21. Nonprice Vertical Restraints

Antitrust Law

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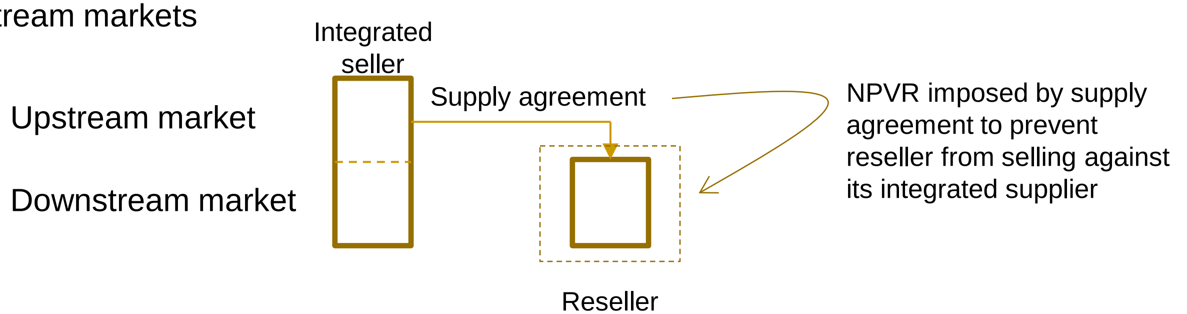
Nonprice Vertical Restraints

- Concept
  - Vertical restraints
    - Generally: Firm A agrees to sell its product to Firm B, but only on the condition that Firm B agrees to observe certain restrictions when it resells Firm A's product
    - *Nonprice vertical restraints*: Vertical restraints other than on the resale price
    - Price-related vertical restraints: Vertical restraints on the resale price
      - Commonly called resale price maintenance (covered in Unit 23)
  - Examples of nonprice vertical restraints
    - *Territorial restrictions*: Limit the geographic area in which the purchaser may resell the product (e.g., New York State, east of the Mississippi River, the United States)
    - *Customer restrictions*: Limit the customers to whom the purchaser may resell the product (e.g., a car manufacturer may restrict its dealerships from selling to national rental car fleets and reserve those sales to itself)
    - *Location restrictions*: Limit the locations from which the purchaser may resell the product (e.g., a car manufacturer may restrict a dealership to selling the manufacturer's car to a particular address)
- Question
  - Under what circumstances, if any, is the imposition of a nonprice vertical restraint a violation of the antitrust laws?

Nonprice Vertical Restraints

- Statutory coverage
  - Sherman Act § 1
    - Applies, since vertical restraints result from an agreement
    - Examples
      - Applies to any agreement between a supplier and a reseller that imposes restraints on the resale of the seller's product (the common situation)
      - Also applies to any agreement between supplier S and purchaser-reseller R1 that S will impose specified nonprice vertical restraints on any other resellers S supplies (presumably to protect R1)
  - Sherman Act § 2
    - In principle, in some circumstances a nonprice vertical restraint could be exclusionary
      - There is a separate question of whether it is *anticompetitively* exclusionary
    - Example
      - *Dual distribution*: Integrated seller restricts independent reseller from competing against seller in downstream markets



    - Section 2 is almost never invoked in practice
      - Easier to prove a Section 1 violation

Section 1 Analysis

- Elements of a Section 1 prima facie case
  - Plurality
    - Satisfied if the supplier and reseller are unrelated companies
  - Agreement
    - Vertical restraints are almost always imposed by a (written) agreement between the supplier and the reseller to govern a long-term supply relationship
      - A common example is a franchise agreement
    - The fact that a reseller is "coerced" into accepting a restriction that it does not want in order to obtain a supply commitment does not negate the existence of an agreement for Section 1 purposes
  - Restraint
    - By definition, a nonprice vertical restraint restricts the reseller's economic freedom of choice in reselling the supplier's product
  - Unreasonableness
    - *White Motor Co. v. United States*, 372 U.S. 253 (1963): Rule of reason
    - *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967): Abrogated *White Motor* and made nonprice vertical restraints per se unlawful
    - *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977): Abrogated *Schwinn* and returned nonprice vertical restraints to rule of reason treatment

Reasonableness Analysis

- Some examples
  - Promoting the efficiency of the supplier’s distribution system
  - Facilitating a horizontal reseller cartel
  - Promoting the interest of a dominant reseller

