer might attempt to integrate vertically, eliminate the seller and thereby avoid the effects of the seller's discriminatory pricing policy. Another alternative which could be utilized by the injured buyer would be to pass along the discriminatory price which he received to his buyers. This option, however, is available only if the injured buyer has some market power (the ability to manipulate price and quantity sold) in the resale of his products. Finally, the buyer might be so injured that he will be unable to survive in the market, and thus go out of business.

Once the determination of economic injury is made, a problem exists in tracing this injury from its appearance in the form of a price differential (out of proportion to the different marginal costs) back to its source. For example, a supplier may discriminate in the price he charges a wholesaler, but the discrimination may be passed on and only belatedly surface at the retail level in the form of a price differential between competing retailers. A mere price differential at any level of the distribution chain, however, is not necessarily the result of an economic injury, but rather may be caused by economies of scale which one firm has attained through increased production or through more efficient operation.

FUNCTIONAL DISCOUNTS AND VERTICAL INTEGRATION

Many of the pressures behind a firm's desire to integrate

84. There is no simple rule concerning the effect of discrimination on output. See J. ROBINSON, *THE ECONOMICS OF IMPERFECT COMPETITION* 188-95 (1933). There is one situation in which some discrimination may be necessary to insure the production of goods. An example is the railroad industry where price discrimination between different classes of buyers is used to keep total revenue greater than total cost. STIGLER, *THEORY OF PRICE*, *supra* note 82, at 210.

vertically are the same for a firm contemplating the performance of additional functions. Accordingly, the study of vertical integration is helpful in providing fuller understanding of functional discounts and their relationship to "buying distribution." Vertical integration occurs when a firm performs all of the functions at the next higher or lower stage in the distribution chain. One approach to the study of vertical integration was developed by Professor Coase.⁸⁵ In his article, he explored the possible rationales for the vertical integration of a firm. Integration is defined as the "organization of transactions which previously had been carried on by the market."⁸⁶ The major premise of the article is that a firm will vertically integrate as long as the internal costs of integrating are less than the market costs. That is, the firm will internalize the transaction if the internal cost is less than the external or market cost for a given transaction.⁸⁷

There are, however, limits to the size of the firm based on a decreasing return to the entrepreneur. The entrepreneur ultimately reaches the point where it is cheaper to use the market than to keep the transaction within the firm. The firm is also limited by the fact that it may be unable to integrate one step at a time. The market may be so structured as to force the firm to jump several steps to effectively integrate. If the entrepreneur has already reached the limit of his skill, this final jump may be too much. In this situation the firm will be precluded from integrating the one step it could viably undertake due to the necessity of jumping several steps.⁸⁸

There are two types of vertical integration: upstream and downstream.⁸⁹ In upstream vertical integration, a firm internalizes a transaction of inputs which had previously been conducted in the market. An example of upstream integration would be a jobber performing all of the wholesale functions. In the case of downstream vertical integration, a firm internalizes a transaction of outputs which had previously been conducted in the market. An example of downstream integration would be a jobber selling

85. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 387 (1937) [hereinafter cited as Coase].

86. *Id.* at 398.

87. The costs of using the market are as follows: (1) the cost to obtain price information for the particular transaction; (2) the cost to hire specialists to interpret this market information; (3) the cost to negotiate the prices vis-a-vis contracts with the parties in the market; (4) the cost of uncertainty of both price and quantity unless long term contracts are used; (5) the tax on each transaction consummated in the market. *Id.* at 390.

88. Professor Coase observed that vertical integration necessarily "varies greatly from industry to industry and from firm to firm." *Id.*

89. See generally SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* (1971).

at retail level. In either upstream or downstream integration, a firm will internalize the transaction if the internal price is less than the market price. Vertical integration, therefore, is actually the total performance of all functions at the next level of distribution. The economic forces behind a firm's desire to vertically integrate or simply perform a few additional functions either upstream or downstream are basically the same.

ANALYSIS OF FUNCTIONAL DISCOUNTS

This article is based on the premise that detrimental effects on competition are engendered by the discrepancies between the economic and legal definitions of injury caused by functional discounts. In economic terms, injury occurs when two buyers purchase goods such that $P1/MC1 \neq P2/MC2$. On the other hand, legal injury only occurs when the following seven elements exist: (1) a seller makes two sales; (2) in interstate commerce; (3) to two or more different purchasers; (4) of commodities; (5) of like grade and quality; (6) at a price difference; (7) which produces a competitive injury.⁹⁰ With two different definitions, in some instances economic injury will result while legal injury does not occur, and in other cases there will be legal injury although there is no economic injury. The two definitions seldom agree.⁹¹

Four areas in present case law highlight the differences between the legal and economic definitions of injury. These four areas include: (1) the cost justification defense which does not allow a fair rate of return on invested distribution capital to be included in the statutory defense; (2) the indirect purchaser doctrine which allows the Federal Trade Commission to ignore an independent segment of the distribution chain, whereby all functions performed by an independent firm within the distribution chain are denied compensation; (3) the price-by-use doctrine which does not recognize the performance of valid functions by an integrated firm in the distribution chain; and, (4) the uniform price rule which allows a dual distributor to economically discriminate by ignoring the performance of functions by firms within the distribution chain, while at the same time not legally discriminating. Each of these areas will be briefly examined to determine the adverse effects on competition engendered by the discrepancies between the economic and legal definitions of injury caused by functional discounts.

