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DUAL DISTRIBUTION AND THE HORIZONTAL-VERTICAL DICHOTOMY OF NONPRICE RESTRICTIONS

I. INTRODUCTION

A crucial phase of any industry's manufacturing program is to place its goods on the consuming market. In this regard, the manufacturer may either distribute the goods to dealers itself or engage a network of independent distributors to do so. Commonly, however, a dual distribution arrangement is employed whereby independent distributors are used in conjunction with direct distribution by the manufacturer. In both situations, the manufacturer will often impose certain nonprice restrictions upon its distributors to reduce competition among them.[1] In turn, this promotes interbrand competition by enabling the manufacturer to attract highly aggressive distributors and retailers, to induce its distributors to engage in and contribute to promotional activities, and to exercise control over the service and safety of its products in order to attract and keep its customers.[2]

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1. To reduce intrabrand competition, i.e., competition among different distributors of the same product brand, the manufacturer will often impose nonprice restrictions on the area in which its independent distributors may market the product. These territorial restrictions take the form of exclusive and non-exclusive "areas of primary responsibility" whereby the distributor agrees to concentrate his best efforts on marketing the product in that area. An area of primary responsibility clause does not prevent the distributor from making sales in other territories. If, however, he fails to concentrate his best efforts in his assigned area, the distributorship is subject to termination. ABA ANTITRUST SECTION, VERTICAL RESTRICTIONS LIMITING INTRABRAND COMPETITION 3 n.6 (Monograph No. 2 1977). A territorial sales restriction clause, however, restricts the distributor from making sales outside of a specified territory. *Id.* at 4.

Similarly, a manufacturer may impose customer restrictions on its distributors. These prevent the distributor from making sales to specified customers or classes of customers regardless of the customers' locations. *Id.* at 4 n.9.

Similar restrictions may be imposed upon distributors by the manufacturer in a dual distribution arrangement. Customer restrictions may be more important here because the manufacturer will want to reserve so-called national accounts, government contracts and foreign accounts to itself. These accounts are more profitable to the manufacturer who is more experienced in negotiating bulk orders. Additionally, area of primary responsibility clauses permit the manufacturer to make sales within a distributor's area without violating the terms of the distributorship.

2. *See* Continental T.V., Inc. v. GTE Sylvania, 433 U.S. 36, 54-55 & n.23 (1977); ABA ANTITRUST SECTION, VERTICAL RESTRICTIONS LIMITING INTRABRAND COMPETITION 5 (Monograph No. 2 1977).

In White Motor Co. v. United States, 372 U.S. 253 (1963), the Court suggested that vertical distribution restrictions may protect against aggressive competition and be a means by which a small company may break into a market or remain in business. *Id.* at 263. Impliedly, the Court was recognizing that the overall effect of limitations on intrabrand competition may have the more

An issue which has not been firmly and specifically decided is whether such nonprice restrictions imposed upon distributors in a dual distribution system are violative of section 1 of the Sherman Antitrust Act.[3] The courts have developed two modes of analysis with which to evaluate the legality of various business arrangements.[4] Furthermore, the decisions have come full circle in recent years regarding which mode will determine the legality of such restrictions and the procedures employed to enforce them. This Comment will examine the two modes of analysis established by the courts for evaluating nonprice restrictions employed in distribution systems. Specifically, the application of these modes to a dual distribution system will be discussed in light of the leading United States Supreme Court decisions.

II. Narrowing the Issue

A. *General Considerations*

Section 1 of the Sherman Act provides that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."[5] Such a broad proscription provides little guidance to the business community or the courts for determining whether a particular business arrangement is in compliance. On its face, the language seems clear; any act or agreement which results in a restraint upon trade is illegal. However, as Justice Brandeis noted, such a "test" is too simplistic to be functional since "[e]very agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence."[6] Such an observation is particularly true of nonprice vertical restrictions placed on distributors by manufacturers. Such restrictions are designed to restrain the distributor from marketing the product outside of a particular geographic territory and/or limit

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desirable effect of increasing or maintaining interbrand competition. *Cf.* Comanor, *Vertical Territorial and Customer Restrictions:* White Motor *and Its Aftermath*, 81 HARV. L. REV. 1419, 1422-27 (1968) (vertical restrictions have the undesirable effects of eliminating intrabrand competition and increasing market power and restricting price competition through product differentiation in interbrand competition).

