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THE RULE OF REASON AND THE PER SE CONCEPT: PRICE FIXING AND MARKET DIVISION*

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II

THE first section of this article¹ argued that the uncertainty and inconsistency which patently afflict the law concerning price fixing and market division are attributable to the twofold failure of Sherman Act courts to be clear about the ultimate values the law implements and to develop a realistic analysis of the economic phenomena with which the law is required to deal.

The main tradition of the Sherman Act's rule of reason—established by Justice Peckham, Judge Taft, and Chief Justice White in 1911—necessarily rests, whether phrased in such terms or not, upon the premise that the law's exclusive concern is with the maximization of wealth or consumer want satisfaction. Though this premise is not the only one upon which social legislation may be based, it is implicit—and sometimes explicit—in the key decisions which established the main tradition of the rule of reason, and it is, moreover, the only premise capable of producing rational decisional law under the Sherman Act as now written. Acceptance of consumer want satisfaction as the law's ultimate value requires the courts to employ as their primary criterion the impact of any agreement upon output, and thus to determine whether the net effect of the agreement is to create efficiency, and thereby increase output or, alternatively, to restrict output.² This common acceptance of the wealth-maximization premise and its inherent standards of judgment explains why the interpretations given the Sherman Act by Peckham, Taft and White, despite their widely differing phrasings, were so similar in result, and why each

1. Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division I*, 74 YALE L.J. 775 (1965).

2. Peckham, Taft, and White all displayed concern that the law not destroy efficient forms of combination but that it strike down combinations whose sole effect was the elimination of competition. *Id.* at 783-805, 829-32. White most explicitly defined the evil to be avoided as restriction of output because his version of the common law, which he incorporated into the Act, viewed the evils of monopoly as: (1) the power to fix price; (2) the power to limit production; and (3) the danger of deterioration in quality. *Id.* at 802. These evils are each reducible to restriction of output. The second—limitation of production—is obviously that. The first—the power to fix prices—can be wielded only by restricting output. The third—deterioration in quality—is merely a restriction of output accomplished by putting less into each item produced rather than making fewer items.

The net effect of the two opposing tendencies—efficiency and restriction of output—determines whether the questioned agreement is efficient in the larger sense of allocating resources to maximize consumer want satisfaction. In order to avoid confusion, the narrower meaning of efficiency will be used throughout this article. The broader meaning will be indicated by such phrases as consumer want satisfaction, wealth maximization, etc.

assigned a prominent place within the rule of reason to a category of agreements illegal per se.

The primary deviant tradition of the rule of reason—originally espoused by Justice White in 1897 and in 1918 by Justice Brandeis—rejects consumer welfare as the sole value of the law and admits competing considerations, most notably, perhaps, concern for small producers. The criteria required by the simultaneous use of wholly inconsistent values are necessarily either arbitrary or indefinable. Probably because this deviant strain has never become dominant, the criteria of the Brandeis tradition have in fact remained rather vague. They seem reducible, however, to the idea, early rejected by the judges of the main tradition, that a cartel should be judged by the “reasonableness” of the price it fixes. White’s 1897 *Trans-Missouri* dissent is thus to be equated with Brandeis’ reading of the Act in the 1918 *Chicago Board of Trade* opinion. The introduction of values incompatible with consumer welfare, values that could, in fact, be furthered by cartel agreements at the expense of consumers, was the reason that neither White (in 1897) nor Brandeis (in 1918) gave a prominent, or perhaps any, role to the per se concept.

The main tradition, with its insistence upon efficiency and restriction of output as the standards of the Sherman Act, is, therefore, entitled to be preferred not merely as a matter of precedent but also because of its exclusive ability to achieve those attributes of rationality, efficacy, tolerable certainty, and the proper demarcation of the respective functions of legislature and judiciary which are characteristics of good law.³

Though a proper choice of values is necessary to good law it is not sufficient. The Sherman Act, which deals with price fixing and market division in widely varying business contexts, requires a coherent analytical structure to translate values into conclusions. The Act, however, has not evolved doctrine adequate to cope with this diversity of phenomena. Too often the law deals with particular forms of price fixing and market division as isolated and unique topics, neglecting to locate each within a rational conception of the whole. Perhaps just as often the law commits the opposite error of failing to make distinctions corresponding to economic differences, and applies broad formulas to situations in which they are wholly inappropriate. This second section of a three-part article attempts to provide a general theory capable of

3. 74 YALE L.J. 775, at 829-47 and particularly at 831-32, 840-47.

making the law of price fixing and market division internally consistent, congruent with the law of similar behavior, and effective in serving consumer welfare.⁴

THE RULE OF REASON: ANCILLARY RESTRAINTS AND THE
PER SE RULE

Much of the Sherman Act's doctrinal chaos is attributable to judicial and scholarly fondness for impossibly broad statements of the per se rule. The warmth and security that sweeping, absolutist formulations offer is likely to prove here, as in other areas of the law, the forerunner of icy intellectual demise. It is frequently said that any agreement to eliminate competition is per se illegal,⁵ but the inescapable fact is that an agreement which eliminates competition is basic to almost every productive unit consisting of more than a single person. The agreement may be spelled out or, more often, may be tacit, but, to the degree that coordination of the productive activities of persons is achieved, actual or potential competition must be eliminated. Holmes's *Northern Securities* dissent demonstrated that an all-embracing rule against the elimination of competition would require the atomization of society. Such a rule is inconceivable.⁶

The problem is to devise a per se rule which avoids the dilemma Holmes foresaw not by illogical refusal to apply the rule, but through

4. The third section of this article will attempt to apply the theory to a number of particular topics (for example, price-fixing and market-division provisions in patent and know-how licenses) which appear to have created considerable conceptual difficulty.

5. As so used "competition" does not mean the presence in a market of a sufficient number of sellers to insure competitive behavior but merely a condition of rivalry between business units. This distinction corresponds to the semantic shift between Peckham in *Trans-Missouri* and *Joint Traffic* and White in *Standard Oil* and *American Tobacco*. Peckham was able to read the Sherman Act as forbidding every agreement in restraint of trade by equating that phrase to the elimination of a competitive structure. White was able to deny that the statute forbade every restraint, without changing Peckham's test, by equating the term to the elimination of rivalry. In accordance with White's usage, which has become accepted in the law, references in this article to restrictions or eliminations of competition are to be taken to mean restrictions or eliminations of rivalry. Similarly, restraint of trade means restraint of rivalry and not restraint of output. A restraint of trade becomes "unreasonable" only under those conditions, discussed in the text, when its primary effect, if it has any effect, is presumed to be a restriction of output.

6. It is thus quite possible that a modern society should permit all forms of industrial, agricultural, and commercial combination—indeed, a number have approximated such a policy—but it is utterly inconceivable that anything recognizable as a society should prohibit all. As Professor Arthur L. Corbin puts it, perhaps understating the case: "Atomization [of productive units] would be as beneficial as a nuclear explosion." Letter from Arthur L. Corbin to Robert H. Bork, June 27, 1965.

the distinctions provided by its own rationale. The solution may be found by defining the rule in terms of consumer welfare.

The Present Confusion Concerning the Per Se Rule

Failure to define the scope of the per se rule in terms of consumer welfare may account for the Supreme Court's marked inability, to date, to describe the contours of the per se rule satisfactorily. Something of the inadequacy of current definitions may be seen by analyzing the views of Justice Clark and Justice Douglas in *White Motor*⁷ and *Penn-Olin*.⁸ Justice Douglas's opinion for the Court in *White Motor* stated that lack of economic information made it premature to decide whether a per se rule should be applied to vertical market-division agreements by which a manufacturer required its resellers to sell only to customers located within their respective assigned territories.⁹ Justice Clark insisted in dissent, however, that "To admit, as does the petitioner, that competition is eliminated under its contracts is, under our cases, to admit a violation of the Sherman Act. No justification, no matter how beneficial, can save it from that interdiction."¹⁰ It was Justice Clark's ill fortune to be confronted not long afterward, in *Penn-Olin*, with a case involving the suggested application of both amended section 7 of the Clayton Act and section 1 of the Sherman Act to the formation of a joint venture corporation. The government attacked the transaction on the theory that the formation of the joint venture, set up to make and sell sodium chlorate in the southeastern United States, eliminated probable competition between the parent corporations. A majority of the Court remanded the case for further findings on the section 7 issue. Justice Clark's opinion for the Court is instructive, however, because he was faced with the paradoxes of his position in *White Motor*. Though these paradoxes are inherent in that position, the fortuitous overlapping of section 1 and section 7 in *Penn-Olin* laid them bare.

Despite the absence of an explicit agreement to eliminate competition between the parents or between the parents and their joint subsidiary, Justice Clark necessarily held that section 7 applied. He argued, it would seem correctly, that it was realistic to recognize that neither parent was likely to enter the market to compete with the joint offspring.¹¹ Given the reality of that assumption, the point could hardly

7. *White Motor Co. v. United States*, 372 U.S. 253 (1963).

8. *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158 (1964). *White Motor* and *Penn-Olin* are also compared in the first section of this article, 74 YALE L.J. 775, 777-80.

9. 372 U.S. at 261.

10. 372 U.S. at 281.

11. 378 U.S. at 168, 173.

have been decided otherwise. To have required an explicit suppression of competition would have made section 7 a dead letter in horizontal merger cases.

In a rather less felicitous argument, however, Justice Clark also suggested that the absence of an explicit agreement not to compete rendered section 1 of the Sherman Act inapplicable.¹² He may have felt forced to this position because application in *Penn-Olin* of his sweeping *White Motor* formula outlawing all contracts that eliminate competition would have compelled two bizarre conclusions: every horizontal merger accomplished after 1890 was illegal without regard to market share; and the original section 7 of the Clayton Act, as well as its 1950 amendment, as they applied to horizontal mergers at least, were either complete surplusage or dilutions of more stringent Sherman Act standards.

Though he avoided these absurdities, Justice Clark's solution (of restricting section 1 to explicit eliminations of competition) is hardly preferable. The distinction between explicit and implicit eliminations of competition rests upon no discernible policy, as Justice Clark himself persuasively demonstrated when arguing for the application of section 7 of the Clayton Act to the same transaction. The distinction is, moreover, a curtailment of section 1 contrary to the language of the statute.¹³ Finally, it is directly opposed by many important Sherman Act precedents which the Court certainly did not wish to overrule,¹⁴ among them the *Lexington Bank* case,¹⁵ which, in that same term, had applied section 1 of the Sherman Act to strike down a horizontal merger despite the absence of any explicit agreement not to compete—in an opinion subscribed to by Justice Clark.

12. "[R]eaching the merits, we hold that . . . on the present record there is no violation of § 1 of the Sherman Act. . . ." *Id.* at 161. The only explanation offered is the Court's subsequent remark: "There being no proof of specific intent to use *Penn-Olin* as a vehicle to eliminate competition nor evidence of collateral restrictive agreements between the joint venturers, we put those situations to one side." *Id.* at 176.

13. Section 1 of the Sherman Act forbids "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce. . . ." Sherman Anti-Trust Act § 1, 26 Stat. 209 (1890), as amended, 15 U.S.C. § 1 (1964). This language in no way requires that the parties to a contract, combination, or conspiracy articulate a purpose to eliminate competition before they may be held to have created a restraint of trade.

14. *Northern Securities Co. v. United States*, 193 U.S. 197 (1904), for example, was decided primarily upon § 1 grounds and contained no explicit agreement not to compete. Most of the early cases employed § 1 and § 2 interchangeably so that § 1 applied to all horizontal merger cases. This construction of § 1 continues into the present, see note 15 *infra*.

15. *United States v. First Nat'l Bank & Trust Co. of Lexington*, 376 U.S. 665 (1964).

Justice Douglas dissented in *Penn-Olin*, arguing that Sherman Act cases holding market-division agreements illegal per se should be applied under section 7 to strike down the joint venture agreement.¹⁶ He did not discuss the difficulty, suggested above, that such reasoning would render all horizontal mergers accomplished since 1890 illegal. He did suggest that his position here could be reconciled with his majority opinion in *White Motor* refusing to hold market division per se illegal. *Penn-Olin*, he noted, was a horizontal case and *White Motor* was vertical.¹⁷ Justice Douglas did not indicate why that distinction made a difference. In fact, in *White Motor*, he had indicated that the distinction did not make a difference in price-fixing cases where both horizontal and vertical arrangements are per se unlawful.¹⁸

Viewing the two cases together, it may seem likely that Justices Clark and Douglas, as well as a majority of the Court, would at least agree that explicit horizontal eliminations of competition fall within the per se rule. Yet even that conclusion may not be true, and such a rule would seem improper. Its impropriety, as well as the correct rationale for the per se rule, may be suggested by a discussion of partnership agreements containing promises of the partners not to compete with the partnership.

The Respective Functions of the Per Se Rule and the Doctrine of Ancillary Restraints

The partnership is one of the oldest examples in antitrust literature of lawful integration. Partnership is also typically a horizontal arrangement. Justice Peckham cited it as a lawful elimination of competition in *Joint Traffic*.¹⁹ Holmes argued from its assumed legality in *Northern Securities*.²⁰ Taft, in *Addyston Pipe & Steel*, went further and listed the agreement of partners not to compete as one of five ancillary restraints of trade lawful at common law²¹ and, he implied, also lawful under the Sherman Act. The rationale for the legality of this explicit elimination of competition offers a solution to the conceptual difficulties illustrated in the *White Motor* and *Penn-Olin* decisions.

Taft argued that the elimination of competition inherent in the joining of men as partners was justified because "this effect was only

16. 378 U.S. at 181-82.

17. *Id.* at 177-78 n.1.

18. 372 U.S. at 260.

19. *United States v. Joint Traffic Ass'n*, 171 U.S. 505, 567-68 (1898).

20. 193 U.S. at 410-11.

21. *United States v. Addyston Pipe & Steel Co.*, 85 Fed. 271, 281 (6th Cir. 1898).

an incident to the main purpose of a union of their capital, enterprise, and energy to carry on a successful business, and one useful to the community.”²² One may, however, grant that partnership, in the absence of monopoly power at least, is, like other forms of integration or combination, socially desirable, and yet ask why allowing the partnership is not enough. Why should the Sherman Act permit, in addition, an agreement by the partners not to compete with the partnership? It might appear that leaving the individual partners free to take business for the firm or individually would best determine in which instances integration is the more efficient mode of operation and in which disintegration is. Assuming the partnership to lack monopolistic control of the market in which it operates, one complete answer is that the partners must think a general agreement against competition with the firm is most conducive to efficient operation. They could have no other motive for making the agreement. At worst, if there are situations in which individual operation would be more efficient, the agreement must nevertheless, on balance, create more efficiency than inefficiency, and the partners must believe that overall efficiency is best served by not trying to sort out the separate situations.

It may be stated as a general rule, then, that where there is some integration of activities, and when market share is too small to make restriction of output profitable, the purpose of an agreement eliminating competition must be the creation of efficiency. It would theoretically be possible, therefore, to decide the legality of all horizontal price-fixing and market-division agreements which protect integrations of activities by the aggregate market power of the parties. It will be desirable, nevertheless, to frame a general theory of the ways in which market division and price fixing may create efficiency in order to buttress the argument.

Taft suggested the theory of efficiencies when he stated: “Restrictions in the articles of partnership upon the business activity of the members, with a view of securing their entire effort in the common enterprise, were, of course, only ancillary to the main end of the union, and were to be encouraged.”²³ By “ancillary” Taft meant that the agreement was subordinate to the main transaction, the partnership, and causally related to its efficiency.²⁴ This definition required that the agreement be no broader than the need it served. It is desirable, how-

22. *Id.* at 280.

23. *Ibid.*

24. *Id.* at 282.

ever, to be somewhat more specific about the nature of the causal relationship than Taft was. One obvious function of an agreement not to compete in the non-monopolistic partnership case is the prevention of what may be called the "free ride" problem. One or more of the partners must be prevented from appropriating to themselves as individuals the contributions of other partners. If such appropriation occurs, the victimized partners will almost certainly decrease or stop altogether their contributions to the partnership activity. The result will be a less effective partnership in that the efficiencies of combination or integration will be less completely realized than they otherwise might have been. This decay of efficiencies is prevented by requiring of each partner an agreement not to compete with the firm. Each then becomes free to contribute fully without fear of being victimized and the partnership is enabled to become a more efficient unit.

The problem of the free ride may deteriorate the efficiencies of partnership in a variety of ways. In order to further the prosperity of the firm, for example, the various members may specialize in different lines of activity and may make known to the community the excellence of the specialists. If business comes to one partner because of a reputation so gained and he takes it for his individual profit, he has taken a free ride upon the sacrifice of the other partners in leaving that line of specialization to him and in helping to make his ability known. It would often be difficult or impossible to prove that particular pieces of business were ultimately engendered by the firm in this fashion, but to the extent that the other partners suspect that such parasitical behavior is occurring they will be less willing to leave areas of specialization to each other and less willing to advertise each other's merits to the community. Partners will also be less willing to share assets such as specialized knowledge and competence, unique business methods, customer contacts, and the like, when there is a danger that other partners may appropriate the contributions to their individual profit.

Considerations such as these probably underlay Taft's remark that an ancillary agreement eliminating competition is a way of securing to the joint enterprise the entire effort of the partners. For the Sherman Act to allow the partnership to be formed in the interest of increased efficiency, but to disallow the ancillary agreement which makes the integration more stable, and hence further increases its efficiency, would be a pointless contradiction in policy.

Taft's basic insight, then, was that the fundamental criterion for lifting combinations and agreements not to compete out of the category of *per se* illegality was neither their explicitness or implicitness,

nor their horizontal or vertical nature, but their capacity for contributing to efficiency.

This formulation also makes it possible to bring the law of close-knit combinations and loose combinations into symmetry.²⁵ The significant difference between a partnership as such and the agreement not to compete which protects it is the same as the difference between a merger and an agreement to fix prices or divide markets. The difference in both cases lies simply in the relative visibility of efficiency-creating potential. That is, when companies merge or individuals unite in a partnership it can never be stated flatly that no efficiencies may result.²⁶ The case is different with respect to agreements not to compete—of which price-fixing and market-division agreements are merely a sub-category—simply because it is obvious that some of them do not contain any possibility of creating efficiency. Generalizing from the partnership case discussed, one category of agreements which cannot create efficiency are those which do not accompany a combination or integration of other productive efforts of the parties. Thus, if competitors agree to divide markets and do nothing else, it is plain that there is no integration which is being made more effective. The result, if the agreement has any effect whatever, can only be the restriction of output. The second category consists of agreements not to compete which are incapable of adding to the efficiency of the integration which they seemingly accompany. Thus, a market-division agreement between competitors who jointly maintain a product safety testing laboratory could not be related to the efficiency of the joint laboratory.²⁷

25. As used here, a close-knit combination is a combination by ownership and a loose combination is one accomplished by agreement of otherwise independent firms. Loose combination thus encompasses both cartels and cooperative productive or distributive activities by firms which remain separately owned.

26. An important reason is that many of the most important efficiencies are intangible: for example, the ability of the partners to specialize and so avoid the inefficiency of attempting to handle too many matters or matters for which one or the other has no particular aptitude. Mergers may create a variety of efficiencies whose existence cannot be denied with certainty. See, *e.g.*, the efficiencies which determine the best size of a business unit listed in ROBINSON, *THE STRUCTURE OF COMPETITIVE INDUSTRY* 12 (rev. ed. 1958). In addition, managerial efficiency may not be merely a question of the size of the business unit but of the quality of management which is brought to a unit by merger or by contract. Another factor making it impossible to deny the existence of efficiencies in advance is that they may develop gradually and not be immediately perceivable. The important point is that in all combinations or integrations, whether accomplished by ownership or contract, there exists the possibility of increased efficiency.

27. The findings of the laboratory could be used by all the participating manufacturers and there appears to be no theory which indicates that the efficiency of the laboratory would be improved if the manufacturers eliminated competition between themselves. See discussion at pages 449-51, *infra*. *Appalachian Coals* contained restrictions on

These two categories define the proper scope of the per se rule: agreements eliminating competition which have no efficiency-creating potential. Following the common law terminology, agreements in the per se category may be termed "naked" to distinguish them from "ancillary" restraints.

The difference in relative visibility of efficiency-creating potential is undoubtedly the reason the early Sherman Act courts created a per se rule for certain loose arrangements but never created such a rule for close-knit arrangements such as mergers.²⁸ The ancillary-naked distinction is a way of making the rationale of agreements not to compete symmetrical with that of the merger or close-knit combination cases. Once the category of visibly naked restraints is set aside as per se illegal, the category of ancillary agreements is seen to be the same economic phenomenon as the category of mergers or close-knit combinations. Their difference is merely one of legal form: the difference between integration accomplished by contract and integration accomplished by ownership.²⁹ Since the Sherman Act attempts to look beyond legal form to economic substance, ancillary restraints and mergers should be treated similarly. It follows, of course, that a finding of ancillarity does not render a restraint automatically lawful. The function of the ancillarity concept is merely to take the questioned agreement out of the per se category and subject it to the Act's remaining tests—market share and intent.

The Propriety of a Per Se Rule

The propriety of any true per se rule—one which disregards questions of market power and intent—has occasionally been questioned. The most common objections seem to be, first, that there can scarcely

competition which were, on their face, incapable of adding to the efficiencies of the joint sales agency they accompanied. See 74 YALE L.J. 775, 822-25.

28. Even amended § 7 of the Clayton Act, 64 Stat. 1125 (1950), 15 U.S.C. § 18 (1964), as written, and as (increasingly) stringently interpreted, has not framed a true per se rule for all horizontal mergers of the sort which prevails for some forms of agreements not to compete.

29. Coase, *The Nature of the Firm*, READINGS IN PRICE THEORY, 331 (Stigler and Boulding eds. 1952), analyzes contract as being similar to merger in extending the boundaries of the firm by substituting administrative organization of transactions for market organization. The term "contract integration," as used in this article, refers to any coordination of the business activities of otherwise independent units. The term is thus as broad as the area of business contracts. The sole exception to this usage is that "cartels," defined here as eliminations of competition involving no coordination of activities other than the suppression of business rivalry, are not considered contract integrations. The relevant distinction for the Sherman Act, given its economic orientation, is not between ownership and contract but between integration and cartels.

be inferred either a wrongful intent or effect from even a naked price-fixing or market-division agreement between parties who lack market control, and, second, that in any event it seems unfair to punish persons whose conduct cannot conceivably have had anti-consumer consequences. These objections may be illustrated and perhaps answered by taking a pair of hypothetical situations. Suppose that two lawyers engaged in general practice in New York City make an agreement to fix fees but do not coordinate their activities in any other way. Two other lawyers similarly situated form a partnership and agree upon the fees they will charge. In neither case does it appear conceivable that the agreement will have any effect upon the general level of legal fees.

The version of the *per se* rule defended here would result in automatic illegality for the first agreement, and not for the second.³⁰ In fact the second agreement, once market share were shown or conceded, should be completely lawful. This difference in result arises from economic presumptions and considerations of efficient law enforcement. The economic presumptions are different because there is a contract integration (the partnership) to which the price fixing seems ancillary in one case and not in the other. The agreement is ancillary to the partnership because it seems obvious that the partnership would be a less effective integration of the partners' activities if they charged different fees for comparable work. For one thing, clients might become concerned about which partner handled their work. This inference that the price-fixing agreement enhances the efficiency of a contract integration may safely be taken as conclusive without proof of the actual creation of efficiency since the apparent market share of the parties makes it highly improbable that the real purpose or effect of the arrangement is to restrict output.³¹

30. These hypotheses ignore, for the sake of the argument, the questions of interstate commerce and whether the government would waste its time in prosecuting either case.

31. If the partners do, in fact, work less and charge higher hourly fees, that must be taken to reflect a decision to take the rewards of increased efficiency partially through increased leisure. The Sherman Act can hardly object since the ground for objection would have to be that increased efficiency must always be enjoyed through increased income. Such a principle would also have to forbid an individual lawyer from deciding to work harder for fewer hours, or from deciding to work at a more leisurely pace for the same number of hours, or from deciding to quit the practice altogether for more enjoyable though less remunerative pursuits. To apply such a principle would be to convert the Sherman Act into a command that all persons work at peak efficiency at the tasks which consumers indicate to be the most valuable by the rate of remuneration they award. The concept of consumer sovereignty (which is the basis for the construction of the Act presented here) does not require such an intolerable destruction of individual freedom. It can be avoided by construing § 1 of the Act to forbid only that collusion which re-

The presumption runs the other way in the case of the lawyers who merely agree upon fees. There is no contract integration, no coordination of activities, which could be made more efficient by price fixing. There is, therefore, no likelihood of any consumer benefit flowing from their agreement. It may be objected that, given their market share, there is no likelihood of consumer detriment either. One answer to this is that the parties are likely to be better judges of their actual power over some separate segment of the general market than the enforcement agencies or the courts. The same case does not exist for assuming that they know better the efficiency-creating potential of their agreement unless they are able to point to an integration of their activities from which efficiency could conceivably arise.

Considerations of law-enforcement efficiency weigh even more heavily in favor of these divergent presumptions. When economic reasoning indicates, in the case of the partnership, that efficiency is the likely result of the fee-fixing agreement and that restriction of output is highly improbable, it would place an enormous burden upon the defendants and unnecessarily complicate the trial process to require that actual evidence of efficiency be introduced and weighed.³² In the case of the naked fee-fixing agreement between two otherwise independent lawyers, it would place too great a burden upon the government to require it to prove that restriction of output was a real possibility, especially since in most cases the parties' market power will not be as obvious.³³ To make market power always an essential ele-

stricts output and thereby falsifies consumer alternatives by distorting in one market the relationship between cost and price which continues to prevail in other markets. To some, even this may not seem an adequate rationale for infringing the rights of producers (who are also individuals) to freedom of action and association. This raises the topic of the principle of legislation (the proper occasions for governmental coercion) and goes to the question of whether the Sherman Act should have been adopted to begin with. This debate need not detain us here, however, since this article is confined to the question of the proper interpretation of an existing statute. The argument for producer rights, when it is not an argument for repeal, is an argument for judicial balancing of the interests of producers against those of consumers. This balancing is the essence of the Brandeis tradition of the rule of reason and is improper under a statute structured like the Sherman Act for reasons already canvassed. 74 YALE L.J. 775, 829-47.

32. Efficiencies cannot be measured in any quantitative sense because, as mentioned in note 26 *supra*, many of the most important ones are intangible and develop gradually over time. There may be an argument, in cases where borderline market size is involved, for making sure that substantial efficiencies are likely to be present. See note 40 *infra*, and accompanying text.

33. Efficiency and restriction of output are thus tested in the same fashion. Neither can be given a quantitative value. The possible presence of efficiency is inferred from the presence of integration. The possible presence of restriction of output is inferred from the presence of large market size. The two are balanced in the decision of cases by

ment of illegality would introduce the complexities of market definition into every government prosecution and effectively destroy the advantages of the *per se* rule in making rapid and widespread enforcement of the law possible.³⁴ The cost would be too great in prosecutorial resources. The cost of allowing the defense ought to be paid, of course, if the inferences against efficiencies were not so strong. Until a plausible theory of efficiencies from cartels is developed, however, the absence of any underlying contract integration should be sufficient to condemn any horizontal restraint as a *per se* violation of the Sherman Act.

The second objection to the *per se* rule mentioned was its seeming unfairness to parties whose actual capability of injuring consumers, regardless of the parties' intent, is very slight and probably nonexistent. This consideration bears more heavily upon the use of prosecutorial discretion in bringing such a case and upon the severity of the penalties to be imposed. It does not seem a reason to change the substantive rule and absolve the parties completely. Their agreement is in the nature of an attempt to do what is forbidden and their mistake concerning their capacity to do harm seems a weak reason to acquit them. This conclusion is buttressed by the consideration that acceptance of this dubious equitable argument would, by introducing market power as an element of every offense, destroy the *per se* rule and its benefits for law enforcement in all cases.