90. See generally Blackford, *Survey*, *supra* note 21, at 287.

91. M. MASSEL, *COMPETITION AND MONOPOLY* 172 (1962).

Cost Justification

The cost justification defense was incorrectly applied in *FTC v. Thompson Products*⁹² when the Commission charged Thompson with a section 2(a) violation based on Thompson's lower prices to Ford, Chrysler, and General Motors as compared to auto part warehousemen. Thompson defended the lower prices utilizing the cost justification defense. As part of this defense, Thompson stated that it had invested 8.6 million dollars in distribution capital in selling its products to normal auto part warehousemen, but required no distribution capital in selling to Ford, Chrysler, and General Motors because of their willingness to receive shipments directly off the production line without warehousing. The Commission, however, refused to include this cost of capital in Thompson's cost justification defense, and ordered Thompson to stop charging the three automobile manufacturers lower prices than it charged auto part warehousemen. In light of this decision, an integrated wholesaler-retailer cannot expect any price concessions from suppliers based on cost savings in the form of a reduction or an elimination of distribution capital in selling to the integrated retailer-wholesaler. At present, the Federal Trade Commission does not allow a fair rate of return to be included in the cost analysis of an integrated buyer.⁹³ The economic effect of the denial of a fair rate of return on invested distribution capital results in a reluctance by firms in the distribution chain to experiment with new methods of distribution which require the expenditure of capital for distribution facilities. This unwillingness to experiment tends to stifle competition within the distribution markets.

Indirect Purchaser Doctrine

The indirect purchaser doctrine means that if the supplier controls the resale of its products by a wholesaler or jobber, then the supplier is liable for any price differences which appear be-

92. 55 F.T.C. 1252, 1276 (1959). See H. TAGGART, COST JUSTIFICATION 565 (1959); S. Nelson, An Economic Analysis of Antitrust Policy in the Automotive Industry, (Ph.D. Dissertation, University of Wisconsin, 1970) in *Hearings Before the Subcommittee on Antitrust and Monopoly of the Senate Judiciary Committee*, 91st Cong., 2d Sess. 2497, 2620 (Part 5 Appendix) (1970) [hereinafter cited as Nelson, Economic Analysis].

93. *Thompson Products* has been followed in later FTC decisions. See *FTC v. Borden Co.*, 62 F.T.C. 130, 180 (1963); *FTC v. Sperry Rand Corp.*, [1961-63 CCH TRANSFER BINDER] TRADE REG. REP. ¶ 16,350 (FTC 1963); *FTC v. Forster Mfg. Co.*, [1961-63 CCH TRANSFER BINDER] TRADE REG. REP. ¶ 15,729 (FTC 1962). See also Comment, *Price Discrimination—Functional Discounts: "Equal Opportunity to All?"* 9 UTAH L. REV. 626 (1965) [hereinafter cited as Comment, *Price Discrimination*].

tween sales to this indirect purchaser and sales to other purchasers. The indirect purchaser doctrine is normally applied when a jobber buying from a wholesaler has its price controlled by the supplier, which results in the jobber being considered the indirect purchaser of the supplier. The doctrine has been used to broaden the scope of the meaning of purchaser and purchaser liability under the Robinson-Patman Act.⁹⁴

The indirect purchaser doctrine originated in *Matter of Kraft-Phenix Cheese Corp.*⁹⁵ Kraft-Phenix solicited orders from retailers, issued suggested price lists which wholesalers usually followed and directly exchanged fresh cheese for the retailer's stale cheese. Based on these findings, the Commission stated: "A retailer is nonetheless a purchaser because he buys indirectly if, as here, the manufacturer deals with him directly in promoting the sale of his products and exercises control over the terms on which he buys."⁹⁶ The degree of control required before the indirect purchaser doctrine can be applied is a question of fact and, consequently, the determination must be made on a case by case basis. The supplier's control over price has emerged as the significant legal factor in this determination.⁹⁷ The United States Court of Appeals for the Third Circuit, however, has limited the scope of the doctrine by refusing to apply the indirect purchaser doctrine to private suits.⁹⁸ Although the Justice Department and the Federal Trade Commission may continue to use it, private litigants are precluded from relying upon this doctrine.