3. 15 U.S.C. § 1 (1976). Section 1 provides that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."

4. These modes of analysis are examined in notes 9-15 *infra* and accompanying text.

5. 15 U.S.C. § 1 (1976).

6. Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

those customers to whom sales may be made. Therefore, under a plain meaning interpretation of the Sherman Act, such restrictions are illegal.

The Supreme Court has not adopted this literal interpretation but instead has developed two modes of analysis with which to evaluate such restrictions, the per se rule and the rule of reason.[7] As a result, though the issue is whether a certain act, or agreement, or restriction is illegal, the threshold question becomes which mode of analysis is to be used. Although the ultimate decision on this issue necessarily decides the legality of the restriction, the Court's analysis has typically focused upon whether the restrictions are horizontal or vertical.

B. *The Horizontal-Vertical Dichotomy*

The relationship of the manufacturer to its distributors in a dual distribution system is a factor which has troubled the courts. The manner in which a court characterizes this relationship determines how a restriction is analyzed. The current approach is to determine the functional market level upon which each party operates. This, in turn, determines the test to be applied by the court. Accordingly, restrictions or agreements among persons at different levels of the market structure are deemed *vertical* while those among persons at the same level are termed *horizontal*.[8]

In a dual distribution system, the manufacturer, as a supplier, is operating at a different market level than its distributors. However, through its grant of areas of primary responsibility and its reservation of certain national accounts to whom it makes direct sales, it is also operating on the same level as its distributors. This raises the issue of whether such an arrangement is vertical or horizontal and which mode of analysis is to be applied to the restrictions the manufacturer places upon its distributors.

7. *See* notes 9-15 *infra* and accompanying text.

8. Whether an agreement or arrangement is horizontal or vertical is determined by the functional market level at which each party in the distribution chain operates. Accordingly, restrictions or agreements between persons at different levels of the market, e.g., manufacturer and distributor, are deemed vertical. Those among competitors are termed horizontal. Horizontal restrictions have been held to be per se illegal while the rule of reason has traditionally applied to vertical restrictions. *Cf.* United States v. Sealy, Inc., 388 U.S. 350 (1967), licensees of Sealy mattresses were also stockholders and members of the executive committee of the board of directors. Sealy allegedly conspired with its manufacturer-licensees to fix minimum resale prices and to allocate mutually exclusive territories. The Supreme Court concluded that "[i]f we look at substance rather than form, there is little room for debate. These must be classified as horizontal restraints." *Id.* at 352. Consequently, the Court rejected the claim that the territorial restrictions were vertical because "the stockholders and directors wore a 'Sealy hat' when they were acting on behalf of Sealy." *Id.* at 353.

C. *Modes of Analysis*

Subsequent to the enactment of the Sherman Act, two extreme views developed as to the proper application of section 1. At one end, a literal reading of section 1 lead to the conclusion that Congress intended a broad application which proscribed "[*e*]*very* contract, combination . . . , or conspiracy in restraint of trade."[9] This early formulation of the per se rule made no distinction between reasonable and unreasonable restraints upon trade.[10] Subsequent decisions retreated from this harsh view and distinguished between those restrictions which only indirectly restrained trade and those which restrained trade directly.[11] These early per se decisions were harmonized in *United States v. Socony-Vacuum Oil Co.*[12] Since these decisions dealt with price-fixing arrangements, the *Socony-Vacuum* Court held that

9. 15 U.S.C. § 1 (1976) (emphasis added). The classic statement of this line of analysis is:

> [T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. This principle of *per se* unreasonableness not only makes the type of restraints which are proscribed by the Sherman Act more certain to the benefit of everyone concerned, but it also avoids the necessity for an incredibly complicated and prolonged economic investigation into the entire history of the industry involved, as well as related industries, in an effort to determine at large whether a particular restraint has been unreasonable—an inquiry so often fruitless when undertaken.

Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958) (holding that a tying-in arrangement which compelled the grantee or lessee of certain lands to ship over the railroad/grantor's lines was per se illegal). *Cf.* note 13 *infra* (under the rule of reason analysis, this per se approach, as it applies to certain conduct, is not disputed).

10. United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897).

11. United States v. Joint Traffic, 171 U.S. 505 (1898). Both *Joint Traffic* and *Trans-Missouri* involved railroad cartels formed for the purpose of eliminating rate competition among members. In *Trans-Missouri*, the Court held the cartel agreement illegal per se, 166 U.S. at 341. Retreating from this position, the *Joint Traffic* Court held that section 1 of the Sherman Act

> applies only to those contracts whose direct and immediate effect is a restraint upon interstate commerce, and that to treat the act as condemning all agreements under which, as a result, the cost of conducting an interstate commercial business may be increased, would enlarge the application of the act far beyond the fair meaning of the language used. The effect upon interstate commerce must not be indirect or incidental only. An agreement entered into for the purpose of promoting the legitimate business of an individual or corporation, with no purpose to thereby affect or restrain interstate commerce, and which does not directly restrain such commerce, is not, as we think, covered by the act, although the agreement may indirectly and remotely affect that commerce.

171 U.S. at 568.

This approach was expanded so that in addition to summarily invalidating arrangements which had actual, direct effects on competition, the Court would also invalidate those combinations or agreements which resulted in an aggregate of market power capable of producing such effects. Appalachian Coals v. United States, 288 U.S. 344 (1933); United States v. Trenton Potteries Co., 273 U.S. 392 (1927).

12. 310 U.S. 150 (1940). The Court characterized as price fixing a concerted arrangement by the major oil companies to purchase "distressed" gas on the spot market in order to control sharp fluctuations in prices during periods when the oil industry was depressed.

"[u]nder the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate commerce is illegal *per se*."[13]

The other view is that certain agreements or restrictions are not illegal if the effect on competition is reasonable in light of all the attending circumstances.[14] Though the rule of reason initially clashed

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13. *Id.* at 223. The Court relied upon the statement in *Trenton Potteries*, 273 U.S. at 399-400, that

> [t]he aim and result of every price-fixing agreement, if effective, is the elimination of one form of competition. The power to fix prices, whether reasonably exercised or not, involves power to control the market and to fix arbitrary and unreasonable prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow. Once established, it may be maintained unchanged because of the absence of competition secured by the agreement for a price reasonable when fixed. Agreements which create such potential power may well be held to be in themselves unreasonable or unlawful restraints, without the necessity of minute inquiry whether a particular price is reasonable or unreasonable as fixed and without placing on the government in enforcing the Sherman Law the burden of ascertaining from day to day whether it has become unreasonable through the mere variation of economic conditions. Moreover, in the absence of express legislation requiring it, we should hesitate to adopt a construction making the difference between legal and illegal conduct in the field of business relations depend upon so uncertain a test as whether prices are reasonable—a determination which can be satisfactorily made only after a complete survey of our economic organization and a choice between rival philosophies.

310 U.S. at 213-14. *See also* United States v. Sealy, Inc., 388 U.S. 350 (1967); United States v. Bausch & Lomb Co., 321 U.S. 707 (1944); Ethyl Gasoline Corp. v. United States, 309 U.S. 436, 458 (1940) (citing United States v. Trenton Potteries, 273 U.S. 392 (1927), for the proposition that agreements which create potential power for price maintenance in a market are also per se illegal); United States v. Joint Traffic Ass'n, 171 U.S. 505 (1898); United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897). *Accord*, White Motor Co. v. United States, 372 U.S. 253, 260 (1965) ("In any price-fixing case restrictive practices ancillary to the price-fixing scheme are also quite properly restrained.").