There is, then, a strong case for a *per se* rule, even in the extreme situations supposed here, and also for defining its scope by the absence either of a contract integration or of an efficiency-creating relationship between the restraint and the integration.

The Rule of Reason in the Trial Process

The discussion in the remainder of this article may be clarified by outlining the manner in which the existing principal tests of the rule of reason should be applied in determining the legality of an agreement eliminating competition. It should be stressed that the suggestions made here relate only to questions of economic analysis. They

requiring some integration of productive activities as a prerequisite to the validity of any elimination of competition and setting a percentage of the market as a top limit even in such cases. The balance so struck is necessarily rough, but it is all the unquantifiable nature of the factors permits.

34. The proposal made here would, of course, require that the complexities of market definition be introduced into horizontal ancillary restraint cases. This additional complexity constitutes a loss in such cases of the advantages of a *per se* rule cited in the text. The law assumes it advantageous to pay that cost in merger cases, however, and the policy should be the same for ancillary restraints, since they are, in economic terms, the same phenomenon as mergers.

take not only the value premises of the main tradition of the rule of reason as given but operate within its overall framework of economic criteria. These suggestions, therefore, are consistent with the major lines of Sherman Act precedent, though they conflict with many of the detailed rules that courts have elaborated upon the law's foundations. Change in the law would not require legislation since the rule of reason has always assumed that courts would correct the law as economic understanding progressed. Indeed, this mechanism of continual judicial revision and reform was made explicit in Chief Justice White's classic formulation of the rule of reason³⁵ and has always been a primary feature of the law's evolution.

Chief Justice White's statement of the rule of reason, set forth in *Standard Oil*³⁶ and *American Tobacco*,³⁷ contains three tests which may be rendered as (1) the per se concept; (2) the intention of the parties; and (3) the effect of the agreement.³⁸ These three tests are better viewed as guides for the litigation process than as logically separate criteria. In a larger sense, there is only one test—the effect of the agreement. The others are shortcuts to finding or inferring effect.

The method by which Chief Justice White's three-part statement of the rule of reason assists the trial process, and the relation of the economic argument of this article to White's categories, may be clarified by an example. Suppose that the government brings suit charging defendants with agreeing to an illegal division of markets.³⁹ The first step is to determine whether the facts and contentions of the parties properly bring the case within the ambit of the per se rule. If a per se violation seems proven either by the pleadings or at any stage during the trial, the court should announce that fact. At this point the de-

35. 74 YALE L.J. 775, 802-03, 805.

36. *Standard Oil Co. v. United States*, 221 U.S. 1 (1911).

37. *United States v. American Tobacco Co.*, 221 U.S. 106 (1911).

38. 74 YALE L.J. 775, 804.

39. The three categories of the rule of reason just mentioned do not come into play until it is determined whether the agreement in fact existed. Should the defendants deny the existence of any such agreement and lose on that issue, the case may be almost irretrievable from their point of view, for the effort at concealment is likely to be taken as a confession of bad intent. This inference would not seem unfair and might almost be made conclusive, except for the likelihood that the present uncertain state of the law and frequent sweeping overstatement of the per se concept may lead even parties whose sole purpose is the creation of efficiency to try to hide a market-division agreement from the enforcement agencies and the courts. Were the law clarified along the lines to be suggested here, it would seem entirely proper for courts to treat the attempted concealment of the fact of an agreement as conclusive proof of wrongful intent. If the defendants admit the agreement, or if it is proved under circumstances which do not in themselves demonstrate an illicit intent, an investigation channeled by the three-part rule of reason is in order.

fendants could avoid judgment against themselves and obtain an opportunity to go on with the trial only by making an acceptable offer to prove that the market division was ancillary. This would require an offer to prove a contract integration (unless that were conceded) and, in any case, the statement of an economically plausible theory which, if borne out by the evidence the defendants offer to adduce, would show their agreement to have a substantial capacity for increasing the efficiency of the integration. As will be seen, the economics involved in judging the plausibility of defendants' theory, and thus the acceptability of their offer of proof, are not overly complex and are suitable for judicial use in the litigation process. Many trials will end at this point with a decision that defendants have not offered a plausible theory of efficiency.

If the defendants do present an acceptable theory of efficiency, they should be held to have escaped the *per se* rule, or to use Chief Justice White's phrasing, to have passed the "inherent nature" test. The trial should then move to the second and third tests specified by White: the search for the intent behind the arrangement and for its likely effect. The question of intent presents a problem no different here than in other antitrust cases. It will turn primarily upon testimony and documentary evidence of statements and behavior before and during the formation and operation of the questioned agreement. The problem is largely one of the existence and trustworthiness of such evidence. If trustworthy evidence indicates that the defendants' primary expectation of gain lay in the elimination of competition, that should be a conclusive demonstration of the arrangement's illegality. Direct evidence of good intent, that is, of an intention to create efficiency, should be sifted and weighed with greater care. This differing treatment arises from the practical consideration that defendants are more likely to manufacture evidence of good intent than of bad. Only in exceptional cases, however, will evidence of bad intent be so convincing and so separated from other factual questions that it will prove unnecessary to examine the question of the agreement's effect. The two issues are likely to be so intermingled in the fact finding process, in any event, that it would be impracticable to separate them into separate stages of trial.

The task of assessing the probable net effect upon consumers of a market-division agreement which seems likely to create efficiencies is performed by applying rules of thumb constructed with the aid of economic analysis. The main criterion is market power, which is determined primarily by the percentage of the market controlled by the

parties and by ease of entry. An argument could be made that where the agreement seems capable both of creating efficiency and leading to a restriction of output, the law ought not interfere since there is no way of knowing whether its interference will have the net effect of aiding or injuring consumers. This argument is not pursued here solely because the law has assumed that such interference is proper in horizontal merger cases under the Sherman Act. For present purposes, that assumption will be accepted and applied, in the interests of symmetry between the law of contract and ownership integrations.

Courts will determine, probably with the aid of precedent under section 2 of the Sherman Act, what market shares are illegal. Solely for the sake of illustration, let us assume that a share of 50% is chosen as the lawful upper limit. A market division agreement covering a greater share of the market will be illegal regardless of its efficiency-creating potential and the court need not inquire into the topic of efficiencies at all. An agreement in the very low ranges, as already discussed, should be completely lawful if a contract integration to which it appears ancillary is present. The court need not inquire further into actual efficiencies in that case because the inference of their presence is strong and the danger of restriction of output is extremely slight. For agreements approaching the 50% size, however, the court should make sure that efficiencies are present and substantial. This determination provides an added degree of safety in a possibly doubtful zone. The court should not, however, attempt to measure the efficiencies since measurement, for all practical purposes, is impossible.⁴⁰

Since it is suggested that the law assess particular agreements not to compete according to their capacities for restricting output or increasing efficiency, this article takes up, first, the circumstances in which market-division and price-fixing agreements may restrict output, and, second, the methods by which such agreements may create efficiencies.

40. The impossibility of measuring efficiencies has already been alluded to, note 26 *supra*. Courts have never attempted such measurement in merger cases under either the Sherman Act or § 7 of the Clayton Act. They have, however, in close cases listened to argument and taken evidence to satisfy themselves that possibilities of efficiency were present. See, *e.g.*, under the Sherman Act, *United States v. United States Steel Corp.*, 251 U.S. 417, 443 (1920); and, under the Clayton Act, *United States v. Lever Bros. Co.*, 216 F. Supp. 887, 897 (S.D.N.Y. 1963). Under the Sherman Act at least, courts have treated restriction of output in a parallel fashion, not attempting to measure it, but employing a market-share test, which varies with the circumstances of a particular industry, to gauge its probable presence. See, *e.g.*, *United States v. Columbia Steel Co.* 334 U.S. 495, 527-34 (1948).

RESTRICTION OF OUTPUT: HORIZONTAL AND VERTICAL RESTRAINTS

Current doctrine, broadly phrased, appears to be that all horizontal price fixing and market division is illegal per se, that vertical price fixing is illegal per se, and that the legality of vertical market division is uncertain. It is the thesis here that proper doctrine should hold ancillary horizontal price fixing and market division lawful in all cases in which the parties lack market control, and that all vertical market division and price fixing should be lawful regardless of the parties' market size.

The argument for these propositions rests upon a demonstration that the agreements whose legality is proposed have the effect of creating efficiency beneficial to consumers. The demonstration proceeds by first eliminating the alternative explanation for the existence of such agreements: that they increase the parties' revenues by creating the ability to restrict output. With that hypothesis eliminated, the only remaining explanation for the existence of such agreements is that they increase the parties' revenues by creating efficiency.⁴¹ The demonstration is carried further, however, and the succeeding portion of the article attempts to explain some of the mechanisms by which certain market-division and price-fixing agreements do increase the efficiency of contract integrations.

Horizontal Market Division and Price Fixing

Though horizontal arrangements differ widely in their capacities for creating efficiency, the method by which they may restrict output is basically the same for cartels, contract integrations with ancillary restraints, or ownership integrations.⁴² Cases such as *Addyston Pipe &*

41. Occasionally someone suggests a third hypothesis: that ancillary restraints of this sort are made in the erroneous belief that they create efficiency. This alternative theory need not detain us. It is dubious because it assumes that businessmen persist in foolish and expensive behavior. More than that, however, the theory, if true, is irrelevant for the law. The Sherman Act is not a delegation to courts to second guess all attempts to do business more efficiently. If it were, courts should examine not only the wisdom of market division and price fixing but all agreements which, if based on an incorrect judgment, would waste resources. (For example, the foolish purchase of new machinery or hiring of incompetent executive personnel would be agreements in restraint of trade reviewable by courts under the Sherman Act.) The law wisely assumes the rationality of business behavior and attempts only to sort out that which is likely to lead to the restriction of output.

42. The theory of competitive and monopolistic behavior which follows is standard and may be found in such texts as STIGLER, *THE THEORY OF PRICE*, chs. 9, 10, 12, 14 (rev. ed. 1952).

Steel and *Standard Oil* provide familiar instances of cartels and ownership integrations, respectively. The recent *Mattress Cases*⁴³ provide examples of horizontal contract integrations accompanied by ancillary restraints. Otherwise independent bedding manufacturers agreed to make a uniform line of products and to advertise them nationally. Each manufacturer agreed to sell his production of items bearing the common brand only within a designated territory.⁴⁴

The firm operating in a purely competitive industry has, by definition, too small a share of the industry output to be able to affect market price.⁴⁵ The market price, being unaffected by the firm's output decisions, will always be its marginal revenue (the revenue gained by the production and sale of an additional unit). At any given moment the firm's marginal costs are also given.⁴⁶ The only factor under the control of the firm is its rate of output. The firm will increase that rate until its marginal cost equals the market price. Since marginal costs are always rising at this point,⁴⁷ the firm would decrease net rev-

43. *United States v. Restonic Corp.*, 1960 Trade Cas. ¶ 69,739 (N.D. Ill.) (consent judgment), 1962 Trade Cas. ¶ 70,442 (modification of consent judgment); *United States v. Serta Associates, Inc.* (N.D. Ill.) (no disposition as yet); *United States v. Sealy, Inc.*, 1964 Trade Cas. ¶ 71,258 (N.D. Ill.) (awaiting argument in the Supreme Court); *United States v. Spring-Air Co.*, 1962 Trade Cas. ¶ 70,402 (N.D. Ill.).

44. This fact appears from the consent judgments listed in note 43, *supra*, and from the opinion of the district court in *Sealy*, 1964 Trade Cas. ¶ 71,258 (N.D. Ill.).

45. If such a firm raises its prices, buyers will turn elsewhere and it will sell nothing. If it undercuts the market price, it may be able to sell more but it will not be maximizing its net revenues. This follows from the fact that any firm in a competitive market can sell all it wishes at the going price. The firm that undercuts that price merely diminishes the revenues it receives on that amount of sales. See note 46 *infra*.

46. Marginal costs are the costs added at any rate of production by producing one more unit in the period of time used to measure the rate. If a firm is producing five thousand units per month, its marginal costs are the increased costs of producing five thousand and one units per month. Over a period of time the firm can change its cost structure but day-to-day output decisions must be based upon the structure as it exists. This is true, of course, whether the firm is a competitor or a monopolist.

47. If marginal costs were constant or declining, the firm would not be maximizing net revenues since it would pay to produce an additional unit of output. The firm would continue to do just that until a further increase was no longer profitable. The stopping point is always provided by the realization that an additional unit will cost more than it adds to revenues. If there is more than one firm in the market, marginal costs must be rising when the stopping point is reached. If marginal costs remain constant or decline, the firm would continue to expand until it supplied the entire demand. Such a firm would be a natural monopoly. Two firms could exist under such circumstances only on the wholly unrealistic assumption that their marginal costs at the stopping point were absolutely identical and remained so. If one ever gained a slight cost advantage, it would increase output at the other's expense and it would continue to do so until it drove the other firm from the market, for under either the level or declining marginal cost hypothesis the expanding firm would have lower marginal costs from that point on. Whenever two or more firms exist in an unregulated market, therefore, we may be confident that their marginal costs are increasing at the relevant ranges of output.

venues by expanding output beyond that point—the cost of the additional unit would be greater than the price it would bring on the market. To fix the rate of production below this point would also fail to maximize net revenues because an additional unit would sell for more than it cost. Thus a competitive market maximizes consumer want satisfaction because the output is at a level which causes the price to equal the marginal cost of production. The resources of the industry are being used as efficiently as they can be, given the state of technological and managerial sophistication at the moment. Consumers' demand for the product, with the costs given for the moment, determines the amount of output. Consumer demand, of course, is determined by the range of alternative products and services available. If consumer tastes change so that more of the product is demanded, income being constant, less of some other products or services will be demanded. When the demand increases, each firm in the industry will be able to increase net revenues by increasing the rate of output until marginal costs rise to equal the new price level. Firms in industries with decreased demand can maximize revenues only by cutting back the rate of production, in effect moving down the slope of the marginal cost curve, until marginal costs once more equal the new lower price level. Such shifts in demand obviously alter the value of productive resources in various industries. The value of such resources is reflected in the demand of the firms for them. A resource will tend to move where its demand price or the value of its marginal product is greatest.⁴⁸ Thus resources will tend to move in the same directions as consumer demand. A system in equilibrium would produce maximum consumer want satisfaction because the value of the marginal product of each resource would be the same in all of its alternative employments. No shift of resources could increase consumer satisfaction. Our unimaginably complex economic system never reaches equilibrium, of course. Consumer tastes and cost conditions alter too rapidly. But the mechanisms described continually shift resources in pursuit of an ever shifting equilibrium. Consumer want satisfaction is, therefore, maximized as nearly as is possible in a dynamic economy.

When monopoly power exists in a market, resources will be misallocated in the sense that a movement of resources from competitive markets to the monopolized market would increase consumer want satisfaction. Suppose that all the firms in a competitive market either merged or formed a cartel so that they could make their output de-

48. "The value of the marginal product is the demand price for a productive service if the *quantities* of the other productive services are held constant." STIGLER, *op. cit. supra* note 42, at 188. (Emphasis in original.)

cisions collectively as though they were a single firm. The single firm's output will then constitute the total industry output and the firm will not have to reckon with a given market price which remains unchanged by its output decisions but with the consumer demand for its product. With each increase in the firm's rate of output the market price will come down. Unlike the competitor, therefore, the monopolist will not receive as marginal revenue on each additional sale the price at which that sale is made. The additional output per period of time lowers the market price for all sales. The marginal revenue of the monopolist thus declines more rapidly than the market price and the firm will stop increasing output when its marginal costs equal marginal revenue. The price at that output will be above marginal cost. The value of the marginal product of resources in the monopolized industry is thus higher than that of the same resources in competitive industries. Since that value is created by consumer demand, it follows that consumers would prefer to have resources shifted into the monopolized industry until the value of their marginal products is once again equal in all employments. It is this effect of monopoly which constitutes resource misallocation and injures consumers.⁴⁹

A prerequisite for restriction of output is a large enough share of the market so that the firm can alter total industry output significantly by changing its own output. Such a share can be created by growth, merger, ancillary restraint, or cartel. Size achieved by growth demonstrates the presence of efficiencies. Merger and ancillary restraint raise the possibility of efficiency, but cartels have no relationship to efficiency. The economic similarity of mergers and ancillary restraints suggests at once that the law should treat them alike. Taking the law's treatment of mergers as the standard, the legality of a horizontal ancillary restraint should be judged by the market share it creates.⁵⁰

49. Laymen and sophomores criticize monopolies for restricting output and raising prices. . . . The objection must be reformulated: under monopoly the allocation of resources is inefficient. . . . In other words, a productive service will have a less valuable marginal product in competitive than in monopolistic industries, so a transfer of some of the productive service from the former to the latter will increase output.

STIGLER, *op. cit. supra* note 42, at 213.

50. Taft came close to such a position in *Addyston Pipe & Steel* but spoke only of cases in which the restraint was part of a plan to gather all the property used in a business under one management in order to establish a monopoly. In such cases, he said, "the actual intent to monopolize must appear." 85 Fed. 271 at 291. Since the Sherman Act had not yet determined whether specific intent to monopolize was necessary in a merger case, Taft's dictum does not necessarily detract from the fact that he recognized the possible efficiencies created by horizontal ancillary restraints, and further that in some cases approach to monopoly proportions would bear upon their legality.

The economic similarity of ancillary restraints and mergers suggests at once that the permissible market share of the one should be the same as the other. The Sherman Act, however, has typically allowed much larger market shares in merger cases than has section 7 of the Clayton Act. The problem is which standard to apply to ancillary restraints. There may seem a presumption in favor of section 7 criteria since that statute represents the latest congressional expression of policy with respect to mergers. It would, however, be unfortunate as well as improper to carry over the increasingly stringent section 7 standards to section 1 litigation concerning restraints ancillary to contract integrations.

Such a transfer would be unfortunate because strict rules against horizontal corporate mergers, though perhaps tolerable when limited to a specific area, would cut too deeply if applied to other forms of combination upon which the productiveness of the economy depends. As noted, every partnership and corporation may be viewed as a combination. The application of stringent section 7 standards to such existing forms of enterprise would require widespread dissolution and consequent destruction of efficiency. It may be replied that application of strict section 7 rules to contract integrations would be tolerable, because contract integration is also a limited field. This seems a poor argument for applying standards that diminish rather than increase consumer welfare; it offers as an inducement only the promise that the damage will be localized. Even such localization is dubious, however. The Sherman Act, taking section 1 and 2 together, applies to all forms of combination or integration. Importing section 7 standards for corporate mergers and acquisitions into section 1's application to contract integration, therefore, would seem likely to increase substantially the chances of damage to productive efficiency across the entire range of the economy.

The fact that the Sherman and Clayton Acts are different statutes, with different legislative histories and different courses of interpretive development, serves as a natural barrier between section 7 of the Clayton Act and section 1 of the Sherman Act. Were that barrier breached so that harsh section 7 standards secured a foothold in section 1, the remaining barriers to the spread of such doctrines throughout the Sherman Act would be much lower. Assuming *arguendo* that in amending section 7 of the Clayton Act in 1950, Congress intended to require more stringent rules than the courts were then applying under the Sherman Act, it is significant that the new standards were explicitly limited to the field of corporate stock and asset acquisitions. There is

thus a strong presumption that it would be improper for a court to transplant section 7 standards to contexts in which Congress did not limit the common-law development of the Sherman Act. This conclusion is reinforced by the fact that much of section 7's harshness is induced by the belief that the statute was designed not merely to preserve competition but also to preserve small competitors.⁵¹ Whatever the merits or demerits of such a notion in the section 7 context, this policy consideration does not seem transferable to section 1. One reason is that, as has already been argued, the exclusive proper concern of section 1 is consumer want satisfaction. A second reason is that efficiency created through the contract integration of selected activities of firms that remain otherwise independent differs from merger in preserving rather than eliminating independent business units. For a variety of reasons, therefore, the standards evolving in section 7 litigation should not be applied to loose arrangements or contract integrations tested under section 1 of the Sherman Act.

Rejecting a section 7 test raises the question of what market percentages should be lawful for a horizontal restraint ancillary to a contract integration case. A definitive answer to this question is beyond the scope of this article,⁵² but perhaps the most satisfactory course for

51. See, e.g., *Brown Shoe Co. v. United States*, 370 U.S. 294, 315-16, 333, 343-46 (1962), and *Procter & Gamble*, 1963 TRADE REG. REP. ¶ 16,673.

52. Two considerations may indicate the proper range of critical sizes. The first is that before restriction of output becomes a danger, the firm (including in that term a cooperating group employing an ancillary restraint) must have a large enough share of the market so that its restriction of output will significantly restrict the output of the entire industry. Only the latter restriction can raise the market price. In the ordinary case, it seems highly dubious that output restriction would be a profitable policy even for a firm with 50% of a market. In order to restrict industry output by 10%, such a firm would have to cut its own output by 20%, and then more than half of the increased revenue from the higher price would go to its competitors. As the competitors increased their output in order to equate their marginal costs with the higher market price, the output-restricting firm would find its own position in the market reduced and the price falling toward the original level.

The implications of this analysis may seem to require qualification in the light of some contemporary oligopoly theory which suggests that where a few sellers occupy the entire market they may, without colluding, arrive at output decisions similar to those which would be produced by collusion. The antitrust law is struggling with the subject of oligopoly in a variety of contexts, however, and it seems unnecessary to attempt a solution of the problem in the limited context of contract integrations. It may be worth noting, however, that the oligopoly theory described seems far from a completely reliable guide to actual market behavior. Many markets occupied by only two or three sellers, or buyers, do not seem to display symptoms of output restriction. In fact, the discovery of actual collusion in a number of supposedly oligopolistic industries suggests that sellers often find the supposedly softer competition in such markets not nearly as attractive as real cartels, even allowing for the very considerable legal risks involved in cartel-

contract integration law under section 1 of the Sherman Act is to follow the lead already provided by section 1 and section 2 merger cases.⁵³ There may be an argument for modifying even those limits upward since contract integrations are probably a good deal less permanent than ownership integrations. On the other hand, the developing concern about oligopoly may tend to lower allowable market shares in all Sherman Act cases. Probably the results would be generally satisfactory if, in cases where entry is likely to be slow or non-existent, parties controlling up to 25% of the market were permitted to engage in ancillary restraints, and if the allowable share scaled rapidly upward to perhaps 50% or 60% as entry became easier. Higher market shares than these could be defended, but these should be the minimum allowable if consumers are not to be deprived of the efficiencies that ancillary restraints create.

Vertical Market Division and Price Fixing

An arrangement is vertical, according to the usage employed in this article, when a firm operating at one level of an industry places a restriction upon competition at another level of that industry for the firm's own benefit. (This definition excludes restraints, vertical in form, which are actually the results of horizontal cartels at any level of the industry.) The thesis advanced here is that every vertical arrangement should be lawful. In *White Motor*, for instance, absent an allegation that the market divisions or the price maintenance had been imposed on White by its resellers acting in concert or that White employed the resale price maintenance pursuant to an agreement with other truck manufacturers, summary judgment should have been entered for defendant on all issues.

Vertical integration by contract may be feared either because of its effect in foreclosing competitors from a source of supply or from customers or because of its effect in eliminating competition among the firms controlled on the second level of the industry. Though not always sufficiently distinguished, both of these theories of injury to com-

ization. Such collusion seems to indicate that oligopolies, as such, are not nearly as likely to restrict output as are cartels or monopolies. This may in turn indicate that the Sherman Act should not be concerned with the creation of oligopolies when the size of the units seems related to substantial efficiencies.

53. In the absence of a recent authoritative Supreme Court pronouncement on allowable percentages in Sherman Act merger cases, Judge Learned Hand's dictum in *United States v. Aluminum Co. of America*, 148 F.2d 416, 424 (2d Cir. 1945), may be as useful as any other gloss on the prior cases: "That percentage [90] is enough to constitute a monopoly; it is doubtful whether sixty or sixty-four percent would be enough; and certainly thirty-three percent is not."

petition appeared very early in the history of the Sherman Act. The foreclosure theory dates at least from the 1911 *American Tobacco* case⁵⁴ and the suppression of competition or cartel theory of vertical restraints was accepted as valid in the 1911 *Dr. Miles*⁵⁵ case. Neither of these theories appears to have any merit.⁵⁶ This article, however, deals with market-division and price-fixing agreements and so is concerned only with the cartel theory of vertical integration.⁵⁷

Taft apparently saw the essential point concerning vertical restraints when, in *Addyston Pipe & Steel*, he justified "a case in which a railroad company made a contract with a sleeping-car company by which the latter agreed to do the sleeping-car business of the railway company on a number of conditions, one of which was that no other company should be allowed to engage in the sleeping-car business on the same line."⁵⁸ This agreement may be analyzed as giving a monopoly to the sleeping-car company on that particular railroad. That is no different in economic principle than if the railroad had chosen to deal with four sleeping-car companies but had assigned each an exclusive share of its track (market division) or had required them to maintain a certain scale of charges to the public (price maintenance). Seen in this way, Taft's analysis of the sleeping-car case is relevant to the vertical restraints discussed here.

Taft justified the elimination of competition at the sleeping-car level in terms which made the market share of the railroad irrelevant:

The railroad company may discharge this duty [of furnishing sleeping-car facilities] itself to the public, and allow no one else to do it, or it may hire someone to do it, and, to secure the necessary investment of capital in the discharge of the duty, may secure to the sleeping-car company the same freedom from competition that it would have itself in discharging the duty.⁵⁹

For present purposes, the important part this passage is Taft's insight that, since the railroad company could have furnished the sleeping-car facilities itself without competition, nothing is lost if it grants to its hired sleeping-car company the same freedom from competition.

54. See Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157, 160-63 (1954).

55. *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

56. The argument against the "cartel" theory of vertical integration follows in the text. The argument against the foreclosure theory is set out in note 80 *infra*, and the articles there cited.

57. See 74 YALE L.J. 775, 775-76.

58. 85 Fed. at 287. See 74 YALE L.J. 775, 798-99. The case Taft discussed was *Chicago, St. L. & N.O.R. Co. v. Pullman Southern Car Co.*, 139 U.S. 79 (1891).

59. 85 Fed. at 287.

This reasoning would suggest, if followed logically, that a vertical elimination of competition would always be lawful because nothing is lost to consumers that was not already lost due to the horizontal position of the firm imposing the restraint.⁶⁰

Justice Hughes reached a contrary conclusion in his *Dr. Miles* opinion. The Court there held illegal a resale price maintenance program, and Hughes stated that the claimed benefits to the manufacturer of resale price maintenance were irrelevant. Hughes argued that since any benefit which the dealers might obtain by agreeing on prices themselves would be insufficient to validate their agreement, the benefit which the manufacturer might derive from imposing such an agreement could provide no greater justification.⁶¹ Hughes' reasoning seems weak both in its premise that all horizontal price fixing should be per se illegal and in its assumption that vertically imposed and horizontal price restrictions always have the same impact upon consumers.⁶² That reasoning, nevertheless, clearly requires the conclusion that all vertical restraints suppressing competition among firms at a second level of the industry are illegal.

Justice Douglas' *White Motor* opinion thus seems to represent a small, tentative step away from the Hughes and toward the Taft position on vertical restraints.⁶³

60. In the first section of this article it was noted that Taft's reasoning suggests another recurrent theme in antitrust by offering, seemingly as a justification of the exclusive arrangement with the sleeping-car company, the observation that the railroad company could have offered the sleeping-car service itself and allowed no one else to do it. This raises the question—though only to assume the answer—of whether it should always be lawful to accomplish by contract results that may lawfully be attained by ownership. That, of course, is one way of stating the entire problem of price fixing and market division.