The necessity and present vitality of the indirect purchaser doctrine is suspect in view of the *Perkins*⁹⁹ case. Notwithstanding the sufficient overlap of control between the favored wholesaler, jobber, and retailer to warrant application of the indirect purchaser doctrine, the Supreme Court ignored the doctrine entirely, and instead applied a result-oriented test by looking at Perkins' injury and placing the legal liability on Standard. After *Perkins* the indirect purchaser doctrine's utility is dubious, at best. The lower courts, however, continue to apply the doctrine

94. 15 U.S.C. §§ 1, 13(a), (c), (f) (1970).

95. 25 F.T.C. 537 (1937).

96. *Id.* at 546.

97. See *Checker Motors Corp. v. Chrysler Corp.*, 405 F.2d 319 (2d Cir. 1969), *cert. denied*, 394 U.S. 999 (1969); *Hiram Walker, Inc. v. A & S Tropical, Inc.*, 407 F.2d 4 (5th Cir. 1969), *cert. denied*, 396 U.S. 901 (1970); *Dean Milk Co. v. FTC*, 395 F.2d 696 (7th Cir. 1968); *Schwartz v. Sunkist Growers, Inc.*, 203 F. Supp. 92 (E.D. Mich. 1962); *Massachusetts Brewers Ass'n v. Ballantine & Sons Co.*, 129 F. Supp. 736 (D. Mass. 1955). See also F. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 8 (Supp. 1964) for a compilation of Commission decisions focussing on the degree of control over price.

98. *Klein v. Lionel Corp.*, 237 F.2d 13 (3d Cir. 1956).

99. 395 U.S. 642 (1969).

where the supplier retains sufficient control over price in the resale of his product by the wholesaler or jobber.¹⁰⁰

One of the most controversial applications of the indirect purchaser doctrine has arisen in the automotive replacement parts industry, where the indirect purchaser doctrine has been applied to buying groups, resulting in the finding of violations of the Act by both suppliers and purchasers. Cooperative buying groups have been called the "third force" in today's modern economy because they enable small jobbers or retailers to combine and achieve the same economies as large, integrated wholesaler-jobber-retailers who are bargaining with the large suppliers.¹⁰¹ A buying group or cooperative is an organization of buyers who pool their orders to obtain better prices than would be available to them individually.¹⁰² The functions which a buying group performs at the next level of distribution can encompass all or none of the functions at that level.

A group of retailers constituting a buying group may simply combine their purchases and attempt to buy directly from a supplier, performing the same functions as those done by an integrated wholesaler-jobber-retailer. Alternatively, these same retailers may choose to combine orders and operate a warehouse for storing carload shipments, thereby performing many or all of the functions of a jobber and wholesaler. Although section 4 of the Robinson-Patman Act exempts buying groups and cooperatives from various legal penalties, this exemption does not include violations of section 2.¹⁰³

From an economic perspective, the price concession granted to a buying group should be based on the functions which the group performs. If a group of retailers merely combine their orders, then any price concession granted by a jobber (or supplier attempting to sell directly to them) should only compensate the re-

100. Although the Supreme Court did not deal with the indirect purchaser doctrine in *F.T.C. v. Fred Meyer, Inc.*, 390 U.S. 341 (1968), the *Fred Meyer* decision can be interpreted as eliminating the direct dealing and control requirements of the indirect purchaser doctrine with respect to disfavored customers, if the defendant has engaged in direct sales to the favored purchaser. See *Checkers Motors Corp. v. Chrysler Corp.*, 405 F.2d 319, 322 (2d Cir. 1969), *cert. denied*, 394 U.S. 999 (1969).

101. Address by Commissioner Philip Elman, The Annual Convention of the Cooperative Food Distributors of America, Miami Beach, Fla., May 2, 1966, in *Hearings Before the Special Subcommittee on Small Business and the Robinson-Patman Act*, 91st Cong., 2d Sess., at 1324 (1970).

102. Palmer, *Buying Groups Under the Robinson-Patman Act*, 42 CHI.-KENT L. REV. 143 (1965).

103. See, e.g., *Mid-South Distribs. v. FTC*, 287 F.2d 512 (5th Cir. 1961); *Kentucky Rural Elec. Cooperative Corp. v. Moloney Elec. Co.*, 282 F.2d 481 (6th Cir. 1960); *American Motors Specialities Co. v. FTC*, 278 F.2d 225 (2d Cir. 1960); *Southern California Jobbers, Inc.*, 1965 CCH TRADE REG. REP. ¶ 17,410.

tailers for the performance of this function. If, on the other hand, the retailers combine and perform all of the functions traditionally performed by a jobber, the group should receive the jobber price instead of the retail price.