Relying on the decision in Northern Pac. Ry. v. United States, *see* note 9 *supra*, courts have extended this analysis to horizontal market division and group boycotts. *See* Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959), and Fashion Guild v. FTC, 312 U.S. 457 (1941) (group boycotts); Addyston Pipe & Steel Co. v. United States, 85 F. 271 (1898), *aff'd*, 175 U.S. 211 (1899) (horizontal market division).

On February 8, 1982, the Sixth Circuit Court of Appeals in Com-Tel, Inc. v. DuKane Corp., 1982-1 Trade Cas. ¶ 64,504 (6th Cir. 1982), held as a per se illegal group boycott, restrictions imposed at the insistence of one distributor through its manufacturer on its co-distributors. The court stated that "although the coercive pressure in this situation was applied vertically, we conclude that the stifling of competition . . . was predominately horizontal, warranting application of the per se rule of illegality as a group boycott." *Id.* at ¶ 72,783.

14. 166 U.S. at 354 (White, J., dissenting). "It is . . . not to be doubted that the interpretation of the words 'every contract in restraint of trade,' so as to embrace within its purview every contract, however reasonable, would certainly work an enormous injustice and operate to the undue restraint of the liberties of the citizen." *Id.*

Justice White's initial approach, which rejected any form of per se analysis, was that the Sherman Act could not have been intended to proscribe every contract which had some restraining effect on competition:

> To define . . . the words "in restraint of trade" as embracing every contract which, in any degree produced that effect would be violative of reason, because it would include all those contracts which are the very essence of trade, and would be equivalent of saying that there should be no trade, and therefore nothing to restrain.

with the per se approach, it was later modified so that both approaches now coexist.[15] These approaches provide the extremes; however, a common thread runs through both. Competition remains the standard for any analysis of alleged antitrust conduct. The prevailing controversy is whether non-price restrictions imposed by a dual distributor are illegal per se as horizontal restrictions or whether they should be classified as vertical restraints and analyzed under the rule of reason.

III. THE FORMATIVE DECISIONS

The Supreme Court has, through a trilogy of decisions,[16] attempted to resolve this issue. Curiously, in no case has the Court properly recognized the problem as one involving a dual distribution

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Id. at 351.

From this premise, Justice White proposed a two-step analysis, whereby courts were to draw a distinction between those arrangements which directly restrain trade or competition and those which indirectly or partially had such an effect. If the restraint was indirect or partial, the courts should determine whether the arrangement was proscribed by using reason after an examination of all attending circumstances. *Id.* at 351.

15. In Standard Oil Co. v. United States, 221 U.S. 1 (1911), Chief Justice White employed the rule of reason analysis which he had previously advocated in dissent. *See* note 14 *supra.* However, he retreated from his initial position by recognizing the viability of a per se approach. Under this reformulated rule of reason analysis, competition remained the fulcrum but the crucial inquiry became whether the particular act or arrangement resulted in an *undue* restraint on trade. Interpreting section 1 of the Sherman Act, the Chief Justice stated that

> [t]he statute . . . evidenced the intent not to restrain the right to make and enforce contracts, whether resulting from combination or otherwise, which did not unduly restrain interstate or foreign commerce, but to protect that commerce from being restrained by methods, whether old or new, which would constitute an interference that is an undue restraint.

221 U.S. at 60.

Reason, in light of all the attending circumstances, remained the standard which guided the court's judgment. *Id.* Therefore, if the arrangement or restriction had the effect of suppressing or eliminating competition, reason dictated that such a restraint was undue and illegal. In contradistinction, a due or reasonable restraint on trade would be that which merely regulated competition.