74 YALE L.J. 775, 799. The analysis in this section of the article indicates that Taft assumed the right answer for vertical restraints. In general, there should never be an objection when one party confers market power it has upon another. It is the creation of larger market shares—which can only take place horizontally—with which the law should be exclusively concerned.

61. 220 U.S. at 408-09.

62. In his subsequent *Appalachian Coals* opinion Hughes departed from this premise. There, dealing with a horizontal elimination of competition through a joint selling agency—and with specific price-fixing provisions in the contracts—Hughes noted that the elimination of competition which promotes efficiency, as in mergers or partnerships, is not a per se offense. *Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 360-61, 366-67 (1933). In *Dr. Miles*, however, Hughes did not consider whether an asserted benefit to the manufacturer from imposing price conditions must not be a claim of efficiency.

63. *White Motor* should not perhaps have been a wholly unexpected development. The earlier *Paramount* litigation had upheld the legality of reasonable clearances in the licensing of films to motion picture theatres, which is to say the legality of reasonable vertical market division. A three-judge district court upheld the legality of reasonable clear-

Addyston Pipe & Steel, *Dr. Miles*, and *White Motor* are used here merely to suggest the range of judicial positions with respect to vertical restraints. Though it is not suggested that the authors of those opinions held consistently to the implications of their reasoning, the rationales of the opinions may be used as models of possible approaches to the problem of vertical market division and price fixing. Of the three, Taft's approach seems most nearly correct.

The railroad case which Taft analyzed may be used to illustrate the argument for the legality of vertical restraints. This example presents the argument in its most extreme form. If the case for legality can be established here, it would seem valid for all other situations. Let us suppose that the railroad company had a complete monopoly over transportation in the area it served, and further, to make the illustration of general applicability, that rate regulation was either absent or wholly ineffective. In these circumstances, the railroad may be expected to calculate the amount of sleeping-car service it should provide and the price to be charged in order to realize the largest monopoly return. It will, of course, equate marginal revenue and marginal cost. The railroad may realize, however, that the scale of operation of sleeping-car service justified by its railroad is not the most efficient and that it can get the service provided more cheaply by a sleeping-car company

ances in *United States v. Paramount Pictures, Inc.*, 66 F. Supp. 323 (S.D.N.Y. 1946). The government had argued for the per se illegality of clearances in the district court but its appeal did not raise the point. Justice Douglas' opinion for the Supreme Court, 334 U.S. 131, 144-48 (1948), noted that the issue of per se illegality was not before the Court, but went on to review the district court's holding concerning the factors to be considered in determining whether a clearance is unreasonable, concluding:

In the setting of this case the only measure of reasonableness of a clearance by Sherman Act standards is the special needs of the licensee for the competitive advantages it affords.

Whether the same restrictions would be applicable to a producer who had not been a party to such a conspiracy is a question we do not reach.

Id. at 147-48.

It is impossible to imagine that clearances were per se illegal after this. In a horizontal cartel case in which the government had not appealed the issue of per se illegality, Justice Douglas would surely not have reviewed a decree regulating the conduct of the cartel, stated the Court's "measure of reasonableness" for the cartel's by-laws, and then suggested that less stringent inhibitions might apply to firms not parties to additional conspiracies. The Court's treatment of the clearance question must be, and has been, taken as a strong indication that such agreements are legal if reasonable.

Seen against this background, the cautious refusal of Justice Douglas and the majority in *White Motor* to fashion a per se rule for all vertical market divisions until more was known of their economic impact may be seen as a step toward rather than away from a per se rule. The usual, though inexplicable, reading of *Paramount's* treatment of clearances as a precedent for the motion picture industry only, however, probably precludes reading the progression in this way.

that sells such service to a number of railroads. This method will seem preferable because, for the monopolist as well as for the competitor, any reduction of the marginal costs of operation will increase net revenues. Such cost reduction will also, of course, increase the amount of sleeping-car service offered the public and lower the price. At this point, it is immaterial what price is arrived at between the railroad and the car company. They will wish to maximize net revenue and will not, therefore, wish to change the rate of output of sleeping-car service from that at which marginal cost equals marginal revenue. The way they split the total between themselves will not affect the public.

This reasoning also shows that the output to the public and the price will not be changed by the railroad's agreement not to allow another sleeping-car company on its line. This restraint may protect the car company in whatever bargain it has been able to negotiate with the railroad but the agreement will not change the motivation of either party to keep output where marginal cost and marginal revenue are equal.

One possible objection to this analysis is worth discussion. This objection could apply only when both vertically-related parties possess monopolies (bilateral monopoly). This condition may be thought to obtain here because the railroad has a monopoly in the area and its promise gives the sleeping-car company a monopoly in the same area. When the bargain between the sleeping-car company and the railroad is made, the car company may view the price it pays the railroad as its own marginal cost (assuming the price varies with the amount of sleeping-car business done) and may then arrive at a new determination of the output level which will measure its own maximizing point. If the price the railroad charges the car company includes an element of monopoly profit, as it surely will, this new determination by the sleeping-car company will lead it to an even greater restriction of output and a higher price to travellers than would be the case if the interests of the two companies were identical. This possibility, of course, would not only be worse for the public than the full monopoly output and price, but would be worse for the railroad. The result is highly unlikely, however. In the first place, this analysis does not take into account the added efficiencies gained by employing the car company instead of the railroad offering the service itself. These may be such that an additional restriction of output by the car company would still give a greater output than if the railroad offered the service. In the second place, and more important, the railroad, either in its original contract or in later renewals, will be able to protect itself against the

sleeping-car company's additional restriction of output by providing for control over the amount of service and the price which the car company must provide. Thus, the agreement can provide in advance against any additional restriction of output by the car company since the output which would be chosen by a single monopolist is the basis upon which the bargain between the two is made and provides the maximum revenue for division. We may be certain, in any event, that either because of offsetting efficiencies in the railroad's operations or the ability of the railroad to control the output level of the sleeping-car company, or for both reasons, the result of their arrangement will be primarily to increase efficiency rather to restrict output. If the railroad company did not predict that efficiency would be the net result, it would have no incentive to enter into the arrangement in the first place. Thus, even the limited bilateral monopoly objection, which would apply only where the firm granting freedom from competition had market power, is without substance.

It may be asked why the whole problem is not better avoided, where the railroad has a monopoly position, by making illegal the railroad's agreement not to permit another sleeping-car company on its line since such a rule would enable the railroad to defeat any attempted additional restriction of output by the car company. The answer is that the sleeping-car company requires the agreement as protection from bad faith on the part of the railroad. The car company, as Taft pointed out, is required to make an investment of capital to fulfill its contract. Without the protective clause, the railroad, by employing another sleeping-car company, could in effect cancel the whole deal any time it decided it could make a better one. The sleeping-car company would have no similar option if it should decide it had made a bad bargain. In order to get the level of investment it wants from a car company, therefore, the railroad must give the exclusive contract.

The foregoing analysis of Taft's argument may be generalized to cover all vertical restraints by which a supplier eliminates or limits competition among the resellers of its product. A vertical elimination of competition by a single manufacturer can, by definition, never affect a larger proportion of the total output of the industry than the manufacturer produces. This means that the elimination of competition at the retail level creates no more market power than the manufacturer has at the manufacturing level. Vertical price fixing and market division, therefore, creates no additional horizontal market control and hence raise no danger of additional power to restrict output. This remains true whether the manufacturer has 1% or 100% of the market.

Only one full monopoly return can be taken from a series of vertically related activities. The point may be illustrated by supposing that a monopolistic manufacturer bought all its retail outlets. Taking into account all relevant costs of manufacturing and retailing as well as the elasticity of consumer demand, the firm would set a rate of output which would maximize net returns. If the manufacturer then sold the retail outlets, costs and demand remaining unchanged, the maximizing output would remain the same. The manufacturer would never impose a limitation upon competition among its resellers which had the effect of restricting output further, for that would decrease the manufacturer's net revenue. The same reasoning applies to an oligopolistic manufacturer. Any manufacturer with the power to restrict output will want the entire profit from the restriction to accrue to itself rather than to somebody else. And it can hardly be imagined that a competitive manufacturer using vertical price fixing or market division is moved by an altruistic impulse, verging on the suicidal, to give its resellers greater-than-competitive profits at its own expense.

In the case of an individual manufacturer's imposition of restraints upon competition among its resellers, therefore, the manufacturer's motive can never be restriction of output. An alternative explanation for the manufacturer's behavior is necessary, and the only satisfactory alternative hypothesis is that the manufacturer believes the restraint will increase its net revenue by increasing distributive efficiency. This is not to say that the elimination of competition among resellers may not have some tendency to affect efficiency adversely. Market division, for example, may result in the allocation of some accounts to resellers that would not otherwise be able to hold them. But any such adverse tendency must be outweighed by a tendency to create efficiency. Otherwise, the manufacturer would not employ the restraint.

Where a group of manufacturers agree to use vertical restraints (as in *Sealy*, where the manufacturers agreed to maintain the prices charged by their respective retailers) the manufacturers' agreement is horizontal. The inference that the net effect of the agreement must be the creation of efficiency then arises, as in all horizontal restraint cases, only if the manufacturers are parties to a contract integration and, collectively, lack market control.

In the earlier discussion of the per se rule it was noted that no restraint could qualify as ancillary, and thereby escape per se illegality, unless it accompanied a contract integration and was capable of enhancing the integration's efficiency. Both of these requirements are always satisfied in vertical cases. The integration in vertical situations may be

of varying degrees of completeness, but at a minimum the parties are always related as buyer and seller, and almost invariably the buyer resells or uses the product in making a further product which it sells. The parties' activities are thus coordinated. They perform different and specialized functions in getting a final product to the ultimate consumer. Though vertical, their relationship is the same in economic reality as that of partners. The ability of all truly vertical restraints to enhance the efficiency of the integration has been demonstrated by the argument that they can serve no other function. This same argument demonstrates that market power is irrelevant in a vertical case, so that vertical restraints are not only always ancillary but should always be lawful.

The argument for the legality of vertical eliminations of competition as well as that for the legality of certain horizontal eliminations of competition has proceeded on the theory that, where restriction of output is not a danger, the motive of the parties must be to increase efficiency. The parties may, of course, be mistaken. The net effect of such an agreement may be inefficiency. That possibility, however, does not affect the rules proposed here. The Sherman Act can only strike down agreements whose effect, through one mechanism or another, is to create market control which raises a likelihood of output restriction. Where that danger does not exist the Act must necessarily leave judgments concerning the most efficient methods of doing business to businessmen. For a court to strike down, for example, a vertical market division on the theory that the manufacturer had made a mistake as to the most efficient mode of distribution would be equivalent to judicial supervision of any other normal business judgment. The court might as well second-guess management's judgment on assembly line planning, inventory policy, product design or any of the other decisions that affect efficiency. Whatever else it is, the Sherman Act is not a device for imposing upon the entire economy, or any aspect of the economy's behavior, a judicial form of public utility regulation.

This analysis also indicates that the legality of vertical restraints should not depend upon the form of the restraint. Resale price maintenance, vertical territorial limitations,⁶⁴ and vertical customer alloca-

64. Both Justice Douglas' opinion for the Court and Justice Brennan's concurring opinion in *White Motor* distinguished between the continuing per se illegality of resale price maintenance and the uncertain status of vertical market division. 372 U.S. at 260-64, 268.

The argument in the text for the legality of vertical eliminations of competition is independent of the provisions of the Miller-Tydings and McGuire amendments to the Sherman Act. These amendments provide a rather narrow exception to the judge-made rule against vertical price fixing. It is proposed here that the courts abandon that rule. Congress' making of an exception, however, may arguably be read as approval of the rule outside

tions⁶⁵ are equally incapable of restricting output and must, therefore, be presumed equally capable of producing efficiencies.⁶⁶

A Consideration of Some Objections to the Legality of Vertical Restraints

The argument made here for the *per se* legality of vertical market division and price fixing may be subjected to a variety of objections. The major ones, which require discussion, are: (1) It may often be impracticably difficult to tell whether a particular restraint is manufacturer-imposed or the tactic of a dealer cartel; (2) it may be difficult to distinguish individual manufacturer employment of resale price maintenance from collusive manufacturer use of that device to discourage defection from a manufacturer cartel; (3) vertical restraints may result in the transference of an imperfect market structure from one level of an industry to another; (4) vertical market division may be used to create price discrimination; and (5) the distinction between horizontal and vertical restraints may be difficult to make in many cases. None of these objections seem weighty enough to invalidate the policy suggested here. The first, second and fifth raise problems of law enforcement which seem soluble. The third objection is a truism without implications for policy. The fourth is an infirm objection both because it will usually be impossible to tell whether the market division creates or prevents discrimination and because the effect of discrimination upon consumer want satisfaction cannot be determined.

The Dealer Cartel Objection.

The dealer cartel objection is grounded in the theory that some restraints which appear vertical may actually be horizontal cartels

the area of the exception. That argument does not seem strong enough to require the courts to freeze their present position should they become convinced of its economic unsoundness. In any event, the Supreme Court could put the matter up to Congress by announcing the legality of all vertical eliminations of competition other than resale price maintenance and stating that only an inference as to Congressional intent drawn from the existence of the Miller-Tydings and McGuire amendments prevented the abandonment of the rule against vertical price fixing.

65. Justice Brennan thought that White's customer allocation clauses—which forbade resellers to deal with classes of customers reserved for direct selling by White—were more dangerous than the territorial restrictions, since “they serve to suppress all competition between manufacturer and distributors for the custom of the most desirable accounts.” 372 U.S. at 272. Yet such agreements suppressed competition no more completely than did the allocation of reseller territories. It seems clear, moreover, that White's customer allocation clauses were vertical and could not have been used to restrict output by eliminating rivalry between White and its resellers. See pages 424-25, 470-71 *infra*.

66. The topic of efficiencies is taken up at pages 429-64 *infra*.

among resellers which they coerce or induce a manufacturer to administer and police. For purposes of this discussion that theory will be accepted.⁶⁷ Such cases should be treated by the law as horizontal cartels and therefore illegal per se.⁶⁸ The existence of such reseller cartels constitutes a serious objection to the legality of vertical restraints only if reseller coercion or inducement is more common than manufacturer origination of vertical-appearing restraints *and* if there is little likelihood that the enforcement authorities can tell the two apart.

It is useful to begin by considering the breadth of the dealer cartel objection. It does not seem to apply with equal force to all types of vertical-appearing restraints. Vertical market division among the resellers of one brand provides a poor instrument for reseller cartels.⁶⁹

67. See generally Bowman, *The Prerequisites and Effects of Resale Price Maintenance*, 22 U. CHI. L. REV. 825 (1955).

68. It may be objected that a reseller agreement cannot, consistently with the argument of this article concerning horizontal restraints, be treated as per se illegal but must be tested by the market share of the resellers and their intent. A contract integration might be perceived in the relationship of the resellers as members of the same distributive system, having a common supplier and brand. Or the resellers might agree upon a form of cooperation such as a joint advertising campaign which would supply the needed contract integration. The analogy to horizontal cases is faulty, however. In a vertical system, the horizontally agreeing resellers necessarily affect the interest of the manufacturer. If they must force the use of resale price maintenance or vertical market division upon the manufacturer, that is excellent evidence that the manufacturer regards the restraint not as creating efficiency but as restricting output. The case for preferring the manufacturer's judgment is that he can never be interested in restriction of output at the reseller level and the resellers can. In addition, the manufacturer is likely to be the better judge of the effect of restriction upon his overall business and output than are organized resellers. A rule making reseller-imposed restraints illegal thus achieves the benefits of a per se rule's clarity without substantial danger of destroying efficiency. Of course, a conspiracy of the resellers of a single manufacturer will be very unlikely to change total output and price. They will more likely, on the same analysis as the sleeping-car contract with the railroad, see text at notes 63-65 *supra*, merely affect the split of any greater-than-competitive profits between the manufacturer and themselves. But there is no consumer benefit in permitting this split and there is always the danger that the conspiracy may broaden to include resellers of one or more additional manufacturers. Broadening the conspiracy would create additional horizontal market power and make additional restriction of output possible. It seems best, out of caution, to maintain a per se rule against all reseller-imposed restraints, as Justice Brennan stated in *White Motor*. 372 U.S. at 267.

69. The case of a cartel agreement among resellers dealing in only one brand is discussed in the text at note 70 *infra*. It is difficult to imagine that exclusive outlets for different brands could use vertical-seeming market division as a cartel tactic. This would require that the manufacturers divide territories among themselves in order to eliminate competition among all resellers. Not only does that seem unlikely but the presence of the cartel would be made immediately visible by the division of territories according to brands. Outlets which carried all brands could not use the device either since the cartel would have to consist of one member in each geographical market and would have to force all, or virtually all, manufacturers to abandon all other outlets in each territory. The loss in market coverage in industries that found multiple outlets useful (*e.g.*,

The resellers would gain no market power their manufacturer did not already possess and could do no more than share whatever extra-competitive profits the manufacturer might be able to command.⁷⁰ It also seems highly doubtful that resale price maintenance can be used effectively by a reseller cartel where resellers specialize in the products of only one manufacturer. Reseller specialization implies that the products sold by each reseller are different. It is also probable that the resellers will display a wide range of costs of operation. Reseller interests, accordingly, would be quite diverse, and considerable negotiation would be required to arrive at acceptable cartel prices. The prices might well have to be different for different resellers. Under such circumstances, cartelization would usually prove impossible. If it were possible, the resellers would then have to force the agreed prices and a program to maintain them upon each of the manufacturers. The likelihood that such a cartel could be stable and effective is small. For reasons which will be discussed, the likelihood that such a cartel could go undetected approaches the vanishing point.

The dealer cartel objection, then, probably applies almost entirely to resale price maintenance of products sold through common outlets. It is, perhaps, unsafe to speculate on the relative frequency of reseller coercion and manufacturer initiation in creating price maintenance programs in such marketing situations. The fact that resellers in the past may have succeeded in imposing such programs is probably not an accurate guide to the probability of their success today and in the future. New high-volume, low-price methods of retailing have created such diversity among retailers that cartelization is probably much more difficult. The reseller that depends on low prices is unlikely to join a cartel to force resale price maintenance upon manufacturers. The presence of such resellers probably also makes manufacturers less likely to submit to cartel pressures from other resellers. The fact that resellers do agitate for price maintenance and assist manufacturers in detecting

drugs, cosmetics, phonograph records) would impose so high a cost that most if not all manufacturers would surely prefer to continue to use the non-cartel resellers. If, for the sake of argument, one assumed that such a cartel might occasionally succeed, the collective withdrawal of the manufacturers from all but one reseller in each area would make the cartel enormously visible and create a large class of complainants.

70. This conclusion, again, follows from the analysis of the contract between the sleeping-car company and the railroad. In order to make cartelization effective, the resellers of two or more manufacturers (which, collectively, had market power) would have to agree upon prices as well and force the appropriate resale price maintenance programs upon their respective manufacturers. Aside from the difficulty in organizing and operating such a cartel, reseller ability to fix prices in this fashion would make market division superfluous.

price cutting is also not necessarily evidence of reseller cartelization. Many resellers may be expected to like price maintenance and the particular types of competition it encourages even when the manufacturer initiates it. They will, therefore, actively participate in policing the program.

The argument below suggests that the enforcement agencies should find it relatively easy to separate manufacturer-originated and reseller-coerced resale price maintenance programs. (The argument should be qualified, however, by conceding that if experience should show that in common outlet industries all but a very few price maintenance programs were reseller-imposed, it might be more economical to employ a rule of per se illegality for such situations than to expend resources in attempting to identify and save the few efficiency-creating programs. That is, vertical market division, as in *White Motor*, and resale price maintenance in specialized outlets, as in *Union Oil*, would be lawful, but resale price maintenance in common outlets, as in *Parke, Davis*, would be per se illegal.)

Four considerations indicate that there should be little difficulty in determining whether the impetus for a resale price maintenance program comes from the manufacturer or from a reseller cartel.

First, under the rule of legality suggested here there would be no occasion to hide manufacturer-imposed restraints. The group of resale price maintenance programs requiring investigation would thus be visible, and any disguised program could be presumed to be horizontal in nature. The task of the enforcement agencies in ferreting out secret horizontal programs would be no different and no greater than it is under present law.

Second, a reseller cartel would have to comprise at least a majority of the industry and the resellers of more than one manufacturer. A majority of the industry is required because otherwise the resellers taken collectively would not have the requisite market share to make output restriction profitable. The resellers of more than one manufacturer are necessary in order to create a restriction of output beyond any that the size of an individual manufacturer already created. The only caveat to this guide would be the possibility that part of the price maintenance would operate in the open and the rest in secret, thus making it appear that the conditions here were not fulfilled. This method of concealment seems so unwieldy and likely to be so rare that the requirements mentioned would still provide useful guides to the enforcement agencies in choosing which resale price maintenance programs to investigate for evidence of reseller conspiracy.

Third, the presence of reseller cartels which coerce manufacturers to use resale price maintenance will often be discoverable through the complaints of coerced manufacturers. Those manufacturers who fear reseller retaliation will have little difficulty in making their complaints secretly. The likelihood of manufacturer complaint is increased by the fact that any effective reseller cartel will have to coerce more than one manufacturer; in many industries a minimum of three or four would be required and often far more. The absence of manufacturer complaint could not be relied upon to demonstrate conclusively the vertical nature of parallel programs of resale price maintenance, however, since it may be possible in some cases for resellers to buy the manufacturers' cooperation by sharing the cartel profits with them. This possibility seems slim for the same reasons, discussed next, that manufacturers will not often impose vertical restraints to police manufacturer cartels. Manufacturer complaints therefore, could be relied upon to uncover many, perhaps most, reseller cartels.

Fourth, detection of reseller cartels is relatively simple because the very large numbers and disparate interests involved makes such cartels notoriously difficult to organize, administer, and police.⁷¹ The cartel must be initiated by a vigorous organizational campaign which cannot be carried on in secrecy.⁷² Subsequent suggested or actual changes in prices must be discussed and justified to the numerous members. Defection by resellers who see the opportunity for greater profits in cutting prices must be discovered and stopped. Having the appropriate manufacturer cut off the misbehaving reseller will hardly work because it will create a government informant. If, in addition, manufacturers are brought into the cartel to prevent them from complaining, the already insuperable problems of maintaining secrecy will be intensified. Additional organization and communication will be required to negotiate the terms of the division of the spoils with the manufacturers, to keep readjusting prices and terms as market conditions change, and to assure the manufacturers that they are being treated equally.

The foregoing points are reinforced by the fact that once the cartel

71. McGee, *Ocean Freight Rate Conferences and the American Merchant Marine*, 27 U. CHI. L. REV. 191, 196-204 (1960).

72. The organization of large numbers of resellers, many of whom are apathetic or timid, if not hostile to the notion of cartelization, seems often to require relentless organizing, fight talks against manufacturers, and wide publicity. Often the reseller organization advertises in the trade papers, news articles about its efforts appear in trade papers, the organization is often formalized or even incorporated, dues or contributions are collected, and large meetings are held in such places as hotel ballrooms. Observation of some reseller attempts at cartelization suggests that they are not merely usually ineffective but that they are so highly visible as to be impossible for an enforcement agency to miss.

nature of an allegedly vertical restraint is suspected, the running of a grand jury will bring out any element of horizontal conspiracy. Quite aside from the access to files and correspondence that grand jury subpoenas give, the power to call and question industry members makes the idea of concealing a widespread cartel wholly impractical. Businessmen willing to lie concerning an antitrust violation in the grand jury room comprise a relatively rare species. They will be even rarer in reseller cartel cases where they would have to rely upon a large number of other persons being equally willing to perjure themselves, to do so successfully, and to coordinate their fabrications. A witness contemplating perjury must also take into account that the government has the files and correspondence of dozens or hundreds of firms and that he has no idea whether the cartel may be evidenced in such documents.

It seems safe to conclude that reseller cartels would be easy to detect and that the rule legalizing vertical restraints suggested here need not be rejected or even seriously questioned on the theory that it would enable such cartels to operate under cover.⁷³

73. An objection related to that discussed in the text might be that in some circumstances reseller pressure for a manufacturer-imposed restraint could be effective without actual reseller cartelization. This theory, which could only apply to the case of common outlets, would be that individual resellers, acting independently, could put non-price-maintained brands under the counter and so coerce all manufacturers to resort to resale price maintenance. The theory seems defective. A reseller who behaved in this fashion would lose sales on the non-maintained brands to resellers who displayed and pushed them. The non-maintained brands would have a price advantage. If some resellers found it profitable to discourage sales of non-maintained brands, it would become increasingly profitable for other resellers to feature them. The manufacturer of non-maintained brands would feel no more pressure to institute price maintenance than the manufacturers of maintained brands would feel to drop price maintenance.

The idea of individual resellers not selling brands that some consumers want because the margin is not above the competitive level is the same as the idea of individual resellers charging more than the price competition allows them. If the reseller can accomplish the first it is because he has some degree of market power, and, in that event, he can get the higher price without resale price maintenance. Reseller coercion, therefore, will not be effective unless resellers collude. That requires a conspiracy whose high visibility has already been discussed. In fact, the existence of conspiracy could be inferred from the mere fact that most resellers were putting non-maintained brands out of sight since such behavior, like parallel price increases when costs and demand had not changed, would be inexplicable under any hypothesis but collusion.

The theory just discussed is to be distinguished from the case where some resellers choose to make a service and sales effort appeal and others choose to make a price appeal. The former are in effect offering consumers a different product. If the product (consisting of the physical item plus the services, atmosphere, etc.) sells, they do not need resale price maintenance to get the higher price. The theory is also to be distinguished from the situation in which the manufacturer uses resale price maintenance in order to induce resellers to engage in a greater amount of sales effort. See text at notes 159-61 *infra*.

The Manufacturer Cartel Objection.

It has been suggested that manufacturers may agree to use resale price maintenance as a means of policing their own horizontal agreement on prices.⁷⁴ The idea is simply that a manufacturers' cartel may break down more easily in industries in which the prices charged by the manufacturers are not very visible so that defection becomes difficult to detect. A refiners' cartel in the gasoline industry would fit this model. If certain resellers of one refiner began consistently underselling to consumers it would be hard to know whether or not the cause was a price cut by the refiner. One answer, it has been suggested, would be for the refiners to agree also upon the prices they would require their resellers to maintain. Retail prices, being highly visible, could easily be checked, and there would be no advantage to a refiner in cutting prices to its resellers secretly if the cut could not be passed on to consumers. Such a price cut would merely expand the resellers' profit margins at the refiner's expense.

The first question is the breadth and reality of the manufacturer cartel objection. The theory of manufacturer cartels does not apply to manufacturer use of reseller market division. Where common outlets are used reseller market division is highly improbable.⁷⁵ Where exclusive outlets are the industry pattern manufacturer imposition of closed reseller territories would leave the resellers of different manufacturers in competition with one another and would in no way solve the cartel's problem of tracing reseller price cuts to manufacturer defection from the price agreed upon at the manufacturing level.

The manufacturer cartel theory, therefore, applies only to the collective use of resale price maintenance. Even there, however, the objection seems applicable only in special cases. Where common outlets are used a manufacturers' cartel would not need to agree to maintain resale prices in order to detect secret price cutting by cartel members. Any manufacturer price cut would inevitably and instantly be reported by resellers to the representatives of the other manufacturers in an effort to obtain matching price cuts from them.⁷⁶ The manufacturer cartel ob-

74. See Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. LAW & ECON. 86, 96-104 (1960). For a critical analysis of the theory, see Bowman, *supra* note 67, at 838-39.