Reasonableness Analysis

- *Example*: Promoting the efficiency of the supplier's distribution system
  - The standard justification for nonprice vertical restraints
  - Paradigm example
    - Consider a supplier of a differentiated product that has important desirable but not readily apparent attributes that positively affect consumer demand. Making these features known to consumers is not costless and requires investment in promotion
    - If the reseller cannot capture the returns from its investment in promoting the product, it will not invest in promotion
    - To encourage the reseller to promote its product and shift the demand curve to the right, the supplier imposes a nonprice vertical restraint to—
      - Reduce or eliminate free-riding on the reseller's investment by other reseller's of the supplier's product
      - Reduce or eliminate direct competition from a perfectly substitutable product (the same product available from a different reseller) and provide the resellers with increased profits that can (in part) be invested in promotion
    - In this situation,
      - Promotion of the supplier's product should increase (shifting the demand curve to the right)
      - Resale prices of the supplier's product should increase because "intrabrand" competition from other resellers of the same product has been reduced or eliminated (decreasing the elasticity of the reseller's residual demand curve)
      - The resale price will be determined by "interbrand" competition from other products in the differentiated space
        - Interbrand competition should increase given the increased promotion of the seller's product

Reasonableness Analysis

- *Example*: Promoting the efficiency of the supplier's distribution system
  - Illustration
    - Courts
      - Overall effect on competition depends on whether the "increase in interbrand competition" is bigger or smaller than the "decrease in intrabrand competition"
        - If the increase in interbrand competition is greater than the decrease in intrabrand competition, then the restraint is procompetitive
        - If the increase in interbrand competition is less than the decrease in intrabrand competition, then the restraint is anticompetitive
      - WDC critique
        - This is not a operationally meaningful test and courts do everything they can to avoid determining this balance—almost no case has been decided using this test
        - A more operationally meaningful—but still challenging—test to apply looks to whether
          - The reseller in fact invested materially in promotion
          - As a result of the promotion, the overall unit demand for the supplier's output increased over what it would have been in the absence of the reseller's promotional activities
            - Need to look at total quantity demand of the supplier's product
            - Requires gross increased individual reseller demand due to promotion and the elimination of intrabrand competition to be offset by gross decreases in individual reseller demand due to the loss of competitive sales in intrabrand competition
        - As a general rule, consumer welfare increases even in the presence of a price increase if overall demand for the product also increases (because of better knowledge of the product's attributes)

Reasonableness Analysis

- *Example*: Promoting the efficiency of the supplier's distribution system
  - Criticism
    - Proponents of a per se rule approach argue that if the problem is promotion of the product, then either—
      - the supplier can promote the product itself, or
      - The supplier can impose promotional requirements on the reseller
      - more effectively than leaving the decision to the individual economic self-interest of the reseller and without the need for eliminating intrabrand competition through a nonprice vertical restraint
    - Proponents of a rule of reason approach respond—
      - The reseller may have informational advantages over the supplier in knowing what will work best in the local market
      - Since resources expended regardless of how the promotion occurs, the cost of sales will be higher than in a world without promotion, and hence the resale price is likely to be higher

Reasonableness Analysis

- *Example*: Facilitating a horizontal reseller cartel[1]
  - Illustration
    - The resellers of the supplier's product face little intrabrand competition. To ensure that they do not engage in significant intrabrand competition with one another that would erode their prices and profits, they induce the supplier to eliminate this competition through a nonprice vertical restraint
      - The most effective inducement for the supplier is for the resellers to share some but not all of their monopoly rents with supplier (say through higher wholesale prices), making the supplier better off with the reseller cartel than it would be without it. This makes the supplier a willing participate and more motivated to enforce the nonprice vertical restraints.
      - In the absence of coercion or sufficient side payments from the resellers to the supplier, there is no reason fro the supplier to go along with a horizontal reseller cartel, since it will reduce the demand for the supplier's product and the supplier's profits
  - Observations
    - There is no opposition to this as a theory of anticompetitive harm, but
    - It may not be practically meaningful, since the supplier (in principle) could always vertically integrate into downstream sales and capture all of the monopoly rents without violating the antitrust laws
      - A general rule is that the elimination of independent distributors and the vertical integration of a supplier into captive distribution is a form of refusal to deal that is not actionable under the antitrust laws
    - In any event, any horizontal reseller cartel would be per se unlawful as horizontal price fixing

[1] *See In re* New Motor Vehicles Canadian Export Antitrust Litig., 522 F.3d 6, 10 & n. 6 (1st Cir. 2008) (noting plaintiffs' theory).