This line of reasoning was picked up in Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918), where Justice Brandeis stated:

> Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.

Id. at 238. In making this inquiry, courts should

> consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts.

Id.

16. Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977); United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967); White Motor Co. v. United States, 372 U.S. 253 (1963).

arrangement.[17] With the latest decision in the area of nonprice restrictions,[18] the Court has come full circle so far as the applicable mode of analysis. The split among the circuit courts on this issue,[19] however, indicates that this decision is not the last word.

In *White Motor Co. v. United States*,[20] the Court was faced with its first opportunity to deal with nonprice restrictions imposed upon distributors and dealers by a dual distributor. White Motor manufactured trucks and sold them to distributors for resale to dealers and users, directly to dealers, and to certain large users. As part of its distribution system, White Motor reserved several large accounts to itself and imposed territorial restrictions on its distributors and dealers.[21] These customer and territorial restrictions were alleged to be per se violations of the Sherman Act.[22]

Without discussing the proper method of classifying such restric-

17. In *White Motor*, the manufacturer sold trucks and parts to distributors, retailers and large users. 372 U.S. at 255. Similarly, Schwinn marketed its bicycles by selling to distributors, for ultimate resale to franchised dealers, and by making direct sales to retailers. 388 U.S. at 370. In neither case did the Supreme Court discuss the agreements as involving dual distribution.

18. Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

19. These decisions are discussed at notes 67-81 *infra* and accompanying text.

20. 372 U.S. 253 (1963).

21. *Id.* at 255-56.

22. In addition to the territorial and customer restrictions, White Motor was charged with price fixing. White Motor argued that the agreements fixing prices were "only an adjunct to the customer restriction clauses and amounted merely to an agreement to give [those] classes of customers [which White Motor reserved to itself through its customer restrictions and which included so-called 'national accounts'] their proper discounts." *Id.* at 257. Price fixing is per se illegal, whether horizontal or vertical. *See generally* United States v. Parke, Davis & Co., 362 U.S. 29 (1960), and Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911) (vertical price fixing agreements); Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. 211 (1951), and United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) (horizontal price-fixing agreements). Any restrictive practices which are ancillary to a price fixing scheme are also illegal. United States v. Bausch & Lomb Optical Co., 321 U.S. 707 (1944). White Motor did not challenge the finding of price fixing and the Supreme Court held that *Bausch & Lomb* did not apply since there had been no finding that the price fixing agreements were an "integral part" of the customer restrictions. 372 U.S. at 260.

White Motor claimed that the territorial restrictions were not illegal since they promoted interbrand competition. *Id.* at 256. Furthermore, it could have fully integrated its distribution system which would have totally eliminated the need for a separate distributorship and dealership program. This, however, was not economically feasible. Therefore, any reasonable restraint on intrabrand competition should not be illegal since the effect was to enhance interbrand competition. *Id.* Moreover, arguing that the customer restrictions were not illegal, White Motor asserted that

> one of [its] purposes was to assure [itself] 'that "national accounts," "fleet accounts" and Federal and State governments and departments and political subdivisions thereof, which are classes of customers with respect to which [it] is in especially severe competition with the manufacturers of other makes of trucks and which are likely to have a continuing volume of orders to place, shall not be deprived of their appropriate discounts on their purchases of repair parts and accessories from any distributor or dealer, with the result of becoming discontented with The White Motor Company and the treat-

tions when employed in a dual distribution arrangement, the Court declared the restrictions to be vertical.[23] However, it declined to decide whether the rule of reason or per se rule was to be applied. Noting that "[h]orizontal territorial limitations . . . are naked restraints of trade with no purpose except stifling of competition,"[24] it was unclear that vertical territorial restrictions have a similar effect. Since the rule of reason "normally requires an ascertainment of the facts peculiar to the particular business,"[25] the Court was unwilling to reach a conclusion on the merits since appeal had been taken from the district court's grant of summary judgment.[26]

Two important points may be drawn from the *White Motor* decision. Initially, though the Court did not expressly acknowledge that White Motor was a dual distributor, it implied as much in its description of the distribution arrangement.[27] Nevertheless, the Court un-

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> ment they receive with reference to the prices of repair parts and accessories for White trucks.'