The Federal Trade Commission's reaction to buying groups and their efforts to receive price concessions has varied between extremes.¹⁰⁴ In recent years, the Federal Trade Commission has applied the indirect purchaser doctrine based on a result-oriented test rather than on one of reasoned economic analysis. Simply stated, the Federal Trade Commission test looks at any price differential between competing group members and non-members, and incorrectly concludes that the members of a buying group are being favored over the non-members if the group price is lower.¹⁰⁵ The courts generally have followed reasoning similar to that of the Federal Trade Commission. Recently, however, the Ninth Circuit has begun to examine the functions performed by the buying group, rather than summarily affirming the Federal Trade Commission orders. In *Alhambra Motor Parts v. FTC*,¹⁰⁶ there were major differences in the methods by which manufacturers sold to defendant jobber-members as compared to independent jobbers, and thus the court held that the burden was on the Federal Trade Commission to show that the cost savings to manufacturers from selling to defendant were not commensurate with the price differential between the price received by defendant and the independent jobbers.

*Purolator Products, Inc. v. FTC*¹⁰⁷ is a recent case which highlights the Federal Trade Commission's position on buying groups and the indirect purchaser doctrine. *Purolator* dealt with "internal distribution discounts" granted by Purolator to affiliated jobber-wholesalers. In making its price comparison, the Federal Trade Commission applied both the indirect purchaser doctrine and the single entity theory. The single entity theory regards the buying group and its individual members as one legal entity. Purolator manufactured automotive replacement filters

104. *Standard Motors Prods., Inc.*, 54 F.T.C. 814 (1957), *aff'd*, 265 F.2d 674 (2d Cir.), *cert. denied*, 361 U.S. 826 (1959) (Commission issued a complaint against a supplier for granting a group a wholesale price); *Mennen Co.*, 4 F.T.C. 258 (1922), *rev'd*, 288 F. 774 (2d Cir. 1923) (Commission issued a complaint against supplier for refusing to grant a group a wholesale price).

105. See *Panel Discussion—Some Special Problems Under the Robinson-Patman Act*, 30 A.B.A. SEC. ANTITRUST 72 (1966), where Francis C. Mayer, Chief of the F.T.C. Division of Discriminatory Practices, stated:

. . . the critical point in these co-op wholesaler cases is the affiliation between the wholesaler and the retailer. If the lower price granted to the wholesaler can be traced to the retailer, then I don't think we have any problems.

106. 309 F.2d 213 (9th Cir. 1962).

107. 352 F.2d 874 (7th Cir. 1965), *cert. denied*, 389 U.S. 1045 (1968).

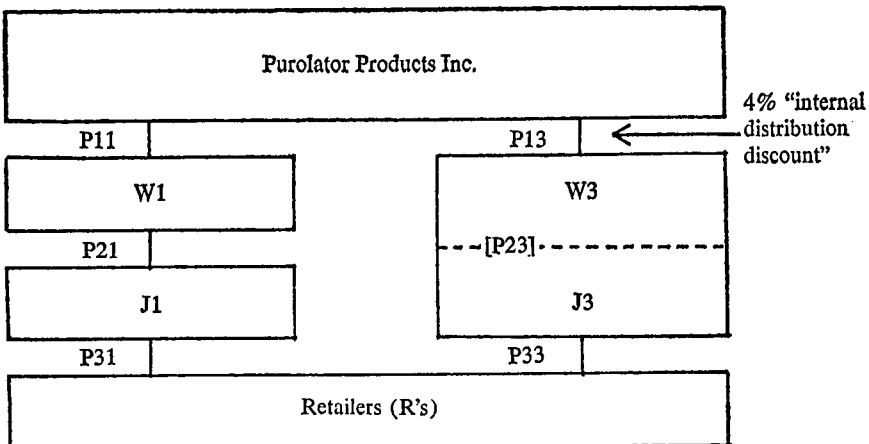
and sold them on a nationwide basis to both independent warehouses and jobber buying groups.¹⁰⁸

The right side (W3-J3) of the diagram in the footnote represents the jobber buying group acting as a wholesaler.¹⁰⁹ The Federal Trade Commission reasoned that jobbers received all of the benefit of Purolator's additional four percent "internal redistribution" discount, and consequently, the price P13 would be used as Purolator's price to the jobber buying group. Obviously, this four percent discount represented what Purolator considered a fair value for the performance of wholesale functions by the jobber buying group. The Commission, however, in using P13 as a standard of comparison, disregarded any functions performed by the jobber group at the wholesale level (W3) and any economies of vertical integration achieved by the buying group. The wholesaler's function of seeking out customers was eliminated by the buying groups as was the jobber's function of seeking out sources of supply. Consequently, the jobber buying group should have been encouraged to exploit this economy of vertical integration by receiving a lower price from the supplier. The supplier, however, could not include any expenses incurred by the buying group in his cost justification defense because the defense only includes seller cost savings.