Reasonableness Analysis

- *Example*: Promoting the interest of a dominant reseller
  - A dominant reseller seeks to reduce or eliminate any intrabrand competition it faces from rival resellers of the supplier’s product
    - This has the same incentive compatibility problem for the supplier as does the horizontal reseller cartel
      - In the absence of coercion or a sharing by the dominant reseller of its monopoly rents (supracompetitive profits) with the supplier, the supplier has no interest in accommodating the dominant reseller with a protective nonprice vertical restraint
      - The supplier can vertically integrate in distribution and capture all of the monopoly rents available at the downstream level

Reasonableness Analysis

- Observations
  - Nonprice vertical restraints can be procompetitive in some circumstances
    - So application of the per se rule would be inappropriate
  - Market power
    - If the supplier does not have market power in the upstream market, it is unlikely that any of its resellers could have market power in the resale of the supplier's product
    - In the absence of market power, a reduction in intrabrand competition should have no anticompetitive effect, so the supplier's market power serves as an initial screen for a possible anticompetitive effect
    - Many, if not most, suppliers imposing nonprice vertical restraints do not have market power
  - The rule of reason test when the supplier has market power
    - If the supplier has market power, the same economic test for assessing whether a nonprice vertical restraint procompetitively promotes the efficiency of the supplier's distribution system will detect a horizontal reseller cartel or the promotion of an anticompetitive NPVR imposed at the behest of a dominant reseller
    - Plus there is likely to be other evidence (e.g., emails) probative of the competitive effect of the restraints to help guide the analysis
  - Empirically, anticompetitive nonprice vertical restraints are extremely rare
    - Only a handful of cases since *GTE Sylvania* have found an anticompetitive NPVR
    - None of those cases make any analytical sense

Seminal Cases

White Motor Co. v. United States[1]

- Background
  - White Motor manufactures and sells trucks and truck parts to distributors and dealers, which operate under:
    - Territorial restraints that created exclusive territories
    - Customer restraints that precluded sales to government purchasers
- Complaint
  - Territorial and customer restrictions were per se unlawful under Sherman Act § 1
- Defense
  - Territorial restraints (exclusive territories)
    - To maximize sales, necessary to incentivize distributors and dealers to—
      - Take sales away from other competing truck manufacturers, not each other
      - Invest in promotion of the White Motor brand (need protection from free-rider problem)
    - Restraints foster competition rather than reduce it
  - Customer restraints (reserved government accounts)
    - *Environment*: Severe competition from other truck manufacturers for large accounts with continuing orders
    - Necessary to reserve government accounts to enable White Motor to efficiently compete with the largest discounts possible over the long term
      - This is probably a dynamic optimization problem: Need to avoid a dealer "hold up" problem in the sale of parts in the short run in order to maximize future sales of trucks
    - Also incentivized dealers to devote their all of their resources to selling trucks to the private sector

[1] 372 U.S. 253 (1963).

White Motor Co. v. United States[1]

- District court:
  - Held that the per se rule applied to the challenged vertical restraints
  - Granted summary judgment to government
- Supreme Court
  - Douglas (for majority)
    - Know too little as to actual impact of either type of restraint to reach a conclusion as their competitive effect

> This is the first case involving a territorial restriction in a vertical arrangement; and we know too little of the actual impact of both that restriction and the one respecting customers to reach a conclusion on the bare bones of the documentary evidence before us.[1]

  - Rejected DOJ's argument to analogize vertically imposed territorial restrictions to horizontal market division
    - To be per se unlawful, restraint must almost always have a "pernicious effect on competition and lack of any redeeming virtue" (*Northern Pacific*[2])
    - The competitive effect of restraints need to be determine at trial and the proper rule applied

[1] *White Motor*, 372 U.S. at 261.
[2] Northern Pac. Ry. Co. v. United States, 356 U.S. 1, 5 (1958).