75. See note 69 *supra*.

76. This common observation concerning reseller behavior is borne out by the difficulties of suppliers in complying with the Robinson-Patman Act. The Act permits a seller to charge a lower price to one customer than to another where the lower price "was made in good faith to meet an equally low price of a competitor." Sellers are frequently told by their reselling customers that they have been offered a lower price by a competitive supplier. They frequently find, however, that the lower competitive offer has either been exaggerated or did not even occur. This playing of suppliers off against

jection, therefore, seems not to apply to industries using common outlets because resale price maintenance would be superfluous as a detecting device and there are, as will be shown, substantial costs involved in using resale price maintenance.

The manufacturer cartel theory of vertical restraints seems limited, then, to the use of resale price maintenance by manufacturers selling through outlets that carry only one brand. But even here it may be doubted that manufacturers often employ resale price maintenance for this purpose. Of course, the manufacturers must comprise the dominant group in the industry to make their cartel effective. Moreover, even resale price maintenance would not be sufficient to remove the incentive to cut prices in order to sign up new resellers. The cartel would therefore have to agree upon a market quota or a new reseller quota.⁷⁷ The cartel, moreover, would be faced with the fact that resellers given a secret price cut by their manufacturer but unable to cut prices themselves would attempt to use the cut to compete by offering other terms and services to consumers.⁷⁸ To be effective the manufacturers' cartel must prevent such behavior, but policing and preventing these less visible forms of competition will be much more difficult than

each other is a common method of reseller price bargaining. Manufacturer agreement to use resale price maintenance collectively would not prevent reseller use of this tactic. Even a manufacturer who offered the lower price in return for preferential treatment plus secrecy could not hope that none of hundreds or even thousands of resellers would use the offer to exact similar offers from other manufacturers. Telser, *supra* note 74, at 97, suggests that in a common outlet case the manufacturers' cartel which used resale price maintenance might be eroded by individual manufacturer price cutting to gain preferential treatment from resellers and that the manufacturers might prevent this by agreeing to let each reseller handle only a single brand. The analysis above, concerning reseller reporting of price cuts, suggests that in common outlet industries detection of manufacturer price cutting would be so simple that resale price maintenance would not be used for that purpose. Manufacturers would not, therefore, agree to use exclusive outlets to prevent the preferential-treatment bribe from undercutting the cartel. In fact, if manufacturer cartels did prefer exclusive outlets, it might be for the opposite reason: false reseller reports of price cuts or other special inducements might constantly raise suspicions of defection where none existed.

77. See Telser, note 74 *supra*, at 97-98. Telser suggests that the cartel would have to agree not to take each other's resellers, but this may not be necessary. Though it might be possible to pick off a rival's reseller now and then with a secret price cut, the practice could hardly be common and go undetected. The argument is similar to that in note 76 *supra*. Most resellers would be likely to try to get their existing manufacturers to meet or beat the offer before switching. This would disclose the price cutting of the defector.

78. *Id.* at 97. Telser suggests that resellers given a price cut they cannot pass on may instead offer customers favorable credit terms, free delivery, a cut on the price of a tied article, and the like. That resale price maintenance has this effect upon resellers is, in fact, the basis for the argument that manufacturers often employ it to induce just these other forms of competition. See pages 453-56 *infra*.

policing prices. The fact that reseller competition must take these forms may decrease the incentive for secret manufacturer price cuts somewhat but an incentive will still exist.

It must be remembered also that resale price maintenance carries with it costs to the manufacturers. To the degree that all outlets did not have identical costs of operation, as they surely would not, resale price maintenance would present serious inefficiencies. To give the least efficient outlets a competitive return the prices of other outlets would have to be pegged at a point that would prevent them from fully utilizing their efficiencies. This loss of reseller efficiency would very often impose serious costs upon manufacturers. The costs could be avoided only by setting different prices for different resellers (where they were not in competition), a process so complicated and difficult that it would seem almost certain not to be undertaken. Moreover, manufacturer agreement on resale prices would require constant revision as marketing conditions changed. And perhaps the conditions would change in different directions in different markets, or in different directions for different resellers within the same market. The manufacturers' cartel would have to renegotiate the appropriate resale prices continually. The problem would be intensified if the products were somewhat differentiated and so sold at different prices. The question of the appropriate resale price differential would frequently require review. The time lags and inevitable compromises involved in all of these changes would be other costs of the program.⁷⁹ All of these costs would have to be set off against the expected returns from cartelization at the manufacturers' level. These costs, moreover, would be incurred not to make cartelization possible but simply for a device that assists in detecting or discouraging secret manufacturer price cutting. To the degree that other less visible forms of reseller competition are possible, the device paid for is not even wholly effective for the marginal purpose it serves.⁸⁰

79. *Id.* at 99.

80. One other theory requires mention. This is the theory that manufacturers, either collectively or singly, may offer resale price maintenance in return for resellers' promises to deal exclusively, and that the object of the maneuver is to foreclose the outlets to existing or potential rival manufacturers and so increase the market power of the manufacturers offering maintained prices. In the first place, the tactic could not work if there were any significant number of resellers left for the other manufacturers or if entry into reselling were easy, as it almost invariably is. In such cases existing or potential manufacturers would be in no way "foreclosed." Moreover, a manufacturer, or group of manufacturers, comprising less than the entire industry will obviously not be able to get all the retailers to deal exclusively in exchange for resale price maintenance. The more

These considerations by no means prove that resale price maintenance is never a tool of manufacturers' cartels, but they may lead one to doubt that price maintenance will be used for this purpose with any frequency. Assuming, however, that there are some few cases of resale

resellers have their price fixed, the more attractive it will become to be a reseller free to compete in prices. Non-price-maintaining manufacturers, therefore, seem certain to be able to hold or find an appropriate fraction of the industry's resellers. In the hypothetical case where all of the manufacturers join to sign up all of the resellers in this fashion it may be thought a way of requiring new entrants to come in on both levels at once. If greater-than-competitive profits are being made (which seems to be the point of the argument), it is difficult to see why the requirement of entering both levels at once poses a problem. One suggestion seems to be that in some cases the diversity of products required in reselling may be greater than those required in manufacturing. But in such cases it is not at all clear why only one manufacturer is likely to be attracted by the greater-than-competitive profits being made. The problem under discussion is actually that of "foreclosure" by vertical integration (whether by ownership or contract). These matters have been canvassed elsewhere. See Bork and Bowman, *The Crisis in Antitrust*, 65 COLUM. L. REV. 363, 366-68 (1965); Bork, *Contrasts in Antitrust Theory: I*, *id.* at 404-09; Bowman, *Contrasts in Antitrust Theory: II*, *id.* at 418-19. BORK, *Vertical Integration and the Sherman Act: the Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157, 194-201 (1954). So far no satisfactory theory of "foreclosure" seems to have been worked out.

It seems true, nevertheless, that manufacturers, singly or in concert, do sometimes maintain resale prices and require their resellers not to handle the goods of rival manufacturers. An explanation is required but a further study of actual cases will be necessary to supply it. One possibility may be expounded first for the case of the single manufacturer. It is conceivable that a manufacturer wishes its resellers to engage in a significant amount of service and local sales effort because it feels that there is an important segment of the market which is sales-and-service elastic rather than price elastic. Resale price maintenance, like market division, is a method of inducing such reseller activities. See text at notes 159-61 *infra*. The manufacturer may also feel, however, that the likelihood of having the reseller effort be effective or, if effective, always accrue to that manufacturer's products is considerably lessened when the reseller displays lower price items of similar description in the same store. In such cases the manufacturer may well require exclusive dealing as a means of realizing the benefits of the efficiencies gained through resale price maintenance.

The same rationale might explain collective manufacturer use of resale price maintenance with the requirement that only goods of those manufacturers (or of manufacturers whose products retail above a certain price) be carried by the resellers. This might occur where no one manufacturer provided a sufficiently broad line of products to permit resellers to operate efficiently as exclusive outlets for one brand. By joining together in a joint marketing scheme of the sort described, the manufacturers act, in these respects, as a single firm and gain the efficiencies of resale price maintenance unavailable to any of them singly. *Fashion Originators' Guild v. FTC*, 312 U.S. 457 (1941), may fit this theory.

These are matters requiring further investigation. In any event, the "foreclosure" idea, even if accepted, would justify making illegal only resale price maintenance given as a quid pro quo for reseller exclusive dealing and which was used by a monopolist or by agreement among manufacturers comprising most of an industry. The latter agreement should be unlawful, in any case, because it is a horizontal restraint among firms which, taken together, possess market power.

price maintenance employed to police a manufacturers' cartel, these few cases should not be difficult for the government to detect.

The considerations here in many respects parallel those in the reseller cartel case. In the first place, the rule suggested would not increase the government's burden in discovering cartels employing secret resale price maintenance schemes. Secondly, resale price maintenance used as a tool of a manufacturer cartel would have to be employed by manufacturers controlling the industry since an effective cartel must possess market power. An industry pattern of resale price maintenance would direct government investigation to cartelized industries. Another sign of manufacturer cartelization would be attempts by manufacturers to discourage resellers from competing on terms other than prices. Where a manufacturer cartel is not involved resale price maintenance would often be used precisely to encourage such competition.

With the search thus narrowed it should not be difficult to uncover those cases in which manufacturer cartels were responsible for the use of resale price maintenance. Manufacturer cartels, too, require organization, administration, and policing. Thus, the evidence of manufacturer collusion seems rarely, if ever, successfully concealed once a determined governmental investigation begins. The added administrative problem of agreeing not only upon the manufacturers' prices but upon resellers' prices, and changes in both to meet changing conditions, would make successful concealment even less likely than in the case of a cartel that controlled only manufacturers' prices. The grand jury in this situation too, provides a potent means not only of discovering documents and evidence of excessive communication between manufacturers but of encouraging a desirable degree of candor in industry witnesses.

The Objection That Vertical Restraints Transfer Imperfect Market Structures.

The objection to vertical restraints has frequently been made that they transfer the market structure existing at the manufacturer level to the reseller level.⁸¹ The notion seems to be that if a monopolist, or a group of oligopolists acting non-conclusively, extends control to the retail level through vertical restraints, the public has lost a benefit of competition at that level even though monopoly or oligopoly exists

81. See STOCKING & WATKINS, *MONOPOLY AND FREE ENTERPRISE* 322-23 (1951); Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795 (1962).

in manufacturing.⁸² It is obvious, however, that consumers lose nothing in such a case. The monopolistic or oligopolistic manufacturer may be assumed to restrict output, but it will have no incentive to cause a further, unprofitable, restriction of output at the reseller level. Output and prices will remain unchanged except to the extent that the efficiencies created by the restraint increase output and thereby lower prices.⁸³ To say that vertical restraints transfer a market structure from one level of industry to the next, therefore, is to state a truism which has no policy implications adverse to the restraints.

The Problem of Price Discrimination.

Vertical restraints may also be used to separate markets with differing elasticities of demand for a product so that a different profit-maximizing price may be charged in each.⁸⁴ This category of cases is narrow. In the first place, resale price maintenance alone cannot be used to separate markets. A manufacturer might wish to set different reseller prices for different markets but the separation of the markets would have to be accomplished by a market-division agreement to prevent cross-selling by the resellers.⁸⁵ Secondly, a territorial market-division agreement could almost never be used to create price discrimination. A seller might be supposed to wish to discriminate on a territorial basis when: (1) He wants to employ price discrimination as a predatory tactic to drive rivals out of business in the lower-price market; or (2) he is faced with rival sellers of the same product in one market but not in

82. So put, this objection dates back at least to the *Dr. Miles* case, *supra* note 55, at 403, where Justice Hughes remarked that merely "because there is monopoly of production, it certainly cannot be said that there is no public interest in maintaining freedom of trade with respect to future sales after the article has been placed on the market and the producer has parted with his title." The argument in the text, however, indicates that this is precisely what can be said.

83. The problem is identical to that of vertical integration. A manufacturer controlling its resellers' business practices would have no more reason to cause the reseller to restrict output or raise prices than would a manufacturer that purchased the same resellers. See Bork, *supra* note 54, at 195-96.

84. It is conceivable that an ancillary horizontal restraint could be used for this purpose as well. The members of a cooperating group, such as the manufacturers in the *Mattress Cases*, see text at notes 43-44 *supra*, could divide markets to enable some members to charge a higher price but such a scheme would necessarily involve profit pooling. Otherwise the members assigned to less profitable markets would not agree to the division. No example of a horizontal restraint used for this purpose comes to mind. If there are any, they are subject to the same limitations and analysis as the text demonstrates apply to vertical restraints.

85. See Bowman, *supra* note 67, at 839-40.

another so that his revenue-maximizing price differs in each market. In neither of these cases would a market-division agreement be used to create the capacity to maintain differential prices since in each case the rival sellers in the lower-price market, not being bound by the agreement, would always be able to sell in the higher-price market.⁸⁶

Price discrimination enabled by vertical restraint, therefore, is confined to the case in which the differing elasticities of demand (which make the discrimination profitable) are created by the fact that the customers to be separated place different values upon the product. The customers might place different values upon a product because different alternatives are open to each. For example, a computer manufacturer might sell a machine which can be used in both manufacturing and banking. The computers of other manufacturers might be equally satisfactory in manufacturing but unfit for bank use. The elasticities of demand for the computer might, therefore, differ for bankers and manufacturers. The computer manufacturer will not be able to take advantage of the difference and charge a higher price to banks unless he can prevent cross-selling. Where resellers are involved, he may be able to accomplish market division by a customer allocation clause. He could use territorial division only in the rare case where the two classes of customers happened to be geographically separate. The problem of price discrimination, then, insofar as it concerns the topic of this article, relates almost entirely to the proposed legality of vertical customer allocation clauses. These clauses may be used, as will be shown, to create a number of efficiencies valuable to consumers. The question now is whether the possibility that they may sometimes be used to create price discrimination should weigh against their legality.

Three considerations indicate that the Sherman Act should ignore the possible use of customer allocation clauses to create price discrimination. (1) The identification of discrimination, particularly in a litigation context, is probably impossible. A law against price discrimination might easily compel more price discrimination than it stopped; (2) any attempt to enforce a law against discrimination imposes costs

86. That is, if a multi-plant manufacturer sold on both the East and West Coasts and, for either of the reasons mentioned in the text, charged a lower price on the East Coast, he would not use a territorial-division agreement to keep his East Coast resellers from shipping to the West Coast. If the East Coast resellers could, but for the agreement, reach the West Coast market and break down the higher price structure there, so could rival East Coast manufacturers. Since the rival manufacturers are not bound by the agreement, the agreement could not preserve the power to discriminate. If shipping costs separated the two markets, the agreement would be superfluous.

which, if they were fully measurable, might be prohibitive; and (3) even if discrimination could be readily identified, it is unclear whether, on balance, discrimination benefits or injures consumers.

The ability to identify price discrimination is, self-evidently, essential to any proposal that the law prohibit it. The fact is, however, that there are now available no reliable means, and certainly no means suitable for use in litigation, for making the identification. As writers on the Robinson-Patman Act have repeatedly pointed out, the tendency to equate price differentials with price discrimination is wholly erroneous. Discrimination in the economic sense occurs only when a seller makes a greater return on some sales than on others.⁸⁷ Direct observation of prices, which are visible, must, therefore, be replaced by comparison of returns, which are not visible. Since the seller's costs may differ from market to market, the observation of differing prices would not show discrimination, and the observation of equal prices would not show the absence of discrimination. Thus, if White Motor spent more in sales effort and servicing to reach certain large-volume accounts than it did in selling smaller accounts through resellers, other costs being equal, it could avoid price discrimination only by fully reflecting those cost differences in a higher price to the large-volume accounts. A customer allocation clause might then be essential to prevent economic discrimination. Striking down the clause would create price discrimination. The law could be sure it was preventing rather than creating discriminations only if it could identify and allocate all relevant costs.

The identification and allocation of all relevant costs is, however, for practical purposes, usually impossible. Nor does the analogy provided by Robinson-Patman Act litigation suggest the contrary. The Robinson-Patman Act attempts, in a rough fashion, to deal with the problem of economic price discrimination through the cost justification defense, which provides that the statute does not outlaw price "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."⁸⁸ It is common wisdom in the antitrust field, however, that

87. See Dam, *The Economics and Law of Price Discrimination: Herein of Three Regulatory Schemes*, 31 U. CHI. L. REV. 1, 4-9 (1963); McGee, *Price Discrimination and Competitive Effects: The Standard Oil of Indiana Case*, 23 U. CHI. L. REV. 398, 399 n. 2 (1956); Adelman, *The Consistency of the Robinson-Patman Act*, 6 STAN. L. REV. 3, 4 (1953); and ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 29-31 (1962).

88. 15 U.S.C. § 13(a) (1964).

even when such cost differences seem to exist, the cost defense is so difficult to establish that it is usually worthless.⁸⁹ The difficulty stems from the inadequacy of accounting techniques to measure and allocate accurately all relevant differences in cost. To the degree that the law recognizes only the costs which the accountant can "prove" and ignores all others, it is measuring accounting data and not price discrimination. When the law requires price differences to reflect only demonstrable cost differences and ignores the others, it compels price discrimination. This result clearly seems to be occurring in Robinson-Patman litigation.

If attempts to prove costs have been unsatisfactory even within the range of costs which Robinson-Patman permits to be shown, the prospects are even more bleak for any law that attempts to deal with economic discrimination by including, as it must, a whole range of even less provable costs which lie outside the Robinson-Patman defense.⁹⁰ These difficulties are made insuperable by the fact that avoidance of economic price discrimination by law would *require* the seller to reflect *all* economic cost differences in differential prices and then stand prepared to prove every one of them. Anything short of that utopian standard would not be a law dealing with price discrimination.

In addition to these difficulties, in framing a new legal policy it is appropriate for Sherman Act courts to count the consumer costs inevitably incurred in any attempt to ban price discrimination. Even the limited, unrealistic cost defense of the Robinson-Patman Act requires enormous expense in accountants' and lawyers' time.⁹¹ The attempt to limit price differentials to the range of readily provable costs also distorts business policies and price and output decisions. The cost of such distortion to consumers in legally compelled misallocation of resources can be imagined only vaguely.⁹² There is, therefore, no

89. See ROWE, *op. cit. supra* note 87, at 296-312; Dam, *supra* note 87, at 13-14; Adelman, *supra* note 87, at 7-14. See also *Automatic Canteen Co. of America v. FTC*, 346 U.S. 61, 68-69 (1953).

90. See ROWE, *op. cit. supra* note 87, at 30, 281-90.

91. *Id.* at 307-09.

92. For example, if White Motor incurred higher costs in selling and servicing large-volume accounts directly than it did in reaching smaller customers through resellers, it would wish to separate the two markets and charge a higher price to the large accounts. If the law forbade discrimination and White discovered that it could "prove" in an accounting sense only half of the cost differences it believed to exist, White would be motivated to limit the price differential to half of what it should be. White would obviously not continue to fail to cover costs. It would either reduce its service and sales efforts to cut unprovable costs or switch to another method of distribution, perhaps

certain way of knowing that consumers gain as much as they lose in such efforts. Resources expended or misallocated in law enforcement and compliance are as effectively lost to consumers as resources misallocated by cartels. Even if identification of price discrimination in the litigation context were ultimately possible, therefore, it would be far from certain that the costs of enforcing a ban on price discrimination did not greatly exceed its benefits.

If these problems were not enough, there remains the unfortunate fact that, given the present state of economic knowledge, it is impossible to be certain that banning all price discrimination (assuming, for the sake of argument, discrimination to be identifiable without cost) would actually benefit consumers. The balance of advantages for the consumer in the short run is not always clear, and, in the long run, seems to favor allowing the discrimination.

The power to discriminate in the economic sense requires some degree of power in at least one market. In assessing the impact of discrimination upon consumers two situations must be distinguished. The first is that of a firm which, prior to its segregation of markets, does not possess power in the general market for its product and is, therefore, not restricting output. In this case, the initiation of market separation to gain power in a separate submarket and the ensuing price discrimination may or may not alter the industry's physical output but in the short run seems likely to decrease consumer want satisfaction. Because market power and the ability to discriminate in such cases probably rests upon product differentiation, the long-run result of the discrimination will probably be an increase in product differentiation by other sellers and perhaps a net gain in consumer want satisfaction. The second situation is that of a firm which possesses market power and is restricting output in the general market prior to the initiation of price discrimination accomplished by segregating the general market into submarkets. In this case, the initiation of segregation and discrimination will have an indeterminate effect upon output. That is, discrimination may or may not result in an increase in the firm's output to a level which more closely resembles that which would prevail under conditions of competition. The impact of price discrimination by a monopolist upon consumer want satisfaction, there-

reaching the large-volume accounts through resellers. These, being second choices, would almost surely be less efficient means of doing business and would therefore impose a cost upon consumers. White's other alternative would be to cut back its sales to the large accounts in an effort to lower costs in line with the lower prices forced upon it. Such a restriction of output would, of course, constitute a misallocation of resources detrimental to consumers.

fore, is indeterminate in the short run. In the long run price discrimination, by increasing the chances that the monopoly will be attacked by the government or eroded by entry, may tend to enhance the prospects for increased consumer welfare.

To illustrate the first situation, let us suppose White Motor had 5% of the general market for trucks but that a fifth of its sales were to special customers who found White trucks much preferable to any other make. White would clearly not restrict output in the general market, and would be unable to take advantage of its monopoly power over the special customers because of their ability to purchase from White's resellers.⁹³ If White adopted customer allocation clauses and reserved the special customers to itself, it would promptly raise prices and thereby increase its net revenues on sales to such customers. This raise would certainly restrict White's output.⁹⁴ The value of the marginal product of resources engaged in making trucks for the higher-price market would be greater than the value of the marginal product of the same resources devoted to truck manufacturing for the general market. Consumer want satisfaction would be increased if resources could shift from the lower to the higher value employment. But White has prevented this beneficial shift through its customer allocation clauses.

The long-run effect of permitting White to discriminate in this manner would, of course, be the entry of other producers into the higher-price market. Since White's power to discriminate and achieve monopoly returns in the special market arose from the fact that it offered a differentiated product, other manufacturers will have an incentive to differentiate their products. They will differentiate in order to cut into White's special market and, if possible, to carve out special markets of their own. Entry into the field of differentiation would tend to return the profitability of that activity to the com-

93. If White's resellers were competing among themselves no one of them could discriminate since it would always pay another reseller to offer the special customer a lower price. In this way, the price to special customers would be forced down to the general market price. If the resellers had closed territories, each could discriminate but the overall level of discrimination might not be as accurate as if White had set the prices to special customers and, moreover, White would not get all of the benefit of the discrimination.

94. If White selected its special customers accurately, and could confront each with an all-or-nothing offer, there might seem to be no change in output whatever. This would be true, however, only if the customers were ultimate consumers. If the customers were themselves producers of other goods or services, as customers for trucks almost always are, the increased cost of trucks would sooner or later decrease their output and hence their demand for trucks.

petitive level. This effect does not appear to provide a reason for Sherman Act courts to interfere with price discrimination, and may suggest the contrary. If product differentiation succeeds, it is because consumers like and respond to it. The range of consumer choice is enlarged, and each consumer is likely to find a product more closely tailored to his wants than before differentiation became common.⁹⁵ To outlaw discrimination in order to save short-run consumer benefits might deprive consumers of more substantial long-run benefits. This "long-run" effect may occur within a very short time period. The long-run merely refers to the time required for adjustments to new market conditions. In this first case, then, there seems to be no clear reason for a court to interfere with price discrimination.

To illustrate the second case, suppose that White produced all trucks purchased in the United States and that it faced two general classes of customers with very different elasticities of demand. White, as a monopolist, would restrict output but the output chosen would be a compromise between the different outputs appropriate for its two classes of customers. The situation would, nevertheless, be unfavorable to consumers since the value of the marginal product of resources would be greater in this industry than in alternative employments. Upon the initiation of price discrimination, output for customers with low elasticities of demand would be restricted and output for those with high elasticities would increase. The value of the marginal product of resources employed in the higher-price market would diverge even more sharply from the value of the same resources in other industries. The value of the marginal product in the lower-price market, however, would move downward toward the value of the same resources in alternative uses. Whether the discrimination benefitted or injured consumers would depend upon which of these effects on the value of the marginal product predominated. Perhaps the total effect can be gauged by the effect of the discrimination upon total output. If White's total output increases, the value of the marginal product of the resources it uses must, on the average, have moved closer to the value in other employments. If White's output decreases, the values must have been further separated. Consumer want satisfaction, therefore, can be correlated with the effect upon

95. The analysis is not changed if the product differentiation seems rooted less in physical characteristics than in advertising which develops "irrational" preferences. Such preferences are likely to be confined to ultimate consumers, however, and no likely situation comes to mind in which customer allocation clauses would be used to segregate ultimate consumers. This topic, therefore, need not be developed in the present article.

output. In the abstract, the effect of discrimination upon a monopolist's output is indeterminate.⁹⁶ In concrete cases, perhaps the effect may be estimated by the relative sizes of the higher-price and the lower-price markets. There will be difficulty in close cases because the discrimination will change these relative sizes by tending to shrink the higher-price market. The situation before the discrimination cannot safely be used as a guide because other factors may have changed and because the two segments of the market may not be clearly visible to an outside observer prior to the price differentiation. There may be some cases, nonetheless, in which it is clear that the higher-price market is much the larger and that outlawing customer allocation clauses would increase consumer want satisfaction. These cases, however, are only a part of the total range of discriminations by a monopolist. Discriminations by a monopolist in the sector of the economy to which section 1 of the Sherman Act applies (primarily the sector not subject to administrative regulation) are, in turn, probably less frequent than the product differentiation case already discussed. A law against customer allocation clauses which create price discrimination would only rarely, therefore, benefit consumers. Broadly applied to discriminating monopolists, such a law might easily do more harm than good.

The likely long-run impact of price discrimination upon monopoly position, and hence upon consumer welfare, slightly favors permitting the discrimination. Insofar as a monopoly is not based on government protection or economies of scale so great that a single firm inevitably occupies the whole market, the monopoly is vulnerable either to anti-trust attack or to the entry of new firms. The existence of price discrimination will assist in calling the monopoly to the attention of the enforcement agencies. By increasing the monopolist's rate of return, price discrimination will also more certainly attract the attention of potential entrants.

Taken in combination, the extraordinary difficulties (often amounting to impossibility) of finding out whether price discrimination is prevented or created by a customer allocation clause, the high costs

96. See SAMUELSON, *FOUNDATIONS OF ECONOMIC ANALYSIS* 42-45 (1947). As an example, using purely arbitrary figures, suppose that White had one identifiable class of customers willing to pay from \$5,000 to \$7,000 per truck and a second class willing to pay from \$7,000 to \$9,000. If White were unable to separate these two classes, it would have to charge a single price to all. Let us suppose the maximizing monopoly price would be \$6,500 per truck at an annual output of 20,000 units, but upon separating the two classes of customers White arrives at a maximizing price to the first class of \$5,500 and to the second of \$7,000. Without empirical data concerning the demand schedules of the customers it is impossible to predict whether White's output would rise or decline.

of even attempting to outlaw discrimination, and the uncertainty whether a successful ban would aid or injure consumers, seem to argue conclusively against taking the subject of discrimination into account in deciding the legality of customer allocations.

The Problem of Distinguishing Between Horizontal and Vertical Restraints.

Since vertical restraints should be treated as completely lawful while ancillary horizontal restraints should be judged by the criteria of market share and intent, it is necessary to be able to distinguish the two types. Though the distinction is often quite simple, there are cases which may be thought to present some conceptual difficulty. The test is simply whether, assuming market power to exist, the agreement eliminating competition could lead to a restriction of output. If it could, the restraint is horizontal; if it could not, the restraint is vertical.