The left side of the diagram represents a traditional independent wholesaler (W1) and jobber (J1). Purolator approved all jobbers to whom the wholesaler sold, imposed exclusive dealing or requirement contracts on the wholesalers, controlled jobber inventories, and effectively controlled the prices charged by W1 to

108. A complete treatment of the auto replacement parts market may be found in DAVISSON, *supra* note 5.

109. Relevant portions of Purolator Products, Inc., Distribution System.



J1 through suggested resale price lists. Based on its own policy, Purolator stipulated before the trial examiner that it reserved to itself the legal right to control sales to jobbers. The elements of the indirect purchaser doctrine being present, the Commission applied the doctrine and attributed the price P21 back to Purolator. By attributing P21 back to Purolator, the Commission necessarily ignored all of the functions performed by W1, such as providing investment in distribution capital, and consequently these functions were denied compensation.

After applying the indirect purchaser doctrine and the single entity theory by attributing the buying group price (P13) to the individual member jobbers (J3), the Commission reasoned that J1 and J3 competed with each other, and consequently, price P21 should be compared to P13. P21 represented a jobber price which economically should be higher than P11 due to W1 performing functions at the wholesale level. Assuming that the marginal costs of selling to W1 and W3 were the same, prices P11 and P13 should have been equal. The effect of the Commission's action was to compare prices at two different levels between two different channels of distribution without taking into account either the different functions performed at each level or the economies of vertical integration achieved by the two channels of distribution.

The Commission's *Purolator* decision was affirmed by the Seventh Circuit, which, for the first time, passed on the legality of the indirect purchaser doctrine in group buying cases. The court stated that the doctrine "appears to have a reasonable application to the facts of this case and a rational basis in law."¹¹⁰ As support for applying the doctrine, the court further remarked that if "the seller controls the sale, he is responsible for the discrimination in the sale price, if there is such discrimination."¹¹¹ This blind application of the doctrine is economically incorrect. The proper question in determining price discrimination is not the degree of control over the resale of products, but rather what functions are performed by the various entities at each level and in each channel of distribution. Only after these questions are answered can the proper prices be correctly compared to determine the extent of any price discrimination caused by the supplier in its pricing scheme.

Purolator appealed the Seventh Circuit decision to the Supreme Court, charging that the indirect purchaser doctrine had

110. 352 F.2d at 884.

111. *Id.* at 883.

no legislative foundation.¹¹² This ground of attack was technically correct; there is no explicit basis in the legislative history of the Robinson-Patman Act for the indirect purchaser doctrine. Once the doctrine was applied, however, it was evident that Purolator exercised sufficient control over the resale of its products by W1 and J1.

The Justice Department filed an *amicus curiae* brief in opposition to the position taken by the Federal Trade Commission. Commenting on buying groups in general, the brief stated that "where such integration produces significant economies, it should spur competition by forcing the competitors of the integrated entity to look for more efficient methods of distribution."¹¹³ The Department further stated that the present application of the indirect purchaser doctrine ignored the valid functions performed by W1 and allowed the J1 jobbers to compete unfairly with the J3 jobbers. The Department further noted that the doctrine "should only be used to compare prices paid by purchasers at the same level of distribution who presumably perform the same functions,"¹¹⁴ indicating that only the same level of distribution should be compared, and that within identical levels, the differing methods of distribution found in each channel of distribution should be considered before any valid price comparisons could be made. Based upon the Supreme Court's denial of certiorari in the *Purolator* case, the Federal Trade Commission's position on the indirect purchaser doctrine is still viable.¹¹⁵

Price by Use Rule

The price by use rule requires that the buyer's use of the product in reselling, rather than his buying capacity, determines the price which he legally should be charged for the product.¹¹⁶ Applying the rule to a specific situation, when a jobber integrates upstream and assumes all of the duties of the wholesaler (the next higher level of distribution), the price charged this jobber must legally be determined by the jobber's use of the product. Thus the jobber-wholesaler must legally receive the jobber price

112. Petitioner's Brief for Certiorari at 17-19, *Purolator Products, Inc. v. FTC*, 352 F.2d 874 (7th Cir. 1965), *cert. denied*, 389 U.S. 1045 (1968).

113. Brief for Justice Department as *Amicus Curiae* at 21, *Purolator Products, Inc. v. FTC*, 352 F.2d 874 (7th Cir. 1965), *cert. denied*, 389 U.S. 1045 (1968).

114. *Id.* at 23.

115. See generally Nelson, *Economic Analysis*, *supra* note 92. For a recent case applying the indirect purchaser doctrine see *Southern Gen. Builders, Inc. v. Maule Indus., Inc.*, 1973-1 CCH TRADE CASES ¶ 74,484 (S.D. Fla. Feb. 24, 1972).