White Motor Co. v. United States

- Supreme Court: Reversed (5-3)
  - Brennan (concurring)
    - Agrees that the Court knows too little about the effects of the challenged restraints to apply the per se rule, but offers some thoughts as to the types of problems the restrictions might raise
    - Territorial restraints
      - A form of restraint on alienation, which the antitrust laws have regarded as “inherently suspect”
        - But still may be justifiable in certain cases → premature to classify as per se illegal
      - Government analogy to horizontal market divisions misleading
        - Would apply per se rule if market division through exclusive territories was the result of an agreement by the distributors and dealers, even if formally implemented by the manufacturer
        - But here, an equally plausible inference from the record is that the territorial restrictions were forced upon unwilling dealers to serve the interest of the manufacturer in promoting interbrand competition
      - Questions for trial
        - Did the territorial restraints promote competition overall?
        - If so, were the restraints the least restrictive alternative?
    - Customer restraints
      - Inherently more dangerous, since eliminate all intrabrand competition for most desirable accounts
      - Not obvious how this promotes interbrand competition
      - In the absence of a competition-enhancing justification and if the dealers would have provided White Motor with significant competition for government accounts in the absence of the restriction, would find the restraint unlawful
        - Not clear whether Brennan reached this conclusion by applying the per se rule or as the result of a rule of reason analysis

White Motor Co. v. United States

- Supreme Court: Reversed (5-3)
  - Clark (dissenting, with Warren and Black):
    - Record shows this to be "one of the most brazen violations of the Sherman Act that I have experienced in a quarter of a century"[1]
    - Restraints create local monopolies in White Motor trucks
      - The customer "might buy another brand of truck, it is true, but the existence of interbrand competition has never been a justification for an explicit agreement to eliminate competition."[2]
      - Even worse than horizontal price-fixing agreements, "because price-fixing agreements, being more easily breached, must be continually policed by those forming the combination, while contracts for a division of territory, being easily detected, are practically self-enforcing."[3]
    - Per se rule should apply to both types of restraints
- Footnote
  - At the time of the Supreme Court decision, White Motor had discontinued selling through distributors and instead sold directly to dealers. Why do you think White Motor did this?

[1] *White Motor*, 372 U.S. at 276 (Clark, J., dissenting).
[2] *Id*. at 279.
[3] *Id*. at 279-80.

United States v. Arnold, Schwinn & Co.[1]

- Background
  - Schwinn, the nation's largest manufacturer of bicycles in the 1950s, sold and consigned bicycles through a series of wholesale distributors and licensed retailers
    - 1952 market share: 22.5%
    - 1961 market share: 12.8% (although its dollar and unit sales had increased substantially)
  - *Distributors sales*: By contract, Schwinn imposed restrictions on its distributors as to the resale of its bicycles
    - *Territorial restrictions*: Each distributors could only sell in a contractually-specified exclusive territory
    - *Customer restrictions*: Each distributors could only sell to licensed Schwinn dealers
  - *Consignment and agency*
    - Schwinn sold bicycles directly to licensed retailers through consignment or agency arrangements with distributors
    - Schwinn sold bicycles directly to licensed retailers under the so-called "Schwinn Plan," which involved direct shipment by Schwinn to the retailer and the payment of a commission to the distributor taking the order
    - In either case, Schwinn sold only to licensed retailers
  - *Retailers*: Can only sell to the public, not to nonfranchised retailers
- DOJ Complaint (1958)
  - Schwinn's restraints restricted intrabrand competition and were per se unlawful
    - No allegation that interbrand competition was affected

[1] 388 U.S. 365 (1967).
[2] *Id*. at 382.

United States v. Arnold, Schwinn & Co.

- District court
  - Restrictions on resale were per se unlawful
    - Injunction against territorial restrictions on distributor resales (i.e., where the distributor resells as a principal)
  - Consignment and agency arrangements did not violate antitrust laws
- Supreme Court: Reversed (5-2)
  - Direct appeal under the Expediting Act
    - DOJ: Abandoned claim of per se illegality; sought review under the rule of reason
    - DOJ: Distributor territorial exclusivity unlawful regardless of form (sale, consignment, or agency)
    - DOJ: Customer restrictions limiting sales to licensed retailers unlawful
  - Fortas (for the majority)
    - Initial observations
      - No horizontal restraints or horizontal price fixing—presented as a pure nonprice vertical restraint case
      - Schwinn was not a new entrant or a failing company, but rather the nation's largest bicycle manufacturer

United States v. Arnold, Schwinn & Co.