The factual situation of the *White Motor* case may be used to illustrate the point. White imposed six restrictions upon competition: (1) control of certain resale prices; (2) the requirement that resellers make no sales outside their assigned territories; (3) prohibitions of reseller sales to certain customers reserved for direct sale by White; (4) White's agreement not to compete for retail sales with its resellers in the categories of customers assigned to them; (5) White's agreement not to appoint additional resellers within an existing reseller's territory; and (6) the reseller's agreement to sell only White trucks.⁹⁷

These restrictions are all vertical because none of the agreements could restrict output. The argument concerning agreements (1) and (2) has already been made.⁹⁸ Agreements (5) and (6) are essentially the same as the agreement between the railroad and the sleeping-car company which Taft justified, and the same analysis which shows that that agreement could not restrict output applies to them.⁹⁹ Agreements (3) and (4) are subject to the same reasoning. Only the fact that they eliminate competition between parties operating at the same level (White as a retailer and the resellers) may seem to give the agreements a horizontal cast. The fact that White is a retailer is misleading and irrelevant, however. The agreement is still vertical. Assume that White manufactured all the trucks sold in the United States, and that it sold

97. Only the first three agreements were challenged by the government. This seems somewhat anomalous since (3) and (4) are identical in being customer allocations. The government, however, challenged only the allocation of accounts to White and not the allocation to resellers.

98. See text accompanying notes 63-66, *supra*.

99. See text accompanying notes 58-66, *supra*.

25% of them directly to customers and the remainder through resellers. Since White could collect its entire monopoly profit at the manufacturing level and would wish the costs of retailing kept as low as consistent with efficiency, it would have no incentive to divide markets at the retail level in any way which would lead to a restriction of output there. If its own retailing operation were less efficient than that of the independent resellers, White's best course would be to get out of retailing, let more efficient firms take over, and thereby increase the price it could charge as a manufacturer.¹⁰⁰ If for some reason White wanted to keep a hand in the retail market,¹⁰¹ its least costly method would be a straight subsidy to its own retailing operation. This method would trim the subsidy to the minimum needed and avoid subsidizing its resellers as a customer allocation clause, made for such a purpose, would necessarily do. No rational firm would divide markets to protect its retail operations from the competition of more efficient resellers of its products. Agreements (3) and (4), which allocate customers between White and its resellers, cannot lead to a restriction of output and must, therefore, be classified as vertical.

All of the agreements discussed, (1) through (6), may be confidently classed as vertical only because there is no real likelihood that the resellers could compete with White in manufacturing trucks. If they could, agreements (3) and (4) would, to that extent, become horizontal, and White's market share would become relevant to their legality. Suppose that White made a deal with a nationwide truck rental concern to supply trucks and that the agreement contained the following provisions: (a) White will not rent trucks directly to customers for that service; (b) the rental company will not manufacture trucks; (c) White will not sell trucks to any other rental concern; and (d) the rental company will not purchase trucks from any manufacturer but White. (a) and (b) are horizontal agreements since they presume the likelihood of competition at both levels between the firms.¹⁰² Either agree-

100. The fact that White had an investment in retailing would in no way affect this decision. That investment represents a past cost and is irrelevant in deciding upon a revenue-maximizing course for the future.

101. It could conceivably wish, for example, to acquire first-hand knowledge of retailing problems and trends.

102. The market share of each firm in its own market would be relevant since, if that share were large enough to confer the ability to restrict output, the agreement of the other firm not to compete would preserve that ability. If both White and the truck rental concern were monopolies but entry was likely only by White, the agreement of White not to engage in the rental business would still be vertical. The preservation of the truck rental monopoly would not maintain a restriction of output because White would retain complete power to restrict output even if it entered truck renting and

ment standing alone would be horizontal only if there were a likelihood that the firm which did not promise not to invade might do so, for then an implied promise to that effect would seem likely. That is, if the rental firm agreed not to enter manufacturing but White made no explicit promise about entering the rental business, and further, if it seemed likely on independent grounds that White would enter the rental business, the courts might suspect an implied promise by White not to do so. In that case, the agreement is between firms who are potential competitors and should be viewed as horizontal. Its legality would depend upon the market shares of White and the rental concern in their respective markets, modified, of course, by the likelihood of entry by other firms. Agreements (c) and (d), above, are vertical since they do not eliminate any existing or potential competition. Horizontal analysis becomes proper only when each of vertically-related parties is in fact realistically capable of entering the other's market, or when the party at a competitive level is capable of entering at a level at which restriction of output is possible.

The facts underlying the *Penn-Olin*¹⁰³ case provide a contrast to those of *White Motor* because an agreement which seemed vertical in form was perhaps horizontal in fact. Prior to the formation of Penn-Olin, the joint venture corporation, Pennsalt made sodium chlorate, but Olin did not. Pennsalt appointed Olin its selling agent for the southeastern United States. Pennsalt agreed not to compete with Olin on certain categories of sales in that area. The effect of the arrangement, the district court noted, was to preclude Olin from selling Pennsalt's sodium chlorate in any market other than the pulp and paper mills in the southeast and to preclude Pennsalt from selling to such mills, with the exception of one account it reserved to itself. The agreement was characterized by the district court as creating both "territorial division" and "customer allocation."¹⁰⁴ Though this supplier-distributor relationship was clearly vertical in form, the strong possibility that Olin might otherwise have produced sodium chlorate itself, and thus have entered competition with Pennsalt at both the manufacturing and distribution levels, made it appropriate to analyze the situation further to determine the degree of likelihood of such competition and, if a substantial likelihood existed, the market share of Pennsalt. It

destroyed the monopoly there. If White's market were competitive and the truck rental market monopolistic, however, White's agreement to stay out would be horizontal since it would preserve in the truck rental concern the power to restrict output.

103. *United States v. Penn-Olin Chem. Co.*, 217 F. Supp. 110 (D. Del. 1963), *vacated*, 378 U.S. 158 (1964).

104. *Id.* at 135.

would be better to know what Olin's market share would have been, but the case could as well be decided upon the share of Pennsalt which is protected by the arrangement.¹⁰⁵

The Pennsalt-Olin relationship, of course, was not challenged at this stage¹⁰⁶ but after the contract integration had been converted into an ownership integration by the formation of the joint venture corporation, Penn-Olin, and the construction of new facilities. The relationship of the principals remained much the same, however, with Pennsalt being responsible for the manufacturing operations of Penn-Olin and Olin responsible for the distribution of the product.¹⁰⁷ The effect upon competition between Pennsalt and Olin in the southeastern United States was approximately the same, too. The case was therefore properly analyzed, though in a Clayton 7 rather than a Sherman 1 context, in an effort to see whether the likelihood of competition between the two parents, absent the joint venture, was substantial enough to make horizontal precedent applicable.

A final problem worth notice is whether the vertical nature of a restraint is affected when the parties on whom it is imposed own the firm imposing it. The industry situation in *White Motor* may conveniently be used once again as a background for a hypothetical example. Suppose the resellers of White trucks had purchased White Motor Company. Reseller ownership of White could be viewed as converting the restraints to horizontal agreements since the reseller-owners would now be imposing the restraints upon themselves. This view would seem mistaken, however. The restraints would still be vertical, and this would be true whether they were imposed by White before or after the resellers took control of it. The reason is simply that the resellers as owners of White would have no more reason to restrict their output as resellers than White had before the change in control. If White's share of the final market was large enough to make restriction of output profitable, that restriction would take place at the manufacturing level and would not require the more cumbersome and costly mechanism of division of reseller territories.¹⁰⁸

105. The government challenged this agreement in the district court as per se unlawful. The court, however, discounted the possibility of competition between the two companies. *Id.* at 134-37. The Supreme Court did not discuss the legality of the agreement but confined its analysis to the subsequent joint venture.

106. It would have been inappropriate to apply a per se rule to the agency agreement, as the government urged, since the contract integration of Pennsalt's manufacturing and Olin's distribution is obviously capable of creating efficiencies.

107. 378 U.S. at 163.

108. A possible theoretical exception to this generalization might be constructed by supposing that the split of the profits taken at the reseller level was different from the

The foregoing discussion of the problem of distinguishing vertical from horizontal agreements does not cover the special problems that arise when the restraint is imposed in connection with the licensing or sale of a patent or of know-how. These forms of property are sufficiently distinct so that they will be discussed separately in the third section of this article. It will be helpful in the remainder of this section, however, to indicate briefly why it seems proper to analyze cases such as *Sealy* and *Spring-Air* as horizontal. In each of these cases a corporation owning trademarks and tradenames licensed them to bedding product manufacturers. The licenses required the manufacturers to use identical materials and specifications so that uniform products could be nationally advertised. The licenses also required the manufacturers to sell products using the licensed marks and names only within specified territories and to require their retailers to maintain specified retail prices. The manufacturers in each case, however, owned and controlled the licensing corporation. Though the cases thus seem similar to the hypothetical reseller purchase of White Motor, the resemblance is superficial. *Sealy* and *Spring-Air* are better analyzed as horizontal because the elimination of competition between the bedding manufacturers in such a case may raise a danger of restriction of output greater than that which exists at the level of trademark ownership. A corporation which owns only a trademark is most unlikely to possess the power to restrict output in order to take a monopoly profit from an industry.¹⁰⁹ Entry at the level of trademark ownership is too easy. Other firms need

division of manufacturing profits. This would in turn require that voting control at the manufacturing level be, for some reason, different from the division of profits among the reseller-owners. Such a situation would permit those in voting control to defraud the other owners by shifting the taking of the monopoly profit from the manufacturing to the reseller level. Not only are such cases extremely rare, if they occur at all, but the shifting of monopoly profits could conceivably have antitrust implications only if it were possible to say that the restriction of output or the cost of imposing it was greater than if the monopoly profit were taken at the manufacturing level. For all practical purposes, therefore, reseller ownership of the manufacturer does not alter the verticality of the restraints placed upon the resellers by the manufacturer.

109. A firm, or a group of firms using a common trademark, may well possess monopoly power. The point under discussion, however, is whether that power is likely to be conferred by the trademark or by the structure of, or collusion in, the underlying industry. If ownership of a trademark alone were sufficient to create complete monopoly power, all trademark licensing cases would be vertical since the imposition of restraints upon licensees could never create an additional restriction of output. For reasons given in the text, this does not seem a correct analysis. A trademark would be capable of conferring monopoly power only if the economies of scale in advertising were such in relation to the size of the market that only one trademark could profitably be advertised and, further, if trademark advertising were indispensable to survival in the industry.

only adopt a mark and advertise it to share in the monopoly profit. Manufacturers offered licenses could avoid the monopoly toll simply by establishing trademarks, i.e., integrating backward into trademark ownership. Trademark ownership and exploitation are, therefore, likely to give only a competitive return. There may be an untaken monopoly profit which could be captured by the establishment of market control at some other level of the industry. If bedding manufacturers which collectively possessed market power purchased a trademark corporation and, through it, imposed territorial and price restrictions upon themselves, there would be created the danger, if not the certainty, of output restriction. This indicates that *Sealy* and *Spring-Air* should be viewed as horizontal cases and the legality of the restraints involved should be determined by the market share of the manufacturers.

CREATION OF EFFICIENCY: MARKET DIVISION AND PRICE FIXING

Market division and price fixing may conveniently be discussed separately because the ways in which they are capable of contributing to the efficiency of contract integrations are not in every respect identical. Horizontal contract integrations are typically created by otherwise independent and perhaps competitive firms in order to achieve the advantages that accrue to a larger scale of operations in the activities co-ordinated. Vertical contract integrations are typically created in order to permit a manufacturer to obtain the benefits of a stable relationship with its resellers: reduction of selling costs, accurate estimation of output required, reseller expertise in the marketing and servicing of the particular product, and so forth. The question to be examined here is what additional efficiencies may be created by an agreement eliminating competition between the members of a horizontal system or the resellers in a vertical system. The efficiencies suggested for such agreements do not, of course, exist in all contract integrations, or may be outweighed by other business efficiencies with which they interfere.

The theory of efficiencies presented here is undoubtedly incomplete and is probably inaccurate in certain aspects. But the fact that market division and price fixing can create efficiencies valuable to consumers does not seem subject to reasonable doubt. The present state of legal doctrine, unfortunately, too often precludes judicial inquiry into the efficiency-creating potential of such agreements. Some of the recent cases discussed here give reason to hope that the law will soon permit the relevant inquiries to be made.

Market-Division Agreements

Though there may be other methods which will be revealed by analysis or by study of particular situations, the most obvious ways by which market division may enhance the efficiency of a contract integration include:

1. Optimizing local sales effort: the free ride problem;
2. Optimizing local sales effort: the size of the market problem;
3. Encouraging exchanges of information;
4. Minimizing the costs of providing post-sales service and minimizing the risks of customer dissatisfaction;
5. Preventing overlapping use of a service whose cost is shared; and
6. Preventing duplication of costs and customer irritation due to overlapping distributive effort.¹¹⁰

The first and third points and part of the analysis under the fourth point relate to the solution of the free ride problem. This problem,¹¹¹ in all its manifestations, is similar in form to the partnership case discussed earlier.¹¹²

1. Local Sales Effort: The Free-Ride Problem.

Defendants have occasionally attempted to justify market-division agreements with the contention that they were necessary to insure intensive coverage of markets. In *White Motor*, for instance, the defendant argued that it had "to insist that its distributors and dealers concentrate on trying to take sales away from other competing truck

110. The Note, *supra* note 81, at 813, suggests the first and fourth efficiencies listed, as have other writers, and also suggests three others: facilitation of manufacturer planning by keeping the volume of each reseller constant; encouragement to resellers not to take on competing lines by assuring a sufficient market; and facilitation of manufacturer tracing of defective goods. The first and third seem theoretical possibilities, though the first does not appear a significant efficiency and the third may be important only in special industries. The authors say it is often mentioned in the drug industry. The second factor listed would exist only where the law outlawed an exclusive dealing agreement or where the unattractiveness of the product made it necessary to offer a large protected territory to get a dealer to agree not to handle other lines. The Note contains an excellent summary of reasons given by businessmen for wishing to use various forms of reseller market division. The economic analysis and the policy suggestions of this article, however, differ considerably from those in the Note.

111. Bowman, *supra* note 67, refers to the same phenomenon as the "spilling-over effect," Telser, *supra* note 74, refers to it as "free ride." Both of these authors analyze the problem in the context of resale price maintenance. The analysis here differs primarily in the variety of situations in which the problem is suggested to exist and in the variety of contractual restraints which are believed available to solve it.

112. See text accompanying notes 19-34, *supra*.

manufacturers in their respective territories rather than on cutting each other's throats in other territories."¹¹³

At first glance this argument seems difficult to follow. The self-interest of the dealer would seem sufficient to cause him to cultivate all profitable accounts in his own territory as well as to raid other territories to attempt to capture the profitable accounts there. Merely because there is a more profitable account in a neighboring territory seems no reason for a dealer to ignore any account in his own territory on which some profit is to be made. He would seem more likely to try for both.

There seem two valid explanations for the contention made in *White Motor*. Both have to do with the deleterious effect upon local sales effort of the ability of firms selling the same brand to sell to the same accounts. This section takes up the explanation based on the free-ride problem—that is, the problem created when one firm in an integrated group is able to take advantage of the efforts of other members of the group. The next section discusses the explanation based on the size-of-the-market problem.

Recent litigation discloses a number of distributive systems which appear to employ market-division agreements to prevent any seller from enjoying a free ride upon the efforts of others within the same system. The *Sealy* and *Spring-Air* cases, here viewed as horizontal, involved the licensing of trademarks and trade names to bedding product manufacturers¹¹⁴ who were required to follow promulgated standards and specifications so that the products appearing under the licensed marks and names were uniform. Though confined to selling such products in designated territories, the manufacturers remained free to make and sell anywhere other bedding products under their own labels. The primary purpose of this cooperative effort of geographically dispersed bedding manufacturers seems to have been to attain national distribution of a uniform product in order to gain the advantages and efficiencies of national advertising. Funds for national advertising were contributed by the manufacturers.

Two vertical cases of recent vintage are *White Motor* and *Sandura*.¹¹⁵ *White Motor*'s market-division agreements have been discussed. *Sandura*, a manufacturer of vinyl floor covering products, required its

113. *United States v. White Motor Co.*, 194 F. Supp. 562, 578 (N.D. Ohio, 1961).

114. Thirty-four manufacturers were licensed by *Spring-Air* and approximately thirty by *Sealy*.

115. *Sandura Co. v. FTC*, 339 F.2d 847 (6th Cir. 1964).

various distributors to resell Sandura products only to retail dealers located within assigned territories.

The market-division agreements in *Sealy*, *Spring-Air*, and *Sandura* were upheld by lower courts, and the Supreme Court refused to fashion a per se rule for the *White Motor* restraints, though reserving that as a possibility after further litigation had clarified the economic function of vertical market division. Apparently the various courts which upheld these agreements, despite the semantic applicability of the per se dogma, recognized that issues of efficiency were in play. None of the opinions, however, analyzed the mechanism of efficiency creation in a wholly satisfactory manner.

The opinion of the Court of Appeals for the Fifth Circuit in *Spring-Air* is perhaps least satisfactory in this respect. It analyzes the case rather artificially as involving a restraint necessary to the licensor's protection and exploitation of its trademark,¹¹⁶ but the opinion does not explain how the division of territories was related to these purposes. In its concluding remarks, however, the court suddenly took what seems a more realistic tack:

An agreement which strengthens and promotes competition is not a violation of the law. As a practical matter, it would be extremely difficult for each member of the Spring-Air group effectively to compete with the large bedding manufacturers. Spring-Air is not in a position to compete. It manufactures nothing. The arrangement under consideration gave to the members of the group established brand names, trademarks and national advertising, all of which cost money which was raised by assessments and the contributions of each member.¹¹⁷

This observation shifted the focus of the reasoning from trademark profitability as an end in itself to the efficiency of national advertising by a group of manufacturers. Co-operative advertising is, of course, a form of horizontal contract integration. The court's remark, however, still fails to explain the need for market division.

Sealy is in some ways a more interesting case because the district court's extensive findings of fact provide a better understanding of the role of market division in such a system, because the government's contentions illustrate its attitude toward the idea of ancillary restraints, and, finally, because the government has appealed the decision to the Supreme Court.¹¹⁸ The government's contention in the trial court seemed to be that price fixing and market division are always

116. 308 F.2d at 409.

117. 308 F.2d at 413.

118. *Prob. juris. noted*, 86 S. Ct. 58 (1965).

and everywhere illegal. Rejecting the suggested application of Taft's ancillarity concept, the government urged upon the trial court the flat proposition that "Price fixing and territorialization are not and cannot be ancillary to anything."¹¹⁹ The court in turn rejected the government's per se position. Finding that there was no "central conspiratorial purpose" on the part of Sealy and its licensees, the court cited evidence which showed that: "The Sealy executive committee rejected a specific proposal to divide the country among Sealy licensees; Sealy continually sought new licensees to fill in uncovered territory; and licensees relinquished territory that was not within their natural trading areas, so that it would be covered by other licensees, existing or new."¹²⁰ The court ultimately concluded that

Plaintiff's evidence, read as a whole, conclusively proves that the Sealy licensing arrangements were developed . . . for entirely legitimate business purposes, including royalty income . . . and the benefits to licensees of joint purchasing, research, engineering, advertising and merchandising.¹²¹

The courts in *Spring-Air* and *Sealy* both saw that desirable efficiency was created by the contractual integration of the mattress manufacturers to make a uniform, nationally-advertised product, but they did not attempt to explain the bearing of the market-division agreements to that efficiency or to provide conceptual justification for such agreements within the rule of reason. The Sixth Circuit's *Sandura* opinion came nearer the mark in both these respects. The court stated that closed territories were necessary to get Sandura's distributors to undertake product advertising themselves.¹²² Sandura had contended that its distributors "would not spend to advertise and promote an unpopular product without assurance that resulting sales accrued to them."¹²³ Relying upon the Supreme Court's *White Motor* opinion, the Sixth Circuit concluded that "closed territories made for the vigor and health of Sandura [which, the court had noted, was one of the smaller companies in the industry and had almost gone under in the recent past], increasing the competitive good that flows from *interbrand* competition without any showing of detriment to *intra*brand competition."¹²⁴ The latter remark is not quite fair, of course, since there

119. Post Trial Brief for Plaintiff, p. 24.

120. 1964 Trade Cas. ¶ 71,258 at 80,076-77 Finding 84.

121. Finding 119, *id.* at 80,083.

122. 339 F.2d at 856.

123. *Id.* at 851.

124. *Id.* at 858.

could hardly be any showing of detriment to intrabrand competition other than that it was eliminated. The finding of benefit to interbrand competition rested on the fact that Sandura faced larger and stronger competitors and upon the court's conclusion that the advertising engendered by closed territories was "essential to the continuation of Sandura as a significant competitive force in an industry dominated by firms many times as large."¹²⁵

Though other efficiencies may have been involved as well, the contract integrations in *Spring-Air* and *Sealy* seem to have been created primarily to gain efficiencies of national advertising, promotion, and other forms of sales effort. The members of the Spring-Air and Sealy systems were mattress factories limited to local markets by costs of shipment. A business with only a local market is obviously unable efficiently to employ advertising media that are best used on a national or even a regional basis.¹²⁶ Not only was national advertising said to be extremely important to these groups,¹²⁷ but the behavior of the groups indicates that it was important to have national distribution in order to utilize national advertising most efficiently.¹²⁸ White and Sandura, both national manufacturers, could provide the national advertising and promotion to support their local resellers. Sandura, however, contended that it lacked the capital to engage in extensive national advertising and therefore relied heavily upon the local sales efforts of its distributors.¹²⁹ Sandura, as noted, argued that the distributors would not engage in such efforts unless closed territories assured that resulting sales accrued to them.

125. *Id.* at 857.

126. The advantage of national advertising appears to have been the basis for Clorox's heavier use of advertising as compared with rivals that distributed primarily on a local or regional scale. See *Procter & Gamble*, *supra* note 51.

127. *E.g.*, in *Sealy* the court quoted one licensee as stating, in connection with the suggestion that the royalty basis be changed from licensees' sales to the circulation of national publications in licensees' territories: "The primary purpose of the organization is to secure national advertising, and that mainly is what each factory secures from the Sealy Corporation." 1964 Trade Cas. ¶ 71,258, at 80,075 Finding 26.

128. In *Sealy* the court's findings 31, 85, and 86, among others, deal with this topic. A specific example is provided by finding 90 which recites that "At the Board meeting in June 1937, representatives of the B. F. Goodrich Company stated that they had experienced considerable difficulty in having Sealy mentioned frequently in Goodrich advertising 'because Sealy does not have proper national distribution.'" The *Spring-Air* opinion also suggests the relationship of national advertising to national distribution: "It [Spring-Air] is composed of a group of 34 small bedding manufacturers who attempt to compete with large national bedding manufacturers by making Spring-Air products of uniform nature and quality; and by advertising such products in national magazines." 308 F.2d at 405.

129. 339 F.2d at 851, 853, 856.

But if local sales effort—including in that term local advertising, salesmanship, and all forms of promotional effort—was the main purpose of the vertical Sandura system of closed territories, there is no reason to suppose that either White Motor or the horizontal Spring-Air and Sealy systems were not also vitally interested in such effort. Local sales effort and national advertising may be able to substitute for one another to a certain extent. It seems clear, nevertheless, that national advertising and local sales effort are rarely, if ever, perfect substitutes for one another. In marketing their products almost no firms seem to depend exclusively on national advertising. Local sales effort almost always plays a role, often a vital one. The individual firm will employ marginal analysis not merely in deciding how many dollars to spend upon national advertising and local sales effort, but also in determining its allocation of expenditures between the two and among their various components. The fact that many firms use a variety of forms of advertising and other sales effort indicates that these forms are not perfect substitutes. If they were, no firm would take the extra trouble and expense involved in using more than one. Thus, the mattress manufacturer joining a group such as Spring-Air will likely believe it can sell the Spring-Air line most profitably by combining local efforts with the national advertising campaign. In addition to advertising through local media, the manufacturer, it may be supposed, will resort to such efforts as having salesmen call upon retailers, hotels, and other large purchasers of mattresses in its area to persuade them of the advantages of the brand, and, very probably, to provide them with a variety of consultative services concerning the product and the customer's particular needs.

Local sales effort costs money that can be recaptured only in the price at which the mattresses are sold. The firm that is large enough to distribute nationally under its own trademark will measure such efforts and expenditures simply by their relation to expected sales and revenues. The member of a group has a special problem, however. It may find that it is unable to recapture all of its expenditures in local sales effort because a neighboring member of the group undersells it. The interloper gets all the advantages of the first firm's expenditures without paying for them. It thus gets a free ride and this very fact may enable it to undersell profitably. The customer gets free information and advice. The point is not that such behavior is unfair but rather that by making the effort less profitable, it will decrease the amount of local sales effort members of the group are willing to do. To that extent the group becomes a less efficient marketer than a single fully-

integrated firm of the same size. An agreement dividing territories between the members of the group, such as was actually employed by the Spring-Air and Sealy groups, protects each member from the danger of free rides. Each is able to engage in the optimum amount of local sales effort, and the total efforts of the group once more tend to equal those of a single fully-integrated firm of comparable size. A market-division agreement employed by a co-operating group such as the Spring-Air or Sealy licensees, therefore, seems precisely analogous to the agreement of partners not to compete with the partnership.

The same reasoning applies to vertically-imposed market divisions such as those in *White Motor* and *Sandura*. In selling its products to the public the manufacturer can supply national advertising (assuming it has the funds), but it will undoubtedly want its resellers to engage in the sorts of local sales effort that only they can do effectively.¹³⁰ The manufacturer may perceive or have brought to its attention that reseller local sales effort is less than the desirable amount because some resellers make a practice of free riding. The most efficient (i.e., least expensive) method of obtaining the desired level of such effort is to make each reseller's interest in providing the effort coextensive with the manufacturer's interest in having it provided. Giving resellers exclusive and closed territories creates an identity of interest by assuring, just as in the horizontal case, that the sales engendered by such effort accrue to the business unit that provides the effort.

This analysis applies as well to forms of market division other than territorial allocations. *White Motor*, for instance, required its resellers to agree not to sell to the federal government, any state government, or any department or political subdivision of any such government. In his concurring opinion Justice Brennan said that customer allocations seemed inherently more dangerous than territorial limitations, "for [customer allocations] served to suppress all competition between manufacturer and distributors for the custom of the most desirable accounts."¹³¹ The territorial limitations were equally effective in suppressing all competition between the resellers, so perhaps the factor that troubled Justice Brennan was that the accounts here were more desirable and that the manufacturer rather than the reseller got them.

130. Local resellers will obviously be in closer touch with local customers' desires and needs than a distant manufacturer can be. For the manufacturer to rival its local resellers in effectiveness of local sales effort would require extensive forward integration into the reseller level. The manufacturer would then duplicate many of the functions of its local resellers and increase the costs of distributing its products.

131. 372 U.S. at 272.

As already shown, however, these agreements could not have been imposed by White for the purpose of restricting output. White must have believed that this form of market division, too, enabled it to achieve distributive efficiencies. Customer allocation seems capable of serving the same function with respect to sales effort as territorial limitation. Many large-volume accounts are likely to require special sales effort.¹³² It is likely, for instance that a customer about to purchase a fleet of trucks may require a great deal of study and discussion of its particular problems and requirements from manufacturers who wish to obtain the order. In some cases it is probable that the necessary information and modifications of the trucks or their accessories can be supplied best by the manufacturer. Where this is or may be true it will be less expensive for the manufacturer to deal directly with the customer rather than to have requests and answers relayed by the intermediate reseller. Since the manufacturer may often initiate suggestions to such customers, the interposition of a reseller may lose sales because such suggestions are not made. It would not be an answer to train all resellers to have the same knowledge of customers' needs and of the variety of ways in which the manufacturer might be able to meet them. Training of reseller personnel would require an enormous and continuing effort and would impose large costs upon the manufacturer in order to duplicate in dozens or even hundreds of resellers the knowledge the manufacturer already has and is steadily revising.