116. *General Foods, Inc.*, 52 F.T.C. 798, 824 (1956). See generally ROWE, 1962, *supra* note 16, at 99; Comment, *Price Discrimination*, *supra* note 93.

even though the jobber-wholesaler is buying at the wholesale level and has performed all of the wholesale functions.

The price by use rule originated in *Mennen Co. v. FTC*,¹¹⁷ a 1923 case in which the court stated that "(i)t is not the character of his buying (the purchaser), but the character of his selling, which marks him as a wholesaler."¹¹⁸ Thus, the purchaser's use of the product in resale, not his buying capacity, determined the price which he had to pay. In a more recent Federal Trade Commission decision, it appeared that the principle of functional discounts would be accepted in place of the price by use rule.¹¹⁹ In 1962, however, the Federal Trade Commission returned to its previous position of applying the price by use rule,¹²⁰ which subsequently has been followed in numerous Commission decisions.¹²¹

Where the situation involves an integrated wholesaler-jobber-retailer, the price by use rule dictates that the integrated wholesaler-jobber-retailer be charged the retail price rather than a wholesale price.¹²² The economic effect of this legal rule is that an integrated wholesaler-jobber-retailer performs all of the wholesale and jobber functions without compensation. Using the Coase analysis, the price by use rule makes the internal cost of performing the functions at the wholesale and jobber level higher than the market cost of buying the services in the market. The law therefore acts as a positive disincentive against seeking economies of vertical integration.¹²³ Given the need for experimentation in new distribution patterns, the price by use rule hinders integrated wholesaler-jobber-retailers who are attempting to experiment by further vertical integration.

The price by use rule has also been applied against dual distributors, firms which sell at two different distribution levels.

117. 288 F. 774 (2d Cir. 1923), *cert. denied*, 262 U.S. 759 (1923).

118. *Id.* at 782.

119. *Doubleday & Co., Inc.*, 52 F.T.C. 169 (1955) (section 2(a) is not violated by defendant's granting a wholesaler discount on all purchases by an integrated wholesaler-retailer who actually performed the wholesale functions on all purchases. The nature of the purchaser's buying rather than the nature of his reselling was considered in granting functional discounts).

120. *FTC v. Mueller Co.*, 60 F.T.C. 120 (1962), *aff'd*, 323 F.2d 44 (7th Cir. 1963), *cert. denied*, 377 U.S. 923 (1964) (in his dissent, Judge Swygert clearly explains both the price by use rule and the functional discount).

121. *See, e.g., David Mann et al. Trading as Name Brand Distribs.*, 65 F.T.C. 497, 503 (1964); *General Foods Corp.*, 52 F.T.C. 798, 810 (1956); *Standard Oil Co. (Ind.)*, 43 F.T.C. 56 (1946) (the dissent by Commissioner Mason lampooned the Commission's application of the price by use rule); *Hansen Inoculator Co., Inc.*, 26 F.T.C. 303 (1938).

122. *See Belliston v. Texaco, Inc.*, 455 F.2d 175 (10th Cir.), *cert. denied*, 408 U.S. 928 (1972).

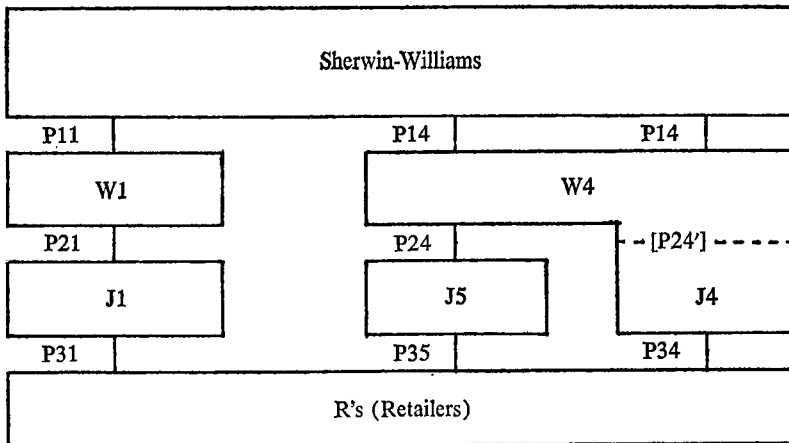
123. A. NEALE, *THE ANTITRUST LAWS* 9 (1970).