Id. at 257.

23. 372 U.S. at 261.

24. *Id.* at 263. The Court analogized horizontal territorial restrictions to group boycotts and refusals to trade which had been held to be per se illegal in Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207, 212 (1959). 372 U.S. at 263.

25. 372 U.S. at 261.

26. *Id.* at 263. *See* United States v. White Motor Co., 194 F. Supp. 562 (N.D. Ohio 1961). The Court acknowledged that, due to the lack of a trial on the merits, it did not

> know enough of the economic and business stuff out of which these arrangements emerge to be certain. They may be too dangerous to sanction or they may be allowable protections against aggressive competitors or the only practicable means a small company has for breaking into or staying in business and within the "rule of reason."

372 U.S. at 263.

In his concurring opinion, Justice Brennan noted that the territorial restrictions provided a novel question and that "[t]o gauge the appropriateness of a *per se* test [in this situation] we must determine whether experience warrants, at this stage, a conclusion that inquiry into the effect upon competition and economic justification would be . . . irrelevant." *Id.* at 265-66. Regarding the customer restrictions, Justice Brennan suggested that they

> would seem inherently the more dangerous of the two, for they serve to suppress all competition between manufacturer and distributors for the custom of the most desirable accounts. At the same time they seem to lack any of the countervailing tendencies to foster competition between brands which may accompany the territorial limitations. . . .
>
> The crucial question to me is whether, in any meaningful sense, the distributors could, but for the restrictions, compete with the manufacturer for the reserved outlets. If they could, but are prevented from doing so only by the restrictions, then in the absence of some justification neither presented nor suggested by this record, their invalidity would seem to be apparent.

Id. at 272-73.

27. There are two points in the opinion where it was implicitly noted that White Motor was a dual distributor. In the statement of the facts, the Court stated that "White Motor manufacturers trucks and sells them (and parts) to distributors, to dealers, and to various large users." *Id.* at 255. Secondly, in arguing that the customer restrictions were permissible, White Motor stated that there was no reason why a distributor should not be limited to selling to one class of customers

hesitatingly declared the territorial restrictions to be vertical.[28] In doing so, the Court focused upon the source of the restrictions for the purpose of distinguishing vertical and horizontal restrictions rather than the type of distribution arrangement employed by White Motor.[29] Secondly, the Court indicated three possible conclusions on the legality of nonprice territorial and customer restrictions. Depending upon the evidence presented at trial, such restrictions may be per se illegal or may be protected under the rule of reason as "allowable protections against aggressive competitors or the only practicable means a small company has for breaking into or staying in business."[30] The Court returned to these issues in *United States v. Arnold, Schwinn & Co.*[31] Again, however, the Court failed to properly characterize the type of distribution involved.

Schwinn, a family owned business engaged in the manufacture and sale of bicycles, sold its products primarily through wholesale distributors with sales to the public through retailers. It marketed its products through three principal methods: 1) sales to bicycle distributors for resale to distributors; 2) sales to retailers by consignment or through an agency arrangement with distributors; and 3) sales to retailers under the so-called Schwinn Plan whereby bicycles were shipped directly to the retailer by Schwinn with a commission being paid to the distributor taking the order.[32]

Under Schwinn's marketing arrangement, specific geographical, "exclusive" territories were assigned to its distributors with instructions to sell only to franchised Schwinn dealers and only within their respective territories.[33] As for its franchised retailers, Schwinn's franchise

"and the manufacturer reserve the right to sell to another class of customers." *Id.* at 258. In light of the facts and White Motor's claims, the point was made clear that it was engaged in dual distribution at the time the restrictions were challenged.

28. *Id.* at 261.