Nor is it any answer to this argument to suggest, as Justice Brennan did, that, if the manufacturer is more efficient in dealing with these accounts, it does not need the customer allocation clauses because it will get the business anyway.¹³³ The sales effort put forth by the manufacturer requires the incurring of costs and these can be recaptured only in the price it charges for its product. If resellers are permitted to sell to such accounts after the manufacturer has done all the preliminary studies and selling, the expenditure of such effort by the manufacturer would be less profitable and the manufacturer would reduce the amount of such effort it engaged in. The customer allocation may thus also function to prevent free rides in much the same way that the territorial limitation upon resellers does. Customer allocation

132. White stated, for example, that "the reason for reserving the right to sell particular accounts, such as government agencies, is even simpler. It is the natural feeling that the only sure way to make certain that something really important is done right, is to do it for oneself. The size of the orders, the technicalities of bidding and delivery, and other factors all play a part in this decision." Brief for Appellant, p. 18.

133. *Id.* at 274-5.

clauses enable the manufacturer whose customers fall into different classes and require different kinds and amounts of sales effort to reach each class most efficiently.

It should constitute no objection to the policy implications of this analysis that the efficiencies gained by preventing the free ride are in the use of local sales effort. Local sales effort, of course, may include an element of advertising, but advertising efficiencies are real and important despite signs of a developing antipathy to them in some antitrust litigation. Secondly, local sales effort encompasses a great deal more than "advertising" in the narrow sense. It may involve, for example, the technical training of personnel and the provision of considerable services and information to customers. Finally, since there is presently no antitrust objection to the most efficient utilization of local sales effort by ownership-integrated firms, there seems no reason to discriminate against the accomplishment of the same objective by contract-integrated systems through the use of market-division agreements.

2. *Local Sales Effort: The Size-of-the-Market Problem.*

Quite aside from the free-ride problem, it seems possible to conceive of a situation in which local sales effort would fall below optimal proportions because particular markets were too small to repay the efforts of two sellers of a single brand. Market division is a way of solving this problem by insuring that only one seller will be able to reach the market or account.

Testimony in the *Sandura* case suggests the reality of this situation. The Court of Appeals' opinion states:

[D]istributor testimony . . . illustrates that closed territories are responsible for more thorough coverage of dealer accounts than Sandura would otherwise enjoy. In the words of one distributor who testified that the Sandura system avoided duplication of effort and resulted in greater coverage of a given territory, "this way we are able to concentrate, and we do a lot of business in little towns, small towns. We don't bypass them. We can back into the hinterland."¹³⁴

This suggestion may make economic sense if in a number of territories there are towns of widely different sizes and if a number of the smaller towns constitute markets of such size that they will not repay cultivation by two distributors.¹³⁵ Where two or more distributors are

134. *Sandura Co. v. FTC*, 339 F.2d 847, 853 (6th Cir. 1964).

135. In many industries distributors not only call upon dealers but perform a variety

permitted to reach such towns, therefore, neither may consider it worthwhile to cultivate them intensively since even sporadic visits by other distributors would diminish the distributor's sales below the point at which such cultivation is profitable. Such markets are then likely to be reached only occasionally, as when some other business causes a salesman of the distributor to pass through the area. The net result is likely to be irregular or intermittent service by the distributors so that dealers are set up or served less efficiently than would be the case if a single distributor had the town exclusively.¹³⁶

3. *Exchanges of Information.*

It is, of course, beneficial to the overall efficiency of any integration for the various units within it to pass on information which may be useful to other units. This efficiency, too, may be impaired if it is possible for the unit receiving the information to use it competitively against the unit supplying it. Thus, it was argued in the partnership case that the individual partners would be less likely to disclose to one another valuable business information if the others were likely to make use of it for their individual profit rather than the profit of the firm.¹³⁷ This manifestation of the free-ride problem has obvious application to distributive systems such as those in *White Motor*, *Sandura*, *Sealy*, and *Spring-Air*. The dealer or distributor of White trucks, or the manu-

of services such as helping to set up the dealership, instructing in record keeping, advising on techniques of promotion and sales effort, organizing displays, keeping inventories balanced and adequate, and so forth. Thus, the distributor may incur significant costs in making dealers efficient.

136. By analogy to the size-of-the-town problem, it may be possible to construct a second situation having to do with the size of the customers. Suppose that methods and costs of selling and servicing large-volume accounts differed significantly. Suppose further that it would be profitable for any single dealer to specialize on large-volume accounts and sell as widely as his costs of doing business permitted, or that it would be profitable for him to stay in a single territory and reach both types of accounts with a compromise organization, but that it would not be profitable for any dealer to specialize on scattered small-volume accounts. The manufacturer might judge that its most profitable course would be to have each dealer build the compromise organization and cover limited areas intensively. If any significant number of dealers made different judgments about their own interests and specialized on large-volume accounts, the small-volume accounts in the markets they could reach might be completely lost to the manufacturer. Whether this result occurred because of some difference in the interests of the manufacturer and particular dealers or merely because of differences in their judgment or business acumen is not important. The manufacturer might well believe it in his interest to assign closed territories of such a size that every dealer found it could operate most profitably by building an organization capable of reaching both large and small accounts. This argument is admittedly speculative and requires a number of preconditions, but it seems at least a possible explanation of some closed territory arrangements.

137. See pages 380-82 *supra*.

facturer of Sealy mattresses, is much less likely to make known to others in the system any particularly successful selling or manufacturing techniques it devises if there is a substantial possibility that such techniques will be used to take business away from it. Market division removes this disincentive to disclosure and so tends to make the whole system more efficient.

This form of efficiency may often be served by a division of fields agreement (a form of market division) to prevent the problem of the free ride created by joining the complementary technologies or resources of two firms. To recur to a hypothetical used elsewhere,¹³⁸ suppose that a boat-building company sees that plastic hulls are a distinct improvement in construction. The company may not wish to have hulls built for it by an independent plastics firm because of the danger that its own designs and marketing plans might then become known to competitive boat builders using the same supplier of plastic hulls. On the other hand, the boat company has no experience in working with plastics and would find it too difficult, expensive, and time-consuming to acquire the necessary equipment and skill to make its own plastic hulls. In many such cases of complementary technologies, moreover, the efficient scale of operation in the other manufacturing field may be much greater than that needed to supply the needs of the first company. If that were true here, the boat company would find that in order to supply its own needs at an acceptable cost it had to manufacture a much wider range of plastic products and attempt to sell them in competition with existing plastics concerns. The investment would be wholly out of proportion to its own needs and would require entry into an industry that in other areas might not look particularly promising. The obvious solution is to find a plastics concern which, looking at the problem from the other side, considers hulls a promising new end use for its product but has no desire to enter the completely unfamiliar field of boat design and construction and lacks the distributive facilities to sell in that market.

Both companies may be able to solve their problem by pooling their specialized technologies and facilities. Each then faces the difficulty that the other may make use of the information gained to enter the other field. The firms can enter into a closer and more effective collaboration by eliminating the possibility of competition between themselves in areas in which the disclosed information would constitute a substantial competitive asset. Whether their arrangement ultimately

138. Bork, *Ancillary Restraints and the Sherman Act*, 15 A.B.A. SECTION OF ANTITRUST LAW 211, 227 (1959).

took the form of a supply contract or the creation of a jointly owned subsidiary to produce plastic boats, the efficiency of their collaborative effort would be enhanced by an agreement that neither would deal with a competitor of the other or enter the other's field. If a joint subsidiary were formed, it would be necessary to have the subsidiary agree to stay out of the parents' fields. The agreement would be most effective if it covered not only the fields of operation directly involved in the joint effort but also fields in which either company operated and the knowledge gained would be an advantage to a competitor. That is, it might be helpful if the boat company agreed to stay out of other aspects of the plastics business in which it could utilize know-how gained in working with the plastics company on hulls.

An incomplete insight concerning this sort of efficiency perhaps formed the basis for the district court's decision in *United States v. Bausch & Lomb Optical Co.*¹³⁹ There the Soft-Lite Lens Co. distributed unpatented, pink-tinted lenses. Originally Soft-Lite bought the glass abroad and had it ground in the United States. Eventually it turned to Bausch & Lomb, first as a grinder, later as sole manufacturer of the glass. The parties agreed that Bausch & Lomb would manufacture pink-tinted glass only for Soft-Lite and that it would not compete with Soft-Lite and that it would not compete with Soft-Lite in the sale of the pink-tinted lenses. The government attacked this agreement as violative of the Sherman Act, but the district court sustained the restraint as reasonable and ancillary:

In the case at bar the main purpose of the contract is to provide a source of supply for Soft-Lite. The restraining covenant is for the protection of the purchaser who is spending large sums to develop his good will and enlarge the public patronage of a relatively new article of commerce. The arrangement, though not a partnership in legal form, is functionally a joint enterprise in which one will produce and the other market the commodity.¹⁴⁰

The efficiency suggested by this passage does not seem real. If Soft-Lite were spending large sums to develop the good will accruing to its own trade name, that investment would not be endangered by Bausch & Lomb's selling the same kind of glass to other purchasers who would market under different names. Nor would Soft-Lite's expenditure of money to develop public demand for a new article of commerce be jeopardized by Bausch & Lomb's selling the glass to others

139. 45 F. Supp. 387 (S.D.N.Y. 1942), *aff'd* on the point under discussion by an equally divided Court, 321 U.S. 707, 719 (1944).

140. *Id.* at 398.

if those others were able, in any event, to get the same product from other suppliers.

The restriction seems to make sense only if additional considerations existed. One such consideration, suggested by the record, is that Soft-Lite believed it had a somewhat unique formula for the glass which was unlikely to be duplicated exactly and quickly. This is to say that Soft-Lite must have had a product which was differentiated physically as well as by its advertised trade name. In return for disclosing the means of differentiation to Bausch & Lomb Soft-Lite would demand that Bausch & Lomb not compete with it, directly or indirectly, by selling the identical glass to others.¹⁴¹ An alternative, though closely related, explanation is that Soft-Lite knew of manufacturing techniques which reduced the cost of producing pink-tinted glass. Though not a manufacturer, Soft-Lite wished to retain the cost ad-

141. Singer, the president and general manager of Soft-Lite, explained his request that Bausch & Lomb put in writing its promise not to sell pink-tinted lenses to others or distribute such lenses itself: "I would not hand them our specifications, our trade-marks, our business, so they won't compete with me on a glass like ours and just forget what we had been told before . . ." Rec. 103. He also testified that Bausch & Lomb offered to try to make a harder, better quality of glass than the French glass Soft-Lite originally supplied them for grinding if Soft-Lite would give Bausch & Lomb the specifications. Singer said he replied: "Well, the first thing my dad will ask me is, what protection have we?" Rec. 466. Further:

"Q. Mr. Singer was there any discussion as to an arrangement to make the glass exclusively for you?—A. There was.

"Q. Will you tell us just what that transaction was?—A. Well, before I brought up the formula specifications I told him my dad would want to know whether or not they would be making a glass like ours for themselves or anybody else; if they would, if it was putting my Dad's interest in the lenses, good will property and trade name in jeopardy, and he says, 'We don't do those things up here. If we make it for you we won't make it for anybody else. Of course we sell colored lenses now and will sell colored lenses, but that particular type of absorption, a rose tint, we will make it for you and for nobody else.'

"Q. You were talking about a particular type which was being developed from the confidential specifications you furnished?—A. That is right.

"Q. And you did not want them to use that in the making of glass for themselves or anybody else?—A. That is right.

"Q. And Mr. Hammele told you they would not operate that way?—A. He told me, promised definitely and said, 'We don't do things that way here,' and I says, 'That is why we came to you.' Rec. 469-70.

Singer returned later and gave the specifications to Bausch & Lomb. Bausch & Lomb experimented and made a better quality glass with those specifications. Rec. 466. The district court's opinion stated: "It is not necessary to find and I do not find that Soft-Lite's specifications for the glass constituted a secret formula for the protection of which a restraining covenant would be proper." 45 F. Supp. at 399. The court found the arrangement proper for reasons cited in the text. The record does not appear adequate to support a finding of valuable, secret specifications, but it also seems inadequate to disprove such a theory. The court did not, of course, find that such specifications did not exist. One could wish, for present purposes, that the question of the specifications had been gone into more thoroughly at the trial.

vantage which knowledge of these techniques gave by requiring Bausch & Lomb not to make the glass for anybody else.

An additional explanation, also suggested by the record, is that the information Soft-Lite wished to protect related not only to the method of making the glass but to its business plans and techniques.¹⁴² Had Bausch & Lomb wished to enter the field of distribution itself or to aid other customers in doing so, such information as Soft-Lite's customer lists, methods of pricing, techniques of "missionary work" in particular territories, etc., could have been used to give Bausch & Lomb or its other customers a free ride at Soft-Lite's expense.¹⁴³

It may conceivably be objected that it might be more desirable from the consumers' point of view to make agreements such as those in *Bausch & Lomb* and the plastic boat example illegal.¹⁴⁴ Absent the ability to make such an agreement, for instance, Soft-Lite would have had the option of giving up its manufacturing or commercial know-how

142. Soft-Lite gave Bausch & Lomb a list of Soft-Lite's customers to whom Bausch & Lomb referred in an office memorandum as jobbers and retail licensees. Finding of Fact, No. 7, Rec. 53. The reason given by Singer was that possession of the list permitted Bausch & Lomb to ship direct when it received an order for Soft-Lite lenses rather than refer the order to Soft-Lite. The list was necessary because Soft-Lite refused to sell certain jobbers for a variety of reasons ranging from credit difficulties to refusal to comply with Soft-Lite's policy on retail prices. Bausch & Lomb's use of the list was said to save several days' time in filling orders. Rec. 107-08. Bausch & Lomb and Soft-Lite apparently worked so closely together that Bausch & Lomb became very familiar with Soft-Lite's business and promotional methods. See Brief for the United States, pp. 17-20 and record citations there; Brief for Appellees, Bausch & Lomb Optical Company, pp. 25-31 and record citations there; Finding of Fact No. 18, Rec. 55.

143. Agreements or tacit undertakings not to compete or to deal with a supplier's or customer's competitors are common in the business world. The above analysis suggests that many of them may be motivated by a desire to prevent free rides on information supplied in the course of coordinating the activities of independent firms. Manufacturers often develop product changes or selling plans which necessarily become known to their suppliers through such matters as changes in specifications, amounts, or delivery dates of supplies ordered. In addition, the manufacturer may wish to work closely with the supplier to develop new products and techniques of manufacture. When the supplier serves competitive manufacturers or may move into manufacturing itself the chance of a deliberate or inadvertent disclosure of such information is always present. Where possible, therefore, many manufacturers prefer an exclusive relationship with a supplier. Such arrangements, too, are, in economic reality, the same phenomena as partnerships or joint ventures.

144. The theory would be that consumers would gain because the information would be more widely used if the firm possessing it were required to disclose without limitation in order to get any benefits from the information itself. The theory under discussion does not involve monopoly at either level which is preserved by the agreement not to enter. It assumes that there are other manufacturers of glass, plastics, and boats, and other distributors of spectacles. The mere possession of valuable knowledge cannot, of course, be viewed as the possession of a monopoly any more than can the possession of any valuable asset.

or of manufacturing the glass itself. An election to disclose and thereby sacrifice the know-how, however, might not benefit consumers even if Bausch & Lomb used the information to enter distribution of pink-tinted glass or to assist competitors of Soft-Lite in doing so. The effect might be simply to transfer the value of the assets from Soft-Lite to Bausch & Lomb. The profit would merely accrue at a different stage of a vertically related process and consumers might receive about the same output at about the same prices. Consumers might be benefited, of course, if the marginal costs of distributing such glass rose more rapidly than the marginal costs of manufacturing so that the most efficient arrangement would be a single manufacturer and more than one distributor.¹⁴⁵ One cannot state *à priori* whether or not this is the general situation where a division of fields is sought to protect the transfer of information.

Weighing on the other side are inefficiencies that may result from refusing to allow a firm in Soft-Lite's position to require the agreement protecting its disclosure of know-how. The first inefficiency is that many firms in such a position will find manufacturing their own supplies a lesser evil than disclosure, even though that choice creates corporate size which may be less efficient and commits them to operations in which they are less skilled than the manufacturer they have given up. Secondly, even if these diseconomies for the firm do not exist, the decision to manufacture glass may waste resources by duplicating facilities already existing in glass manufacturing. Finally, firms in Soft-Lite's position will have less incentive to develop or scout out know how because it will now be less valuable to them or, if making their own supplies is not a realistic alternative, will be of no value to them.¹⁴⁶ The net result must be that a lesser amount of such know-

145. In this situation Soft-Lite would be operating at an inefficiently large scale so that the distribution function would be performed at a lower cost if other firms could enter distribution. Even if this were the case, however, it is unlikely that consumers would suffer, for it would be in Soft-Lite's interest to license other firms to aid it in distribution. This would lower distribution costs and increase Soft-Lite's profit from its manufacturing know-how, in this case taken largely on the royalties charged its distributor licensees.

146. The analysis of this section has not mentioned the possibility that the possessor of know-how may be able to realize its value by selling or licensing it. If this alternative were satisfactory, it would go far to lessen the weight of some of the arguments made in the text. A firm such as Soft-Lite, for example, would continue to have an incentive to develop or locate know-how even if it could not protect itself by requiring Bausch & Lomb not to distribute pink-tinted lenses or to sell to other distributors. Soft-Lite could simply sell its know-how to Bausch & Lomb, realize the value of the asset in that fashion, and become a purchaser like any other. Patent ownership offers an analogy. Patentees do not generally hug the right to work their inventions to themselves. They often license

how will exist or will be profitably employed. The result, in each of these cases, will be a socially disadvantageous loss of efficiency in resource use.¹⁴⁷

For many possessors of know-how, moreover, there is a third alternative which does not involve disclosure or entry into a new field, and which underscores the need for market division to encourage exchanges of information. A manufacturer in the Sealy group or a reseller in White's distributive system, for instance, would have the additional option of keeping the information to itself. If the firm cannot be protected from the danger of the free ride by a market-division agreement, the manufacturer or reseller will not disclose information, the

and recover any advantage the patent confers in the form of royalties. The analogy does not seem persuasive, however. The difference rests in the nature of the legal protection afforded the two forms of property. The patentee discloses his information in his application. Thereafter, if he is issued a valid patent, he may prevent anyone from working his invention, and he may do so regardless of how the infringer acquired his knowledge. The patentee may freely offer his patent for sale or license without fear that those to whom it is offered will use it without paying. The same is not true of the possessor of unpatentable know-how. Secrecy is his only protection, and any other person who acquires the same know-how fairly may use it. But the owner is likely to find it impossible to convince a prospective purchaser of the market value of the know-how without disclosing it to him. The risks involved in such disclosure would lessen the value of sale as an alternative means of capitalizing the value of the asset. If, for example, the prospective purchaser did not buy, it would be next to impossible to discover whether he later began using the know-how anyway, and if that fact were discovered there would necessarily be a dispute as to whether he acquired the know-how in the operation of his business independently of the disclosure. In fact, the purchaser who wanted to protect his opportunity to act in bad faith could claim at the moment of disclosure that he had already learned the information. The point is valid even if the know-how owner does not fear fraud. He and the prospective purchaser may honestly disagree upon the value of the know-how. If the sale is not made, how likely is it that the firm to which disclosure was made will be able to prevent itself from deriving any advantage from the knowledge that it now has? The possibility of sale or license, therefore, is not likely to give a firm in Soft-Lite's position the same incentive to develop or locate know-how that it would have if it could make an agreement such as that upheld in the *Bausch & Lomb* case. The problem of an honest disagreement about price is eliminated there because Bausch & Lomb is not asked to pay anything but only to make a particular variety of lens for Soft-Lite and sell it to no one else. Bausch & Lomb protected itself from any serious disadvantage from even this agreement by noting that it would not feel bound by its agreement if "the progress of science [resulted] in producing glass possessing better properties than is obtainable at the present time." 45 F. Supp. at 390. There is, of course, less reason to fear fraud or honest disagreement on price after disclosure where it is clear that valuable know-how is possessed and the prospective purchaser will commit himself to a price in advance or where a continuing flow of technical information is anticipated and the parties are enabled to work out a license conditioned on periodic royalty payments.

147. Knowledge is a resource like any other. It is desirable for consumer welfare not only that it be developed but that it be freely transferred to employments where the value of its marginal product is greatest. Such transfers will occur more often if firms like Soft-Lite are permitted to protect the asset and so have an incentive to locate it.

contract integration will be less efficient, and consumers will be poorer.¹⁴⁸

4. *Post-Sale Service.*

Market division may in many cases cut costs of providing post-sale service and diminish the risk of customer dissatisfaction with such service. Post-sale service is likely to be particularly important where the product is somewhat complicated and likely to require adjustment by technical personnel after being put in use. At least two kinds of inefficiencies seem likely to arise in connection with post-sale service when market division is not used.

The first variety of inefficiency arises from the familiar problem of the free ride where the service charge is included in the price of the product. If dealers are permitted to sell to customers who use the product in a distant locality, provision of the necessary servicing by the selling dealer will obviously prove very costly. The selling dealer is likely, if he provides any servicing at all, to hold it to an absolute minimum. The dealer close to the customer, on the other hand, will have little incentive to provide any servicing since he is not paid for it. Servicing the product would represent a donation to the customer from the servicing dealer's point of view, and since the customer has already proved his inclination to purchase elsewhere, the local dealer has no reason to expect that the donation will bring him the next sale to that account. If he services the machine well, the customer, happy with the way things worked out, is quite likely to purchase again from the other dealer and expect servicing from the local dealer. If the local dealer services the machine poorly, the customer is quite unlikely to draw the conclusion that he should purchase his next machine from that dealer. The distant selling dealer is thus enabled to enjoy a free ride on any local dealer who is required to perform servicing. The distant dealer can easily make matters worse by skimping on pre-delivery adjustments. This situation, which could arise in either a horizontal or a vertical system, can be cured by a system of closed

148. The foregoing arguments are limited to cases in which information is to be transferred between parties who stand in a collaborative relationship in other respects—supplier and customer of goods or members of a distributive system of goods. There are also cases in which information alone is sold or licensed and the parties have no other area of dealing. This, for instance, is a typical situation with respect to know-how licenses. In such cases, the information itself is the product sold. The forms of efficiency created by market division are then as varied as in the case of the sale of other products. Because the analysis is broader than this topic it is reserved for separate discussion in the third section of this article.

dealer territories. The local dealer then has an incentive to provide good service because he has been paid for it in the price of the product and there will be a close connection between the customer's satisfaction and the probability of selling to him again.

Another form of service inefficiency may be cured by customer allocation clauses. Just as there are cases in which a manufacturer is more competent than a reseller to provide particular forms of sales effort, there may be situations in which the manufacturer has superior expertise in the provision of post-sale service for particular types of accounts. This argument states that manufacturer and resellers should be permitted to specialize according to their different capacities to provide different degrees of post-sales service. Some accounts may not realize the difference in competence between the manufacturer and its resellers in this respect and so may purchase from the reseller and afterward become dissatisfied with the servicing. Such customers will be likely to turn to competitive brands in the future. The analysis here is much the same as that set out above in connection with purchases made from a distant dealer who for cost reasons is unable to provide adequate service. The manufacturer has somewhat more incentive than the local dealer to provide adequate service, for the manufacturer hopes to sell more products in the future. But the manufacturer's incentive will be lessened and its servicing therefore impaired by the fact that the reseller has pocketed the purchase price which includes payment for the service.

A variety of solutions other than market division may be envisaged for post-sales service problems. One alternative would be to sell servicing separately from the product but this method may not be viable in cases where the customer wants to know in advance the cost of acquiring a usable product. This system, moreover, is particularly liable to abuse since the selling dealer, who gets a flat price, has an incentive to cut corners on any pre-delivery adjustments or services. This practice will increase the cost of post-sale servicing. Making the service charge a flat fee will not work either. The customer would know in advance what the usable product would cost but the dealer required to provide the service would often find himself out of pocket unless he skimmed in some cases to keep his costs of servicing within the fee specified. Setting the fee high enough to cover any probable service cost would give the servicing dealer a windfall in a number of cases and increase the total price to prospective customers.

A second method of coping with the post-sale service problem would be to have the dealer closest to the customer perform the service with-

out charge and obtain reimbursement either from the manufacturer or the selling dealer. Where the manufacturer makes reimbursement there is again a strong incentive for the selling dealer to cut corners in readying the product for market. Where either the manufacturer or the selling dealer makes reimbursement, there are obvious opportunities for disputes over such questions as what servicing was really required and how much it ought to cost. Where the dispute is between dealers, the manufacturer is likely to become involved as arbitrator. The servicing dealer, moreover, is likely to keep his services down to what he thinks he can recover without excessive argument and negotiation with either the manufacturer or the selling dealer.

Difficulties of this sort obviously cost money to cure. The manufacturer in a vertical system, or perhaps a specially constituted board in a horizontal system, must police the servicing system and arbitrate disputes between servicer and seller. If this costly function is not undertaken, customer dissatisfaction is apt to rise to critical levels. And, even if the function is undertaken, it may not be possible to avoid all customer irritation.

Justice Brennan, in his *White Motor* concurrence, offered other solutions when the problem was one of reseller incompetence relative to the manufacturer in providing service.¹⁴⁹ He said even this difference in competence did not justify cutting the resellers out of a segment of the market but called for less drastic measures such as improved supervision and training for resellers or perhaps a special form of warranty for the accounts which were likely to receive unsatisfactory service from resellers.¹⁵⁰ Presumably, however, if a manufacturer chooses allocation clauses, that fact indicates the manufacturer thinks it less costly to perform the servicing function itself than to train all resellers who have such accounts in their markets. Moreover, it hardly

149. Justice Brennan made the argument cited in the text in answer to White's contention that certain of its restrictions were required because a distributor or dealer was not competent to handle the intricate process of giving expert advice to customers concerning their needs, determining engine size, etc., until the distributor or dealer had had many months of specialized White training. Justice Brennan apparently viewed this as an attempted justification of White's policy of reserving certain customers to itself, and he answered it in terms applicable to post-sales service. Actually, White was apparently arguing the need for its contractual restriction which prevented distributors from selling to dealers for resale to customers without White approval of the dealers selected. Its "servicing" argument, moreover, concerned what has been termed "local sales effort" in this article. See Brief for Appellant, 17-18. Whether or not Justice Brennan misapprehended the thrust of White's argument on this point, his reasoning remains relevant to the point under discussion in the text above.

150. 372 U.S. at 273-74.

seems a good business tactic for a manufacturer to admit that large accounts are likely to need a special warranty for unsatisfactory service. The prospect of operating troubles followed by negotiation or even litigation on the warranty would likely turn a number of such accounts to other manufacturers. In addition, the costs of making good on the special warranty, particularly if the warranty is to reimburse the customer for all of his direct and indirect losses due to faulty servicing, might far exceed the costs of having the manufacturer do the servicing in the first place.

5. *Effectiveness of a Service or Facility Whose Cost Is Shared.*

The need to separate the markets in which sellers use a service whose cost they share seems to occur only when overlapping use of the service would destroy its effectiveness. This category may consist of rather few situations.