For example, a wholesaler may purchase all of its products from suppliers, but resell its products both to jobbers and directly to retailers (one step down the distribution ladder) thus competing with its own jobber customers. *In re Sherwin-Williams*¹²⁴ is an example of the interaction between the price by use rule and dual distributors. The diagram in the footnote represents the relevant portions of Sherwin-Williams' distribution system;¹²⁵ W4 represents a dual distributor. The Federal Trade Commission ruled that W4 received an unfair advantage in regard to the products which it sold through J4 by receiving price P14 for these products, as compared to other competing jobbers (J1 and J5) who only received the jobber prices (P21 and P24). The Commission, however, did not account for the different levels of distribution, comparing instead only the prices P21, P24, and P14. As remedial action it required Sherwin Williams to separately invoice all of its products sold to dual distributors such that the dual distributor would only receive the wholesale price (P14) for goods resold to jobbers (such as J5). On the remaining sales by the dual distributor at J4, the dual distributor was to receive only price P24. This separate invoicing procedure has been applied with approval in other Federal Trade Commission and court decisions.¹²⁶

The legal solution of separate invoicing is economically unsound. The economic result is that the dual distributor is penalized for its vertical integration of two levels within a distribution channel. The adverse economic effects can be seen in the

124. 36 F.T.C. 25 (1943).

125. Relevant portions of Sherwin-William's Distribution System.



126. See, e.g., *FTC v. Minneapolis-Honeywell Regulator Co.*, 191 F.2d 786 (7th Cir. 1951), cert. dismissed, 344 U.S. 206 (1952); *American Oil Co. & General Fin., Inc.*, 29 F.T.C. 857 (1939); *Albert L. Whiting, Trading as Urbana Laboratories*, 26 F.T.C. 312 (1938). See also *Tyranny of Labels*, supra note 41, at 592; CCH TRADE REG. REP. ¶¶ 3390.30, 3390.401, 29 FTC 584 (1939).

Standard Oil litigation of the 1950's.¹²⁷ Citrin-Kolb Corp. was a jobber which purchased gasoline from Standard and resold the gasoline to independent retailers. When the ownership of these independent retail stations changed hands, Citrin usually assumed the management of the stations during the interim period. For short periods of time, therefore, Citrin was acting as a dual distributor. Due to the application of the price by use rule, Citrin closed the retail stations to prevent its classification as a jobber from being changed to that of a retailer.

The apparent reasons for the Federal Trade Commission's continued application of the price by use rule are its ease of application and its predictability when applied.¹²⁸ The adverse effects on competition caused by the price by use rule outweigh the ease of administration and predictability of results. The market, rather than the Federal Trade Commission, should determine the most efficient distribution system.¹²⁹ Whether the distribution system is one of non-integration, symmetrical integration, scrambled functions, or a mixture of all three, the free play of competitive forces within the market, not legally imposed rules, should determine the distribution system which is used. The price by use rule ignores the performance of valid functions at each level of distribution above the level at which the buyer is reselling. This results in both sellers and buyers being reluctant to experiment with methods of distribution which include either partial or total vertical integration.

Uniform Price Rule

The uniform price rule, simply stated, means that a seller can, with legal immunity, charge all of its buyers the same price without regard to the cost of selling to each buyer.¹³⁰ A seller contemplating the use of functional discounts in its distribution system must contend with the previously discussed legal concepts of cost justification, the indirect purchaser doctrine, and the price by use rule. A logical solution to this dilemma is to charge every buyer the same price because a uniform pricing policy insures total immunity from legal liability under the Robinson-Patman Act.

After involvement in price discrimination litigation, many

127. Note, *Functional Discounts Under the Robinson-Patman Act: The Standard Oil Litigation*, 67 HARV. L. REV. 294, 306 (1953).

128. See Coase, *supra* note 85.

129. REPORT, *supra* note 10, at 208. See generally J. DIRLAM & A. KAHN, FAIR COMPETITION: THE LAW AND ECONOMICS OF ANTITRUST POLICY 251 (1954); Kelley, *Functional Discounts*, *supra* note 3, at 526.

130. See note 37 and accompanying text *supra*.

firms have adopted a uniform pricing policy.¹³¹ A uniform price, however, is not necessarily an economically non-discriminatory price. In all instances where buyers are performing different functions for the seller with varying marginal costs, a uniform pricing policy is economically discriminatory because $P_1/MC_1 \neq P_2/MC_2$.¹³² With the legally stimulated tendency toward a uniform pricing policy, the only way a seller could avoid economic price discrimination would be to vary each customer's marginal cost so that $P_1/MC_1 = P_2/MC_2$. This result is impossible because a buyer's marginal cost is independent of the seller's control.