- Supreme Court: Reversed (5-2)
  - Fortas (for the majority) (con't)
    - *On restricted resales*: Although the DOJ sought a decision under the rule of reason decision, the majority instead applied the per se rule as a restraint on alienation:

      > Once the manufacturer has parted with title and risk, he has parted with dominion over the product, and his effort thereafter to restrict territory or persons to whom the product may be transferred—whether by explicit agreement or by silent combination or understanding with his vendee—is a per se violation of § 1 of the Sherman Act.[1]

      - Applies to
        - Territorial and customer restraints
        - Distributors and retailers
    - *On consignments and agency*: Rule of reason applies
      - Since no effect on interbrand competition, no violation under the rule of reason
  - Stewart (dissenting, with Harlan)
    - Agree that consignment and agency restrictions are subject to the rule of reason
    - Sales restrictions should also be subject to the rule of reason
      - Both sales and consignment restrictions designed to make Schwinn more competitive in the overall bicycle market
      - Error to overrule *White Motor*: Court has learned nothing new in four years
      - Rule against restraints on alienation
        - Ancient
        - By 1711, applied only to unreasonable restraints
          - Cites *Mitchell v.* Reynolds, but this is a case on ancillary restraints, not alienation

[1] *Schwinn*, 388 U.S. at 382.

Continental T.V., Inc. v. GTE Sylvania Inc.[1]

- Background
  - Sylvania manufactures and sells TV sets
    - Prior to 1962, sold through distributors, which in turn sold to retailers
    - In response to a decline in market share to 1-2%, shifted to a franchised system and sold directly to retail franchisees
      - Limited the number of franchisees in each area, but no exclusive territories
      - Restricted franchisees to selling only from a specified location
    - By 1965, market share had increased to 5%
- Complaint
  - Resulted from ruptured franchisor-franchisee relationship
    - Continental, one of the most successful Sylvania franchisees, objected to Sylvania franchising another retailer (Yong Brothers) in the San Francisco area
    - Continental sought another franchised location in Sacramento, but Sylvania refused
    - Continental advised Sylvania that it was moving Sylvania TVs from its franchised location in San Jose to a nonfranchised location in Sacramento
    - Sylvania terminates Continental's franchises, finance company sues Continental to recover money owed and secured merchandise, and Continental cross-claims against Sylvania and finance company
  - Antitrust claim:
    - Sylvania violated Section 1 by entering into and enforcing franchise agreements that prohibited the sale of Sylvania products other than from contractually-specified locations

[1] 433 U.S. 36 (1977).

Continental T.V., Inc. v. GTE Sylvania Inc.

- District court
  - Rejected Sylvania's rule of reason instruction to the jury and gave a per se rule instruction instead
  - Jury: found for Continental and assessed damages at $591,505 (trebled to $1,774,515)
- Ninth Circuit (en banc): Reversed
  - Distinguished *Schwinn*—rule of reason should have applied
    - Nature of restrictions much different
    - Sylvania had very small market share
    - Sylvania's restrictions much less competitively threatening
- Supreme Court: Affirmed (6-2)
  - Powell (for majority)
    - *Schwinn* per se rule governs unless overruled
      - Ninth Circuit "erred" in distinguishing cases
    - But *Schwinn* result cannot be justified under *Northern Pacific* test
      - *Schwinn* overruled *White Motor* with no explanation for change
      - Market impact of vertical restrictions complex: potential for simultaneous reduction of intrabrand competition and stimulation of interbrand
      - Restrictions may produce procompetitive marketing efficiencies (e.g., eliminating "free rider" problems)
    - Rule of reason should apply for reasons stated in *White Motor*

Continental T.V., Inc. v. GTE Sylvania Inc.

- Supreme Court: Affirmed (6-2)
  - White (concurring in judgment)
    - *Sylvania* restraints distinguishable from those in *Schwinn*, so there is no need to overrule *Schwinn*
      - On intrabrand competition:
        - Sylvania location clause permits intrabrand competition
        - Schwinn air-tight territorial and customer restrictions did not
      - On interbrand competition:
        - Schwinn was a “leading producer” with a premium image
        - Sylvania had a minimal market share and no brand image
      - Better to limit *Schwinn*
        - Easy to create de minimis exception
        - *Schwinn* rule consistent with promoting freedom of businessmen to dispose of own goods
        - Economic arguments against per se rule for nonprice vertical restraints work equally well against price-related vertical restraints
  - Brennan (dissenting)
    - One sentence:
      - Would not overrule *Schwinn*
      - Would reverse Ninth Circuit