An example is suggested by the reported cooperation of three regional breweries which pooled their radio and television commercials through a common advertising agency. One brewer marketed its beer in the Gulf States, the second in New England, and the third in the Midwest. Each, of course, marketed and advertised under a separate mark and name. The advertising agency prepared commercials using nationally-known talent. Each commercial was used in all three regions, only the name of the beer being changed. The sharing of the efforts of the agency was said to reduce production costs of commercials by as much as a third. In addition, each regional brewery was usually able to use commercials that had already proved successful in another market. Each brewery had to try an unproved commercial only a third of the time, thus giving the group the benefits of regional testing usually available only to a national concern.¹⁵¹ Whatever the arrangements may have been in the actual situation, it is worth noting that an agreement by the parties dividing the territories in which the commercials might be used (or, what amounts to the same thing, a reliance upon the common advertising agency to prevent such overlapping) would create efficiencies. Overlapping would tend to destroy the value of the commercials for all parties.¹⁵²

151. The actors used were Mike Nichols and Elaine May. The three breweries were Jackson Brewing Co., New Orleans, selling Jax beer in the Gulf States; Narragansett Brewing Co., Providence, R. I., selling Narragansett beer in New England; and Geo. Wiedemann Brewing Co., Newport, Ky., selling Wiedemann's beer in the Midwest. The facts given are taken from *Broadcasting*, July 6, 1964, pp. 38-39.

152. The situation described, however, would not appear to justify an agreement not to sell beer in each other's territories. The efficiencies described in the text seem fully

Examples of this sort seem uncommon because most forms of sharing costs to achieve the most economical scale of operation do not appear in themselves to require market divisions to make the integrations effective. Thus, the mere fact of joining to make a common product and engage in national advertising would not seem to justify the market division of the Sealy or Spring-Air groups if it were not for the problem of local sales effort. Some members of the group might find the national advertising more profitable than others, perhaps because of their superior ability to reach the market areas of other members. The problem of one member enjoying the benefits of funds contributed to national advertising by other members can be solved by varying individual contributions according to sales of the advertised product. The Sealy group, at one time, did measure its assessments in this way.¹⁵³ This solution would in no way impair the effectiveness of the national advertising or the local sales effort that members found worthwhile. It is only the free ride problem's effect upon local sales effort, which is made possible by the fact that the members are selling an identical, nationally-advertised product, which requires market division.

For this reason, market division does not seem necessary to enhance or protect the efficiencies of such activities as joint manufacturing or joint research undertaken by competitors in order to achieve economies of scale which none of them could attain alone.¹⁵⁴ This conclusion

protected by an agreement which restricts only the use of advertising so that identical commercials for different beers do not appear in the same market areas. No additional efficiencies seem achievable by dividing markets for the sale of the product. The notion that consumers who travel from one region to another may continue to associate the commercials with a different brand of beer and so lessen the effectiveness of the commercials in the second market area seems, at first glance at least, too trivial to cause concern.

153. 1964 Trade Cas. ¶ 71,258 at 80,076, Finding 33. In 1932 the Sealy group agreed to change the basis for royalty payments from a percentage of sales to a pro rata amount of national advertising dependent upon the circulation of national publications in each licensee's territory. This change had been suggested because national advertising was what Sealy had to offer licensees. *Id.* at 80,074-75, Finding 26. Presumably, sales might differ according to the individual efforts of the licensees and there would be no justification to charge royalties on such effort. Yet a royalty based on national advertising done in a territory would seem to work best when the territories were closed. Otherwise a licensee who was less able to capitalize on the advertising than an invading neighbor would feel that he was paying too much for the asset and would prefer to have sales made the measure of royalties.

154. Firms which supported a joint research laboratory, for example, could measure their contributions either by sales or by use of the research results. There would be no free-ride problem and no other inefficiencies arising from the continued competition of the firms in manufacturing and sales.

would be different, of course, if the joint undertaking required the contribution by the parties of substantial amounts of technical business know-how which the other parties could appropriate to their own uses outside the joint venture.

6. Minimizing Costs and Customer Irritation Due to Overlapping Distributive Efforts.

The theories that overlapping distributive effort may lead to inefficiency due to duplication of costs or to customer irritation at multiple solicitations seem less substantial than the points already discussed.

The first theory requires as an assumption that a manufacturer can make the allocation of customers among its resellers with an efficiency and precision sufficiently close to that which reseller competition would provide so that elimination of duplicative effort would result in a lowering of the costs of reselling. The efficiencies of allocation by competition are well known. Let us take the case of a manufacturer selling to independent dealers. If he does not divide their territories, there will be a certain amount of duplication of effort as the dealers compete in overlapping areas. The dealer who operated most efficiently would tend, other things being equal, to expand his business at the expense of less efficient dealers. If equilibrium were reached, each account would be handled by the dealer able to do so most efficiently and the total costs of distribution would be at a minimum. There still might be duplication of selling effort when dealers tried to take accounts away from each other, but no dealer could survive who persistently engaged in unremunerative selling effort. Even though equilibrium would undoubtedly never be attained, the system would always be tending toward the most efficient allocation of accounts to dealers, and responses to changed circumstances would seem almost certain to be substantially more rapid and accurate than those a manufacturer could dictate by continually reassigning accounts. If no countervailing factors were present, therefore, no manufacturer would divide his dealers' territories. The other efficiencies of market division discussed here are, of course, countervailing factors which do account for manufacturer-imposed territorial divisions in many cases.

The same analysis seems to apply to horizontal groups. The way for the group as a whole to reduce distribution costs is to divide the business among themselves by competition. This is true even in a cartel situation. The scheme disclosed in *Addyston Pipe & Steel* involved the charging of non-competitive prices to customers, but business was divided among the cartel members according to an internal bid-

ding system.¹⁵⁵ This system, the cartelists apparently believed, would allocate the business among their respective plants most efficiently and thus maximize the profits of the group as a whole.

These considerations suggest that it will be only in rare cases that either a manufacturer or a horizontal group will find elimination of duplicative distributive effort to be an efficiency which justifies market division.

The avoidance of multiple solicitation and consequent customer annoyance seems a highly speculative ground for market division. The idea is that customers may be especially irritated if solicited by more than one seller of the same brand. An answer sometimes given is that multiple solicitation will stop as soon as the customer makes it known to the additional representatives that their visits are unwelcome. This answer seems not wholly satisfactory, however, since the customer may not single out particular representatives for his annoyance but may become irked at the company that sends so many representatives to call upon him. He may also gain an impression of inefficiency in distribution that may make him suspicious of the company's operations in general. Perhaps a better answer to the customer-annoyance contention is that irritation is unlikely to become serious if the customer manages to get better prices from multiple solicitation. This answer may not be complete either, however. The price savings attained may not compensate the customer for the time he spends listening. If this is the case it must mean that the customer himself would not consider shopping around a worthwhile activity, but that he will, for some reason, refuse to turn away flatly all but one of the representatives who call on him. The argument seems to be rather speculative. On balance, it seems likely to be a rather rare case in which serious inefficiencies of the sort discussed in this section are created by duplication of distributive effort.¹⁵⁶

155. 85 Fed. at 274-76.

156. A tempting analogy which may seem to suggest the efficiency of eliminating overlapping distribution is the fully-integrated manufacturer which assigns its salesmen or owned distributors closed territories. This analogy does suggest that market division must often create efficiencies, but it does not indicate that the suggested efficiency under examination here exists. The fully-integrated firm may, for example, wish to eliminate the problem of the free ride among its salesmen quite as much as does a contract-integrated firm. A second difficulty is that a fully-integrated firm, being more aware of retail conditions, may be able to make decisions concerning allocations of accounts within territories more accurately than a firm that uses independent resellers. The latter is likely to find it better to let competition among its resellers make the decisions for it. In fact, the decision whether to employ independent resellers or to integrate into retailing may turn upon an estimate of whether it is more efficient in the

Price-Fixing Agreements

Price fixing and market division are, of course, the same general economic phenomenon. Either may be used by cartelists to restrict output.¹⁵⁷ One would, therefore, expect the courts to treat price fixing and market division similarly in all respects. A difference in treatment is, nevertheless, perceivable in a number of cases. *White Motor*, *Sealy*, *Spring-Air*, and *Sandura*, to name only a few of the most recent cases, all display a greater willingness to contemplate the possible legality of market division than of price fixing. The apparent anomaly is increased by the fact that the two forms of elimination of competition also seem comparable in their capacities for creating efficiency. The efficiencies which may be achieved by price-fixing agreements include:

1. Optimizing local sales effort: the free-ride problem;
2. Optimizing local sales effort: the uniform product;
3. Reinforcing a market-division system;
4. Providing the means of transferring information;
5. Assisting the achievement of advertising economies of scale;
6. Protecting one party to a joint venture against the fraud of another; and
7. Breaking down reseller cartels and preventing the misuse of local reseller monopolies.

1. *Local Sales Effort: The Free-Ride Problem.*

Price fixing can be a method of eliminating free rides in either a vertical or a horizontal contract integration.¹⁵⁸ The analysis is very similar to that already suggested in connection with market division.

circumstances of the particular industry to have the manufacturer or the market organize the allocation of accounts. There are costs in either method. Another weakness in the analogy is that the fully-integrated firm may be more vulnerable to customer annoyance since the customers know that the multiple solicitation is due not to the rivalry of independent businesses but to the policy of the manufacturer.

157. When competitors with market power agree upon a higher-than-competitive price they must necessarily restrict output to raise the market price to the agreed level. They will choose a price that comes as close as possible to the monopoly solution—that is, a price which limits output so that industry marginal cost equals industry marginal revenue. When competitors with market power divide markets each is left with a local monopoly and is free to restrict its own output to the point where marginal cost equals marginal revenue. The primary difference between these arrangements is that where the cartelists have significantly different marginal cost schedules so that no common price is best for all, price fixing, which requires an agreement upon a common price, may be less stable than market division which permits each to arrive at its own maximizing solution. Nevertheless, price fixing and market division, where restriction of output is a possibility, are equally hurtful to consumers.

158. Bowman, *supra* note 67, and Telser, *supra* note 74.

When prices are fixed no purchaser is able to obtain the information and studies he wants from one seller and then purchases the identical product from another at a lower price. Each seller is, therefore, free to engage in the optimal amount of selling effort without fear that another seller of the same brand will enjoy a free ride at his expense. Where a reseller's price is maintained, he is forced to engage in other forms of competition in order to make a competitive return. Market division permits the seller to use an appropriate amount of local sales effort. Price fixing forces him to. Market division may be a superior technique where the appropriate degree of local sales effort varies from market to market and is best left to the seller's judgment. Price fixing may be superior where uniformity of sales effort is important or where the manufacturer believes itself a better judge of selling techniques than a significant fraction of its resellers. Price fixing is also likely to be preferable to market division in any situation where effective marketing requires thorough coverage of an area through numerous resellers rather than use of a single outlet.

2. Local Sales Effort: The Uniform Product.

Price fixing may also be a means of gaining efficiencies of local sales effort in either a horizontal or vertical system even when the free-ride problem does not exist. This situation may occur where the consumer cannot easily obtain sales effort free from one seller and then purchase the physical product from another. In such cases, the sales effort is obviously a part of the total product which the consumer purchases. An example is the provision of services in conjunction with the sale of gasoline. Some major gasoline refiners have made persistent attempts to control the prices charged by their service stations.¹⁵⁹ Assuming that some such refiner attempts are truly vertical, and not the result of collusion among refiners or service station operators, it is worth asking whether local sales effort can really be a factor in such an industry, and why, since free rides are not possible, refiners should need resale price maintenance to ensure the optimization of sales effort by their outlets.

The local sales effort involved in the retailing of a product like gasoline is, of course, quite different from the effort involved in selling trucks or other complicated machinery. Selling effort with respect to products of the latter type is likely to involve technical training of

159. The courts have regularly outlawed such attempts when accomplished by resale price maintenance contracts, and recently, in *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964), the Supreme Court struck down an attempt to accomplish refiner control of retail prices through a consignment contract, casting great doubt upon the legality of any means of vertical control of prices short of ownership and operation of the outlets by the supplier.

personnel, the provision of information to customers, product modification, and so forth. The case for market division and resale price maintenance is more immediately apparent in such situations. But the case for efficiencies in sales effort ought not to be so narrowly conceived. Even with respect to such a simply retailed product as gasoline a good deal of local sales effort goes into merchandizing. In fact, much national advertising of gasoline stresses the extra services, conveniences, and courtesies that local retailers provide. The same concern for local sales effort is shown by the common refiner policy of instructing retailers upon such matters and policing their compliance.¹⁶⁰

Resale price maintenance by a refiner motivates dealers to increase their sales efforts as the only alternative competitive tactic available to them after their pricing freedom has been curtailed. Competition among service stations will, in any event, result in dealers making no more than a competitive return. When a refiner maintains pump prices at a level which seems to ensure a greater-than-competitive return, dealers will bring their returns down to the competitive level once more by adding more local sales effort to the product they sell. Any dealer who did not would lose business.

The next question is why the refiner cannot allow individual service station operators to determine for themselves whether a price or a service appeal would be most effective. The answer is twofold. One is that the refiner may feel that its business and marketing acumen is significantly greater than that of the general run of people it can attract to be service station operators. More important, perhaps, is the fact that a large part of the refiner's brand appeal rests upon the uniformity of the product sold by each of its stations. Since gasoline consumers are mobile they will necessarily patronize many different service stations. A refiner wishing to appeal to those consumers who value a high degree of sales effort must establish the uniformity of his product so that consumers can rely upon getting a particular combination of physical product and sales effort at any station carrying the brand. The deviation of any significant number of stations from the product standard will lessen the effectiveness of the refiner's advertising and reduce the appeal

160. And, in fact, it is observable that many service stations do provide a great number of services that may be classified as local sales effort: the availability and cleanliness of washroom facilities; the cleanliness of the station and neatness of attendants; the geniality with which service is given; the giving of travel directions; the availability of a range of services for the car (lubrication, tire and battery replacement, and minor repairs); recognition of credit cards; and the provision, often without being asked, of such free services as wiping windows, checking the pressure of tires, pumping air into tires, checking the water in the radiator, etc.

which uniformity makes in itself.¹⁶¹ The economic efficiency of establishing product uniformity in this way is very similar to the product uniformity gained in the Spring-Air and Sealy systems by controlling the physical specifications of the bedding products made under trademark licenses. The difference in technique of control is probably attributable to the different composition of the product and the different marketing settings. It is far easier to police physical characteristics by occasional direct observation of the output of some thirty bedding manufacturers than to police the amount and quality of an intangible such as sales effort in thousands of service stations.

3. *Reinforcing a Market-Division System.*

Price fixing seems capable of being used to reinforce a market-division system. Violation of the territorial limitation may sometimes be difficult to detect. Suppose, for instance, that a manufacturer in the Spring-Air system, for one reason or another, sold some mattresses in his territory at a price significantly below the prevailing price in another territory. The lower price might be a deliberate violation of the territorial division, the manufacturer realizing that he could induce a reseller to invade the neighboring territory by selling to him at prices low enough to make such arbitrage profitable. It might be very difficult for the group to show that the invasion took place with the connivance of the low-selling manufacturer. There might also be instances of sales at low prices and subsequent resale across territorial boundaries which were not intended by the manufacturer. Control of the manufacturers' prices by the group prevents the opportunity for such arbitrage.¹⁶² An agreement of manufacturer members to maintain

161. Each service station typically serves some motorists who are passing through and will never return and a great many who will purchase gasoline somewhere in that area again. The refiner wishes all to get the same combination of service and physical product so that they will continue to patronize stations carrying that brand. The interest of the individual service station operator is confined to the potential repeaters, for only as to that segment of consumers can his sales effort operate as a competitive tactic for future sales. The station operator is, however, unable effectively to separate the two classes of consumers and discriminate in sales effort against the non-repeater. For one thing, many of the services he provides—availability of facilities, neatness of the station, etc.—are indivisible. Others—courtesy, cleaning windshields, etc.—can be segregated, but the operator cannot usually be certain whether a particular customer is a potential repeater or not, the effort to discriminate may be more trouble than it is worth, and there is always the danger of being reported to the refiner. These factors tend to create the uniformity of product for all consumers which the refiner desires.

162. An alternative method of control would be to require each manufacturer in a horizontal system or each distributor in a vertical system to exact agreements from its customers not to sell across territorial lines. This might be more difficult to police, how-

the resale prices of their retailers could be used to accomplish the same purpose. Retailers forbidden to advertise or sell at cut prices would find it more difficult to resell across territorial lines.¹⁶³

Price control could reinforce a market-division system which was itself designed to accomplish certain of the efficiencies earlier mentioned plus a few efficiencies that market division is not capable of creating. These effects are possible, moreover, whether the price control is vertical or horizontal, and whether the market division involves territorialization, customer allocation, or some other criterion of separation.

It may be worth suggesting a specific way in which price fixing can cope with the free-ride problem which is not achievable by market division. National concerns with purchasing offices in more than one territory may create the free-ride problem by encouraging one member of a group or one dealer to undertake the task of selling the product, explaining its features, studying and discussing the purchaser's needs, perhaps even designing slight modifications, and so forth, and then going to a different territory and negotiating a large purchase at a low price which does not reflect any of the expense incurred in the selling effort. Fixing prices would prevent this type of free ride in a way that market division could not. It would be possible, of course, to solve the problem by assigning the purchaser to a single territory or requiring that the seller reimburse the member or dealer who incurred the costs of the sales effort. These agreements are equivalent to price fixing, however, and may be less desirable. The fixing of prices permits each member or seller to compete for the national purchaser's patronage in terms of sales effort and services offered. Fixing prices thus makes it more likely that the contract integration will succeed in interbrand competition and also that the business will go to the most efficient unit within the integration.

4. Providing the Means of Transferring Information.

One reason a fully-integrated manufacturer may dictate the retail prices to be charged by its owned outlets is the belief that the manufacturer has greater information as well as greater competence to make

ever, since it might not be possible to discover quickly and inexpensively which of numerous customers had violated its agreement. It would, moreover, be difficult to prove the complicity of the manufacturer or distributor even after a number of violations by various of its customers. A price maintenance plan would solve the question of complicity and would reduce the opportunity for customer cross-selling.

163. There are some indications that an agreement on maintaining retail prices served to reinforce the manufacturers' market division in the *Sealy* case. 1964 Trade Cas. ¶ 71,258, Findings Nos. 248, 253, 255.

price decisions. The same factors might well lead a contract-integrated system to engage in price fixing.

This efficiency seems to be the explanation of the price agreements held per se illegal by the district court in the *Nationwide Trailer Rental System (NTRS)* case.¹⁶⁴ NTRS was an organization of automobile trailer rental operators engaged in the one-way rental trade. The system was created to facilitate the exchange of trailers so that persons renting them for one-way movements did not have to pay the expense of returning the trailers to the renting operator. Trailers involved in this one-way trade continued to be owned by the operators who first put them into the system but would be rented successively by the various operators into whose hands the chances of the business brought them. The renting operator divided the rental fee with the operator who held title to each particular trailer. NTRS was formed to achieve a number of efficiencies in this previously rather confused and haphazard trade.¹⁶⁵

Among other restraints contained in the system,¹⁶⁶ the NTRS Board

164. *United States v. Nationwide Trailer Rental System, Inc.*, 156 F. Supp. 800 (D. Kan. 1957), *aff'd*, 355 U.S. 10 (1954).

165. Prior to the organization of NTRS, persons engaging in the one-way trailer rental business could not control the rental operators into whose hands their trailers might come, 156 F. Supp., Finding 8 at 801-02. Low quality trailers were often used in the one-way trade. *Id.* at 802, Finding 10. The formation of NTRS tended to regularize the trade for member operators who could now be sure their trailers did not go to operators with whom they did not wish to do business. The by-laws of NTRS permitted expulsion of members if necessary "to preserve the good name and business of the System." *Id.* at 803, Finding 15. This suggests that the integration of operators into a system was expected to create good will for all members, perhaps in a manner analogous to the appeal of uniform gasoline service stations. NTRS as well as the individual operators may have engaged in advertising of the system as a whole. NTRS Jurisdictional Statement, p. 8, 355 U.S. 10. In any event, the local sales effort and advertising by each member of the NTRS name would benefit not only himself but other members of the system into whose areas customers might go. The efficiencies of NTRS's uniform lease form and suggested rate schedule are discussed in the text. Unfortunately, neither the district court's findings of fact nor the briefs filed in the Supreme Court focus upon the efficiencies of the NTRS contract integration.

166. The district court held: the NTRS by-laws which provided that no new member should be admitted within the city or immediate vicinity of an existing member without the latter's consent in writing was an agreement for exclusive territories violative of section 1 of the Sherman Act (156 F. Supp. at 805); and the power of the NTRS Board of Directors to expel members when "necessary to keep this System out of legal entanglements or to preserve the good name and business of the System" provided for a boycott and was per se illegal. *Ibid.* The decree required NTRS to admit to membership any applicant, regardless of location, who agreed to meet his financial obligations and maintain safety standards. *Id.* at 807. NTRS contended that this destruction of its ability to grant exclusive territories would damage the effectiveness of the system: "when the persons who build up, by advertising and sales effort, a valuable organization must share that property with every newcomer who applies, it must be obvious that there will be

of Directors adopted a suggested rate schedule which was circulated to the member trailer rental firms, and also adopted a uniform lease agreement for use by members which specified the charge for overtime use of trailers.¹⁶⁷ Since the members were located in different cities and were not in competition with each other, it is difficult to see how NTRS' activities relating to prices could have been designed to achieve an elimination of competition which did not exist.¹⁶⁸ The purpose of the schedule and the lease form, therefore, must have been the creation of efficiency. NTRS in fact stated on appeal that the function of the suggested schedule was to give information to members:

[I]t was essential to the intelligent conduct of a one-way trailer business by the numerous small businessmen—filling station operators and the like who are members of NTRS—that they have an estimate of what rates would prove profitable and reasonable in areas to which they send trailers. Without this information it was impossible for them to bargain intelligently with their customers.¹⁶⁹

The district court, however, held that both the circulation of the suggested rate and the form lease's inclusion of an overtime rate were forbidden tamperings with price under section 1 of the Sherman Act.¹⁷⁰ Curiously enough, however, the court did not stick to its rigid application of the per se rule, for the decree permitted NTRS to set the percentage of the rental which each member must pay to the owner of the trailer in question.¹⁷¹ This softening perhaps reflects a recognition that there is efficiency in having a uniform percentage so that members need not attempt to bargain with each other over every

no incentive for further membership or investment in such an organization." NTRS Jurisdictional Statement, pp. 8-9, 355 U.S. 10. This is a form of the free-ride argument and suggests that the market division in the NTRS system was related to efficiencies of local sales effort. The district court recognized that the boycott it had held illegal per se was related to efficiency, for its decree not only permitted grants of membership to be conditioned upon agreement to meet financial obligations, and to maintain adequate standards for the safety of one-way trailers, but the expulsion of members who violated these agreements. 156 F. Supp. at 807. This appears to be a holding that a boycott may be a lawful restraint when ancillary to a contract integration. It is unfortunate that the district court did not, and the Supreme Court had no occasion to, explain why a boycott that created an efficiency of this sort could be lawful while a market division, which created efficiency of sales effort, and suggested price schedules, which passed information, were necessarily unlawful.

167. 156 F. Supp. at 804-05.

168. The district court did not indicate that the suggested price schedule was unlawful only because the division of territories was unlawful. It seemed to treat the two as independently violative of the Sherman Act. *Id.* at 805.

169. NTRS Jurisdictional Statement, p. 11, 355 U.S. 10.

170. 156 F. Supp. at 805.

171. *Id.* at 806-907.

trailer rental in which the renting operator is not also the owner. It is unfortunate that the court did not explain why it was willing to recognize this efficiency as justifying price fixing but not the efficiency claimed by NTRS for its suggested price schedule and its lease form. The decree provision, nevertheless, seems to constitute a somewhat oblique precedent for the legality of some price fixing where it is necessary (ancillary) to the efficiency of a contract integration.

5. *Economies of Scale in Advertising.*

Price fixing may sometimes be essential to the creation of economies of scale in advertising. This motive seems to have led to a proposed pooling of cooperative advertising allowances by retail druggists to pay for joint newspaper advertising. The advertisements were to list the stores selling products at prices agreed upon by a committee of participating druggists. In an advisory opinion, a majority of the Federal Trade Commission decided that the per se rule against price fixing compelled the conclusion that such joint advertising would be illegal.¹⁷²

The Commission appears to have misperceived the issue, for much of the opinion concerned itself with the undesirability of relaxing the per se concept to allow small businessmen to compete more effectively with larger competitors.¹⁷³ Such a relaxation of the per se rule would of course be an improper introduction of a pro-small business strain into section 1 of the Sherman Act. The issue that should have been discussed is whether the per se concept had any relevance if the agreement on prices of the advertised goods contributed to efficiency. The presence of such efficiency seems to be assumed in the Commission's reasoning that joint advertising would increase the ability of the small druggists to compete. The agreement on prices appears ancillary to the joint advertising since such advertising usually makes price a prominent feature and the participating druggists would have to sell at the price stated. The only remaining questions bearing on legality should have been the market power of the cooperating group and the motives of the participants.

There are undoubtedly numerous instances in which an agreement on prices would contribute to the attainment of economies of scale in advertising. Perhaps the agreement of the mattress manufacturers in *Sealy* upon the prices they would require their respective retailers to maintain was keyed to the efficiency of national or regional advertising in the same way the proposed agreement of the retail druggists

172. BNA, Antitrust & Trade Reg. Rep. No. 91, April 9, 1963, p. x-1.

173. *Ibid.* See particularly the statements of Commissioners Anderson and Higginbotham.

seems to have been keyed to newspaper advertising.¹⁷⁴ The *Sealy* agreement, however, was also invalidated by the currently prevailing view that all price fixing is per se unlawful.¹⁷⁵ Since the district court upheld the territorial market division of the manufacturers, it is difficult to see what policy is served by refusing to permit the agreement of the noncompeting manufacturers to require uniform resale prices on the brand of mattress they sell in common. A variety of other instances in which price fixing is essential to advertising efficiency is easily imaginable, e.g., the fixing of prices on food items in franchised drive-in operations, and the fixing by individual manufacturers of retail prices of nationally advertised consumer goods. The current state of the law, however, has decreased the chance of creating such efficiency by forcing many suppliers to employ suggested rather than fixed prices.

6. *Protection Against Fraud by a Joint Venturer.*

Price fixing as a means of protecting oneself against the possibility of fraud by a joint venturer does not eliminate any price competition that might otherwise exist. In such cases the power to fix prices has already been placed in one party's hands by the basic contract integration and the explicit provision that prices shall be fixed in a certain way merely makes certain that the party with control does not appropriate part of the value of the other party's products to himself.

This sort of price fixing was upheld by the district court in *United States v. Columbia Pictures Corp.*¹⁷⁶ The government there challenged under both section 1 of the Sherman Act and amended section 7 of the Clayton Act agreements by which Screen Gems, Inc., a wholly-owned subsidiary of Columbia Pictures, was granted by Universal Pictures Company, Inc., a fourteen-year exclusive license to distribute for television exhibition approximately six hundred Universal feature films produced before August 1, 1948 for theatre exhibition. Columbia guaranteed Screen Gems' performance of all its obligations under the agreements and that Screen Gems would continue to be the exclusive licensee for television of substantially all of Columbia's pre-August 1,

174. See 1964 Trade Cas. ¶ 71,258, Findings 126, 127, 192, 224, 252, 257, 261, 264, 266, 277, all of which suggest a relationship between the manufacturer's agreement to maintain retail prices and the efficacy of national or regional advertising. The maintenance of retail prices may also have been a device to reinforce the market division among the manufacturers. See note 163 *supra*. Unfortunately for present purposes, the district court, bound by the strict per se rule against resale price fixing in the absence of Fair Trade statutes and the rule against agreements between manufacturers to use Fair Trade laws, did not analyze the efficiencies which might derive from such agreements in a contract-integrated system such as *Sealy's*.

175. 1964 Trade Cas. ¶ 71,258 at 80,107.

176. 189 F. Supp. 153 (S.D.N.Y. 1960).