The difference between economic and legal injury caused by a uniform price rule also hinders any experimentation within distribution markets. A seller cannot experiment with new distribution methods if it is pressured into a uniform pricing policy to insure immunity from legal liability. This liability leads to rigidity in distribution markets and, as a result, firms are not induced to experiment with new distribution systems which require different prices to different customers.¹³³

In comparison to a uniform pricing policy, an efficient economic pricing policy would induce buyers to perform additional functions and could result in the achievement of economies of vertical integration through the performance of these functions. Moreover, many economies of vertical integration are not immediately achievable.¹³⁴ The combined effect of the legal discouragement of partial vertical integration and the delayed effect of achieving any economies from vertical integration results in a negative inducement toward experimenting in distribution systems requiring partial integration.

A FINAL EVALUATION

The uniform price rule is pivotal to the problem of implementing discounts because each of the other problem areas discussed tends to pressure a supplier into adopting such a uniform pricing policy.¹³⁵ Thus, in the price by use area, a seller legally can ignore the separate invoicing requirement of dual distributors by charging all customers the same price. The economic result, however, is that any advantages resulting from dual distrib-

131. EDWARDS, PRICE DISCRIMINATION, *supra* note 9, at 338.

132. *Hearings Before the Subcommittee on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 84th Cong., 1st Sess., pt. 3, at 929 (1955) (remarks by Jesse Markham) [hereinafter Markham, *Hearings*].

133. EDWARDS, PRICE DISCRIMINATION, *supra* note 9, at 335; Markham, *Hearings* 931.

134. EDWARDS, PRICE DISCRIMINATION, *supra* note 9, at 344.

135. See generally Dam, *supra* note 44, at 1, 13-14, 57, 61-62.

ution and other vertically integrated distribution systems are lost. All of the problems discussed in regard to the cost justification defense can be ignored when a uniform pricing policy is utilized because this pricing policy insures immunity from legal liability. The uniform price rule and the indirect purchaser doctrine can be viewed as two sides of the same coin. Under the indirect purchaser doctrine prices at two different levels of distribution are incorrectly compared without consideration of the functions performed at the different distribution levels involved. Under the uniform price rule the prices are equal, resulting in no legal injury, yet different levels of distribution are again ignored.

It is apparent that this iron-clad rule permitting total legal immunity under a uniform pricing policy is an unsatisfactory answer to a complex problem. A more satisfactory procedure entails the examination of each function performed at each level and channel of distribution to determine the cost of the performance of that function. Only after this more difficult determination has been made can it be determined whether a uniform pricing policy is *economically* discriminatory.

One general recommendation is to properly define injury by use of a procedure which consistently compares the same level and channel of distribution. Prices from different channels and levels of distribution cannot be correctly compared unless their relative level and channel are taken into account. In the ensuing discussion, two specific solutions to the functional discount problem will be analyzed. First, the "due allowance" provision of the cost justification defense could be read broadly to encompass many previously ignored economic costs, such as a fair return on invested capital. If the cost of distribution capital were included in the cost justification defense, a supplier would not hesitate to experiment with new distribution methods which require additional capital. A second alternative to the present functional discount theory is to accept a break in the causal chain theory which negates the harm to competition requirement of section 2(a).¹³⁶ If the causal chain between discriminatory price and injury were broken by consumption of the functional discount by the buyer in the performance of those functions for which the discount was granted, no legal injury would have occurred. Performance of the services should be required of the buyer and the functional discount should include a reasonable profit for the performance of his services. Functional discounts so offered would have to be available equally to all buyers who qualify for such discounts.

136. See generally Comment, *Price Discrimination*, *supra* note 93.

A firm within a distribution channel will not perform a function unless the cost of performing the function internally is less than the market cost.¹³⁷ Without the legal acceptance of functional discounts, a seller cannot grant a discount for the performance of the function and thus reduce the buyer's internal price below the buyer's market price. A denial of compensation for the performance of a particular function would result in the total absorption of the cost of performance of the function by the buyer. The buyer will in all likelihood refuse to perform the function because the market price (its cost) will be lower than its internal cost. This results in effectively barring a seller from using functional discounts to experiment with new distribution methods and forcing him to remain bound to an existing, possibly inefficient, distribution system. Functional discounts, however, can be very useful in experimenting with new distribution systems.

A seller may "buy distribution" by granting various functional discounts to different classes of buyers,¹³⁸ and thereby induce competition. Buying distribution is an effective way to experiment with new distribution but, as seen in the previous discussion, sellers have great difficulty inducing buyers to perform additional functions (i.e., buying distribution) without the aid of functional discounts. The present functional discount case law creates differences in the legal and economic definitions of injury which results in firms being discouraged, rather than encouraged, to experiment with new distribution methods. The Federal Trade Commission and the courts should encourage functional discounts as a means of improving economic distribution. Such a change in the present legal view would enable the distribution channels to operate more efficiently, would stimulate competition, and would encourage innovative methods of distribution, thereby benefiting all participants in the economic marketplace.

137. See note 87 and accompanying text *supra*.

138. See note 5 and accompanying text *supra*.