1948 feature films. The government contended the agreements were per se illegal because they included provisions for the advance classification of each Columbia and Universal pre-August 1, 1948 feature into categories of comparable quality and provided that Universal features should not be sublicensed by Screen Gems for less than Columbia features of comparable quality.¹⁷⁷

Defendants' evidence convinced the court that the main purpose of their arrangement was the creation of efficiency. Universal had a library of pre-August 1, 1948 feature films which it considered to be of real value for television exhibition but it had never engaged in that form of distribution. Its existing distributive organization and facilities were geared to theatre exhibition, and distribution to television stations (including the techniques of promotion, advertising, purchase and sale) was so completely different that the same organization and facilities could not be used.¹⁷⁸ Universal apparently did not wish to undertake the expenditures and risks that the creation of such an organization would entail.¹⁷⁹ Though the court did not mention the point, it seems quite possible that a factor in Universal's decision was that it did not have enough of a feature film inventory to justify a distributive organization within the most efficient size range. The solution to this problem of course would be for Universal either to enter the distribution business and seek licenses to distribute other producers' films or turn its films over to a firm already engaged in distribution. Universal chose the latter course. The opinion did state that Screen Gems was seeking additional films to distribute because it required a certain volume of film sublicensing to operate its organization profitably.¹⁸⁰ This evidence tends to substantiate the idea that

177. *Id.* at 161. The government's per se approach was indicated by the court's phrasing of the "broad issue" posed as "whether in the face of the fact that the parties did not have the motive, purpose or intent to fix prices, and without proof by plaintiff of any effect of the Distribution Agreement in the market place, the Court can hold the Distribution Agreement to be illegal on its face as a price fixing arrangement such as is condemned *per se* by the Sherman Act." *Id.* at 160.

178. *Id.* at 166-67.

179. *Id.* at 171, Finding no. 39.

180. Hanft, vice president and treasurer of Screen Gems, testified to the marketing activities involved, and also of Screen Gems' efforts to acquire films and programs to distribute: "We do this because we have a fixed nut. We have an overhead. We have an operation to run, and the more film we can run through that operation the lower will be the cost of distribution on a percentage basis. That means that our profits will increase if we can reduce our cost of distribution."

"At the same time that means that we can support and maintain the relatively large independent organization that we have, and hopefully throw off some profits for the stockholders." *Id.* at 168.

the purpose of this contract integration of Universal's and Columbia's operations was to achieve economies of scale.

This joint selling agency necessarily eliminated competition between the Universal and Columbia films involved. Why then was there an explicit agreement which had the same effect? The classification of films and the no-discrimination provision operated as safeguards for Universal in dealing with a Columbia subsidiary.¹⁸¹ Without them it would have been possible for Screen Gems to defraud Universal by offering sub-licensees Universal films at lower rates if they took Columbia films at correspondingly higher rates. The cost to the television stations would have been the same but profits would have been shifted from Universal to Columbia. The classification of films apparently served the additional function of facilitating the division of receipts when Universal and Columbia films were sublicensed together. Classification in advance saved disputes afterwards.¹⁸² Provisions of these types were common in analogous situations in the distribution of films for theatre exhibition.¹⁸³ The evidence on these points convinced the court that "Each of the provisions of the contract had lawful business objectives and was not included for the purpose of fixing prices."¹⁸⁴ Indeed the government had stipulated as much.¹⁸⁵ There would seem, of course, to be a certain awkwardness in finding that provisions were not intended to fix prices when that was precisely their purpose, but it is clear enough what the court meant: the provisions were not intended to affect general market prices.¹⁸⁶

The court employed the doctrine of ancillary restraints to legitimate the specific provisions of the agreements attacked by the government as violative of section 1 of the Sherman Act.¹⁸⁷ The court thus handled the case before it skillfully but did not articulate a general theory of what might constitute that "legitimate primary purpose" which justi-

181. *Id.* at 173-76, Findings 67-98.

182. *Id.* at 180.

183. *Id.* at 169-70, Findings 22-28.

184. *Id.* at 174, Finding 70.

185. *Id.* at 166.

186. The only remaining question would be whether the size in the relevant market of Universal and Columbia, as well as any other producers whose products were distributed by Screen Gems, was such that the elimination of competition between them should have been held illegal as too likely to affect general market prices. The court saw and faced this problem, too, finding that the agreements had had no effect upon either the price of Columbia or Universal feature films or the general market price for such films. This lack of effect was due, the court said, to several factors, including Screen Gems' relatively small portion of the market. *Id.* at 177-78, Finding 112; *Id.* at 194-203.

187. *Id.* at 178-79.

fies restraints undertaken by parties lacking monopoly power. Nevertheless, such a general theory seems implicit in the court's handling of the specific case, for it upheld the Universal-Columbia arrangement and its subordinate price-fixing arrangements upon an analysis of the efficiencies they created.

7. *Breaking Down Cartels and Controlling Local Monopolies.*

Resale price fixing may be employed by a manufacturer to break down reseller cartels or to control the behavior of a local reseller monopolist. An example of price fixing as an anti-cartel weapon is provided by the *Kiefer-Stewart* case.¹⁸⁸ There, two commonly owned liquor manufacturers, Seagram and Calvert, agreed to sell only to those Indiana wholesalers who would not resell above stipulated maximum prices. In response to a price-fixing charge by a wholesaler plaintiff the manufacturers offered the defense that their price fixing was intended to counteract a wholesaler cartel that had set minimum prices. The Supreme Court held this defense invalid. This holding makes sense only upon the assumption that Seagram and Calvert were separate companies which could not legally coordinate their pricing policies.¹⁸⁹ The Court might consider it too dangerous to permit manufacturers to agree on resale prices in order to break down a resellers' cartel since the opportunity for the manufacturers to agree upon their own prices would be too great. But the *Kiefer-Stewart* rationale appears to make little sense when applied to the action of a single manufacturer. It has been argued that individual manufacturer use of resale price fixing should be lawful. The *Kiefer-Stewart* case merely demonstrates another efficiency such a restraint may provide. If a manufacturer knows, or suspects but cannot prove, that resellers have cartelized, the manufacturer can provide a powerful incentive for resellers to defect from the cartel by refusing to sell to those that comply with the cartel's price agreement. Maximum resale price fixing accomplishes that purpose. Because there is no danger of a restriction of output but rather the likelihood of an increase, the law should welcome the vertical restraint.

Maximum resale price fixing may also be a means by which a manufacturer controls the misuse of a reseller's local monopoly. This situation may arise where both the manufacturer and the reseller possess market power. The situation is then similar to that of bilateral monopolies, analyzed in connection with the contract between the railroad

188. *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.*, 340 U.S. 211 (1951).

189. *Id.* at 215. The holding that Seagram and Calvert were capable of conspiring within the meaning of § 1 of the Sherman Act is highly debatable also. That point need not be discussed here, however.

and the sleeping car company.¹⁹⁰ The manufacturer may wish to fix maximum resale prices to insure that the reseller does not, in its independent interest, restrict output further than is in their collective interest. This use of resale price fixing, too, is beneficial to consumers.

ALTERNATIVES AND OBJECTIONS TO THE DOCTRINE OF ANCILLARY RESTRAINTS

The literature and discussion concerning market-division cases have developed certain points which require brief discussion here. Some of these points are suggested alternatives to the device of market division. The thought behind them appears to reflect a recognition that valid business needs may be served by market division but that there may be alternative methods of meeting those needs which do not so completely eliminate competition between the firms concerned. Others of the points may be described as objections to market division in all or some circumstances. Similar alternatives and objections would no doubt be raised with respect to any proposal to legalize some price-fixing agreements. These points are discussed last so that their relationship to the total doctrine of ancillary restraints may be better perceived.

The Alternative Suggestions

In his *White Motor* concurrence Justice Brennan expressed a common view when he suggested that the legality of closed territories might turn upon "the availability of less restrictive alternatives."¹⁹¹ He suggested not only that the severity of the sanctions which the manufacturer imposed upon resellers might be relevant to legality,¹⁹² but also:

[I]t may appear at the trial that whatever legitimate business needs White advances for territorial limitations could be adequately served, with less damage to competition, through other devices—for example, an exclusive franchise, an assignment of areas of primary responsibility to each distributor, or a revision of the levels of profit pass-over so as to minimize the deterrence to cross-selling by neighboring dealers where competition is feasible.¹⁹³

Although the recognition that market division may create efficiencies is a step forward, an examination of the proposed alternative solutions indicates that they are half-way houses, neither removing the danger of

190. See text accompanying notes 58-66 *supra*.

191. 372 U.S. at 271.

192. *Id.* at 270.

193. *Id.* at 271-72.

restricted output, in situations where that danger is present, nor in many cases adequately creating the full range of efficiencies called for.

Exclusive franchises, profit pass-overs, and areas of primary responsibility, for one thing, focus entirely upon the range of problems to which vertical territorial division is addressed. They are thus of no assistance whatever when efficiencies are best created by horizontal market division, vertical customer allocation, or any form of price fixing. Even within the spectrum of efficiencies which they purport to achieve, these solutions will often be inadequate or even irrelevant.

The Inadequacy of Exclusive Franchises and Profit Pass-Over Systems.

A manufacturer gives an exclusive franchise by appointing a reseller within a designated territory and agreeing to sell to no other reseller having a place of business located within that territory. The franchise often designates the franchisee's business address. Resellers remain free, however, to sell across territorial lines. A profit pass-over system modifies such an arrangement by requiring that a cross-selling franchisee give all or a part of its profits on a sale across a territorial line to the franchisee in whose territory the sale is made. The only difference between exclusive franchises or profit pass-overs and closed territories is the sharpness with which the edges of the territories are defined. Exclusive franchises rely upon costs of doing business at a distance to prevent complete overlapping of reseller sales efforts. Profit pass-overs are a technique for further decreasing the profitability of cross-selling. Both arrangements, therefore, are forms of territorial division.¹⁹⁴ In many cases closed territories will be more efficient than either of the other forms of division. Closed territories permit a manufacturer to place resellers closer together, thus achieving more intensive coverage of the market while still solving the free ride and other problems to which market division is addressed. Closed territories, moreover, solve such additional problems as that of post-sale service which may arise when the customer is free to purchase where he chooses. To permit exclusive franchises and profit pass-overs but not closed territories seems an irrational compromise between a per se rule and a rule permitting ancillary market-division agreements.

When an agreement meets the general conditions for a lawful hori-

194. It seems odd at this late date to hear it suggested that courts should judge market divisions according to the reasonableness of the degree to which they inhibit competition between two sellers. This is equivalent to judging the legality of price-fixing agreements by the "reasonableness" of the price set. That criterion was firmly rejected in such cases as *Trans-Missouri*, *Joint Traffic*, *Addyston Pipe & Steel*, *Standard Oil*, and *American Tobacco* by the judges who established the main tradition of the rule of reason. See 74 YALE L.J. 775, 785-92, 796-97, 801-05, 829-32 (1965).

zontal or vertical restraint which have been discussed in this article there is no danger of restriction of output. The difference between closed territories, exclusive franchises, and profit pass-overs is then only a difference of efficiency-creating potential in different business circumstances. The choice between forms of market division, as well as between market division and the other restraints discussed, should then be left to the interested parties who, presumably, are likely to estimate their needs correctly more often than either courts or government attorneys.

The Fallacy of Area-of-Primary-Responsibility Clauses.

The government's response to manufacturers' insistence on the need for market division among their resellers has, on occasion, been to permit the use in reseller contracts of "area-of-primary-responsibility" clauses.¹⁹⁵ Such clauses allow manufacturers to insist upon intensive coverage of areas assigned to resellers but not to confine the resellers to their assigned territories. If a reseller concentrated on sales elsewhere to the detriment of adequate coverage in his area of primary responsibility, a manufacturer would presumably be justified in terminating the reseller's contract or otherwise disciplining him.

It should now be apparent, however, that the area-of-primary-responsibility solution is inadequate. For one thing, such clauses are not permissible in horizontal contract integrations. Even in a vertical system, however, such clauses do not meet the manufacturer's needs. Since such clauses permit dealers to sell anywhere, they cannot be used to encourage exchanges of information, to minimize the costs of providing post-sales service and the risks of customer dissatisfaction with such service, or to prevent the overlapping use of a service whose cost is shared. Only the elimination of competition between the resellers can accomplish those purposes and the area-of-primary-responsibility concept was devised precisely to avoid the elimination of such competition.

Such clauses do, however, permit the manufacturer to demand of the dealer the amount of local sales effort which the manufacturer considers optimum. The area-of-primary-responsibility concept may be addressed, therefore, to the first two efficiencies discussed earlier: achieving optimal reseller sales effort by solving the free-ride and size-of-the-market problems. The difficulty is that area-of-primary-responsibility clauses are a far less effective solution than market division. Market

195. The first consent decree to permit "area-of-primary-responsibility" clauses was, apparently, entered in *United States v. Philco Corp.*, 1956 Trade Cas. ¶ 68,409 (E.D. Pa. 1956).

division cures these problems automatically by making the reseller's interest in local sales effort coextensive with the manufacturer's interest. The area-of-primary-responsibility clause, on the other hand, permits selling across territorial lines and thereby makes it less profitable for resellers to engage in local sales effort. The resellers' interests then diverge from the manufacturer's. The manufacturer must, therefore, know what degree of local sales effort is optimal in each reseller's territory and must assiduously police each reseller to see that he expends, against his own interest, the effort desired. This solution is obviously not satisfactory.

It would be extraordinarily costly for the manufacturer to learn at first hand the real sales potential of every dealer's area and just how and where each dealer's sales effort should be expended. Since the dealer who is required to undertake unremunerative tasks can hardly be relied upon to identify all such tasks so that they may be imposed upon him, the manufacturer will have to integrate partially into the dealer level to make the survey the dealer is not motivated to make. This survey, moreover, cannot be made once for all time. Changes in population, income, tastes, products, and other factors will continually alter sales potential. The manufacturer will, therefore, have to be in as constant contact with local markets as all of his dealers combined. This procedure is probably so costly in most cases that the manufacturer will not do the job completely. Instead, he will rely upon inaccurate indicia such as whether the dealer comes up to the dealer average in sales to areas containing similar populations. The use of an average, however, is inefficient not merely because all dealers will have an incentive to cultivate less intensively than the manufacturer would prefer (thus depressing the average), but because the use of an average will require too much of dealers in territories that have less than average potential and will require too little of dealers in areas whose potential is greater than average. Market division, which gives each dealer the incentive to cultivate his area as intensively as is worthwhile from the point of view of both the dealer and the manufacturer, eliminates all the extra costs and inaccuracies of an attempt to enforce an area-of-primary-responsibility clause.

Even if one assumed that the manufacturer could reliably enforce such a clause to exploit the potentialities of all local markets and that he would find it worthwhile to do so, the added costs are necessarily a waste of resources from the consumers' point of view. In addition, the dealers, who would be required to perform a number of unprofitable tasks, would have to be remunerated. That is, if we assume, as we

must, that before the enforcement of an area-of-primary-responsibility clause dealers were making a competitive return, the imposition of additional costs would drop their return below the competitive rate. Their obvious response would be to sell less at higher prices. If the manufacturer insisted that they not sell less, he would gradually lose dealers and would find it impossible to recruit new ones. By adding to dealer costs as well as his own costs, therefore, the manufacturer would make a restriction of output inevitable.

These considerations demonstrate that area-of-primary-responsibility clauses are hopelessly inadequate substitutes for market-division agreements.

The Objections: Three False Issues

A common objection to the doctrine of ancillary restraints has been that it is possible to call any restraint of trade "ancillary."¹⁹⁶ That objection is valid, however, only if ancillary is taken to mean no more than "accompanying." This article has attempted to demonstrate that "ancillary" may be used as a term of art to denote a restraint which not only accompanies a contract integration but which contributes to its efficiency.

196. In *Timken Roller Bearing Co. v. United States*, 341 U.S. 593 (1951), appellant attempted to justify a world-wide system of market division and price fixing on antitrust bearings on the ground that they were ancillary to a joint venture between itself and an English businessman. The facts of the case suggested that the restraints came prior to the "joint venture" so that their ancillarity was, in any event, highly dubious. Justice Black's opinion for the Court, however, cast doubt upon the whole idea of ancillary restraints:

We cannot accept the "joint venture" contention. That the trade restraints were merely incidental to an otherwise legitimate "joint venture" is, to say the least, doubtful. The District Court found that the dominant purpose of the restrictive agreements into which appellant, British Timken and French Timken entered was to avoid all competition either among themselves or with others. Regardless of this, however, appellant's argument must be rejected. Our prior decisions plainly establish that agreements providing for an aggregation of trade restraints such as those existing in this case are illegal under the Act. . . . Nor do we find any support in reason or authority for the proposition that agreements between legally separate persons and companies to suppress competition among themselves and others can be justified by labeling the project a "joint venture." Perhaps every agreement and combination to restrain trade could be so labeled.

Id. at 597-98.

From the facts given the agreements should have been illegal, under the analysis of this article, because of the parties' intent and market power. Justice Black's comments, however, seem to suggest that there can never be a valid ancillary restraint. Perhaps he should not be read this way since he next rejected the defense that the restraints were ancillary to trademark licenses on the ground that the licenses were secondary to the main purpose of dividing markets and that the restraints covered products not bearing the name "Timken." *Id.* at 598-99. His rejection of the defense on these grounds seems to imply that the defense of ancillarity under other circumstances might be available.

Three other objections, however, require brief discussion: (1) It would be improper or unfair to permit a manufacturer partially integrated into distribution to impose restraints upon the competitive activities of its independent resellers (this may be called the dual distribution objection); (2) judging the legality of ancillary restraints requires a difficult or impossible balancing of the effects upon inter-brand and intrabrand competition; and (3) ancillary restraints deny consumers the choice between sales effort or other activities and a lower price.

The Dual Distribution Objection.

Dual distribution, a subject much bruited in current antitrust literature, has been a topic of concern to the Sherman Act for years. The analysis contained in this article, however, suggests that dual distribution should be of no concern to the antitrust laws and particularly not in the field of vertical restraints.

The economic theory which underlies concern over dual distribution is that in some situations a firm operating at two levels of an industry might use its strong position at one level to protect its possibly weaker position at another. This theory has led the Supreme Court to contradictory conclusions. For example, in the 1926 *General Electric* case the court permitted a patentee to insert a price-control provision in a license on the theory that the patentee was entitled to protect its own manufacturing of the patented item from the competition of the licensee-manufacturer.¹⁹⁷ The same economic motivation was assumed and disapproved in *McKesson & Robbins*¹⁹⁸ which held it illegal for a dual distributing manufacturer to control the prices of its independent resellers even through the use of state Fair Trade statutes. The theory was that such restraints did not fall within the Miller-Tydings and McGuire exemptions from the Sherman Act because the restraints were the same as horizontal price agreements at the reseller level.

The same theory seems inherent in Justice Brennan's comments on White Motor's use of customer allocation clauses to prevent its resellers from competing with it on sales to certain classes of customers. Justice Brennan remarked that White's justification for dividing markets in retailing between itself and its resellers—"the only sure way to make certain something really important is done right, is to do it for oneself"—proved too much. He said that if the resellers could not be counted on to solicit and service certain accounts adequately, the only solution

197. *United States v. General Electric Co.*, 272 U.S. 476 (1926).

198. *United States v. McKesson & Robbins, Inc.*, 351 U.S. 305 (1956).

might be the elimination of all independent resellers through complete vertical integration.

But that White is unwilling or unable to do. Instead, it seeks the best of both worlds—to retain a distribution system for the general run of its customers, while skimming off the cream of the trade for its own direct sales. That, it seems to me, the antitrust laws would not permit . . . if in fact the distributors could compete for the reserved accounts without the restrictions.¹⁹⁹

It is not entirely clear whether Justice Brennan's primary concern was one of restriction of output on the retailing level or of unfairness to the independent resellers who were precluded from the cream of the trade.

The analysis of vertical restraints contained in this article suggests, however, that the premise concerning economic motivation which underlies these diverse legal conclusions is invalid. A rational firm has no reason to protect its weaker retailing position by imposing restraints upon its independent resellers since that would decrease the firm's net revenues.²⁰⁰ Unfairness to the retailing competitors is not possible either since the manufacturer that wants to attract and keep resellers will have to allow them to make a competitive return. An independent reseller's failure to survive in competition with the owned outlets of a dual distributing manufacturer can come about only because in that case vertical ownership integration has proved more efficient than vertical contract integration. Harm resulting from superior efficiency is precisely the sort which the Sherman Act should not attempt to prevent.

The same analysis applies to the placing of restrictions upon a licensee's competition by a patent monopolist who also manufactures the patented product. The patentee-licensee relationship is, to the degree the patent confers an advantage, the same as the manufacturer-reseller relationship. No rational owner of a valuable patent would use price control in its licenses to protect its own manufacturing operations since his net revenue would decrease. Just as in any other vertical integration, overall net returns are maximized by maximizing net returns at each level independently.²⁰¹ This analysis indicates that *General Electric* and *McKesson & Robbins* came to opposite legal conclusions on the same economic reasoning and that the reasoning was fallacious in both cases. It indicates also that Justice Brennan's suggestion that White Motor should not be permitted to get "the best of both worlds"

199. 372 U.S. at 274.

200. See pages 397-405 *supra*.

201. See Bork, *supra* note 54, at 195-96.

is incorrect. Getting the best of both the world of contract integration and ownership integration is precisely what the antitrust laws should permit, since it means achieving maximum efficiency and thus increasing consumer wealth.

Interbrand Versus Intrabrand Competition

It has become common in market-division cases to pose the issue as a choice between interbrand and intrabrand competition. The same issue could as well be seen as central to efficiency-creating price-fixing cases. When the issue is so phrased, the legality of a particular agreement which eliminates competition is thought to depend upon the comparative importance of the interbrand competition which is intensified and the intrabrand competition which is eliminated.

The difficulty with the interbrand-versus-intrabrand formulation of the issue in elimination of competition cases is twofold. The first is that such a formulation leads courts to make judgments that are not properly their business. The ancillary market-division and price-fixing agreements whose legality is proposed in this article usually involve a decrease in intrabrand competition but never involve the likelihood of restriction of output. This means that the parties to each such agreement are motivated by a desire for increased efficiency. The parties, therefore, have already weighed any losses in efficiency due to the suppression of intrabrand competition and found them more than balanced by gains in other efficiencies. The impropriety of using the Sherman Act as a license for courts to second-guess business judgments about degrees of efficiency where restriction of output is not a danger has already been discussed.²⁰³ The second difficulty with the interbrand-intrabrand formula is that it introduces an inconsistency between the law relating to contract integration and the law relating to ownership integration. Ownership integration, whether created by merger or growth, has usually been judged under the Sherman Act by its market size. Where the integration was below the size which created monopoly power courts never went on to ask whether dissolving the presumably efficient firm would not increase intrabrand competition. In economic analysis, a contract integration is as much a firm as an ownership integration.²⁰⁴ The nature of the standards applied to them through the Sherman Act should be the same.

202. *Sandura Co. v. FTC*, *supra* note 115, at 853-59. Brief for Appellee, p. 31. *White Motor Co. v. United States*, 372 U.S. 253 (1963).

203. See page 404 *infra*.

204. See Coase, *supra* note 29.

The misleading interbrand-intrabrand formula should be abandoned. The criteria of efficiency and restriction of output are superior because they confine decision-making to subjects relevant to the policy of the Sherman Act and because their use makes the law of similar phenomena, contract and ownership integration, consistent.

Consumer Choice Between Lower Prices and Alternative Inducements.

The contention that consumers rather than producers should determine whether lower prices or other inducements are offered²⁰⁵ constitutes a fundamental misperception of the issue. In the case of all ancillary restraints whose legality is proposed here, consumers do make that determination. The decision whether to employ increased sales effort, offer more post-sale service, and so forth, is the same as the decision whether to incur any other costs. The company or group of co-operating companies will attempt to combine expenditures on supplies, machinery, labor, management, advertising, servicing, etc., to arrive at a final package at a price which will prove most profitable. Profitability depends upon favorable consumer response. In a horizontal case, where a group lawfully employing an ancillary restraint is necessarily faced by competitors, the preference of any significant number of consumers for lower prices instead of sales effort or post-sale service, for example, will evoke a response from some producers. In a vertical case the same thing will occur. Where the manufacturer is a monopolist in a vertical case, it may offer different lines of products to attempt most effectively to comply with the preferences of different segments of the market. One line might rely upon heavy sales effort while another might have primarily a price appeal. Where such diversity is not feasible the preference of the majority of consumers will control. In each of the instances where the legality of an ancillary restraint is proposed, consumer choice is as effective as it would be in the corresponding ownership integration situations. Indeed, where contract integration is involved, an ancillary restraint will often be essential to give consumers a choice. But for the restraint, the free ride and other problems discussed would prevent the contract-integrated system from offering the level of sales effort, servicing and other activities which consumers might prefer.

SUMMARY

Courts have always recognized that some restraints upon rivalry are essential to the full efficiency of both ownership and contract integrations. The difficulty has been, and remains, the reconciliation of the

205. Brief for United States, pp. 24, 26, *White Motor*, *supra* note 200.

competing values of permitting efficiency and preventing restriction of output. This reconciliation has been unnecessarily delayed by a tendency to oversimplify economic phenomena, to carry over rules of per se illegality, proper in the cartel contexts in which they evolved, to situations in which restriction of output was patently neither intended nor effected. This misuse of the per se concept destroys efficiency and hence misallocates resources. The overextension of the per se concept by the courts thus has the same sort of effect upon consumers as do cartel agreements.

Some of the recent cases discussed here exhibit a hopeful tendency on the part of the Supreme Court and some lower courts to recognize the efficiency-creating potential of certain market-division agreements. There are as yet few indications of a recognition of the same potential in the parallel category of price-fixing agreements. Perhaps more rational doctrine will evolve from a realization that market division and price fixing are not only very like each other but are merely members of a larger family of agreements that eliminate rivalry between persons or firms. Since some restraints upon rivalry are indispensable to efficiency, there is no *à priori* reason why some market division and price fixing should not share in this beneficial characteristic of the larger class to which they belong. The doctrine of ancillary restraints formulated here offers the means of making the necessary distinction between beneficial and injurious market division and price fixing.

To recapitulate, a horizontal market-division or price-fixing agreement should be lawful when four conditions are met: (1) the agreement accompanies a contract integration (the coordination of other productive or distributive efforts of the parties); (2) the agreement is ancillary to the contract integration (capable of increasing the integration's efficiency and no broader than required for that purpose); (3) the aggregate market share of the parties does not make restriction of output a realistic threat; and (4) the parties have not demonstrated that their primary purpose was the restriction of output. If either of the first two conditions is not met, the agreement is properly classified as illegal per se. The remaining two conditions embody the other existing criteria of the modern rule of reason as enunciated by Chief Justice White.

When a horizontal group agrees to employ vertical restraints (*e.g.*, the agreement of the mattress manufacturers in the Sealy system to maintain the resale prices of their products) the legality of the vertical restraints should be judged by whether the horizontal agreement meets the four conditions above.²⁰⁶

206. Horizontal contract integration at the manufacturers' level removes the case from

The use by an individual firm of vertical market-division or price-fixing agreements should be lawful in all cases. To qualify as vertical the agreements must not arise from an agreement among the firms imposing the restraints and must not have been coerced by a resellers' cartel.²⁰⁷

the per se category appropriate where manufacturers who have not integrated any other activities agree to employ resale price maintenance. In the latter case there seems no explanation for the agreement other than that resale price maintenance is being used to police a manufacturers' cartel. See pages 411-15 *supra*. The situation discussed in note 80 *supra*, may present another example of horizontal agreement to use vertical restraints which may be ancillary to a contract integration.

207. The rule for vertical restraints employs Chief Justice White's rule of reason also. The economic analysis of such restraints, however, indicates that they are always ancillary and will never be instituted with either the intent or the effect of restricting output. See pages 397-405 *supra*.