29. This is, however, tenuous ground upon which to base this decision. In a dual distribution arrangement, the manufacturer also operates at the same level as its distributors. To simply look to the source of the restrictions raises the question of whether the restrictions were promulgated by the manufacturer in its manufacturing capacity or in its distributor capacity. This approach lacks support in light of United States v. Sealy, Inc., 388 U.S. 350 (1967). There, the Court held that market divisions imposed by a licensor upon licensees were horizontal market divisions and not vertical since the licensees owned all of the stock of the licensor. In response to the argument that "stockholders and directors wore a 'Sealy hat' when they were acting on behalf of Sealy," the Court stated that in determining whether such agreements were vertical or horizontal, the emphasis was upon "the identity of the persons who act, rather than the label of their hats." *Id.* at 353.

30. 372 U.S. at 263.

31. 237 F. Supp. 323 (N.D. Ill. 1965), *rev'd and remanded,* 388 U.S. 365 (1967).

32. 388 U.S. at 370.

33. *Id.* at 371.

agreement limited the number of retailers in any given area and limited the franchise to a specified location. Further, each franchised dealer was to purchase Schwinn bicycles only from or through the authorized distributor in that area and could sell only to consumers.[34] It was these restrictions which were challenged by the government in addition to the allegation that Schwinn had been "firm and resolute" in its enforcement of these restrictions.[35]

The Supreme Court characterized Schwinn's distribution system as "a truly vertical arrangement, raising the fundamental question of the degree to which a manufacturer may not only select the customers to whom he will sell, but also allocate territories for resale and confine access to his product, to selected, or franchised, retailers."[36] Referring to the suggestion in *White Motor* that vertical territorial restrictions may be governed by the rule of reason,[37] the Court distinguished the practices of Schwinn. It noted that Schwinn was the largest manufacturer of bicycles, "not a newcomer, seeking to break into or stay in the bicycle business."[38] Nor was the Court persuaded by Schwinn's argument that its distribution program was not illegal since it enabled Schwinn and its distributors "to compete more effectively in the

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34. *Id.* at 370-71.

35. *Id.* at 372. The district court found that the government had failed to prove its price-fixing allegations. 237 F. Supp. at 329. This issue was not appealed. 388 U.S. at 368. Additionally, the government abandoned its position that Schwinn's distribution restrictions were per se illegal and urged that a standard of "presumptive illegality" be employed to invalidate such restrictions. 388 U.S. at 374 n.5. It is not clear whether the government was attempting to establish a new test or whether this "presumption" was to be the new standard for analysis under the rule of reason. *See id.* at 368 ("[W]e are asked to consider these limitations in light of the 'rule of reason,' and . . . to conclude . . . that they constitute an unreasonable restraint of trade.").

Under the suggested theory, once it has been shown that there is a vertical restraint, the practice is to be presumed illegal unless the defendant can show that the restraint is reasonable. The *Schwinn* Court rejected this approach, holding that "[t]he burden of proof in antitrust cases remains with the plaintiff. . . ." *Id.* at 374 n.5. *Cf. In re* Coca-Cola Co., 91 F.T.C. 517 (1978), and *In re* Pepsico., Inc., 91 F.T.C. 680 (1978) (proof of a vertical restraint establishes a prima facie case of illegality which shifts the burden of proof to defendant).

36. 388 U.S. at 378. As noted by the Court in Continental T.V., Inc. v. GTE Sylvania, 433 U.S. 36 (1977), however, the *Schwinn* Court did not follow its announced purpose:

> The Court acknowledged the Government's abandonment of its *per se* theories and stated that the resolution of the case would require an examination of "the specifics of the challenged practices and their impact upon the marketplace in order to make a judgment as to whether the restraint is or is not 'reasonable' in the special sense in which § 1 of the Sherman Act must be read for purposes of this type of inquiry." Despite this description of its task, the Court proceeded to articulate the . . . "bright line" *per se* rule of illegality for vertical restrictions . . . .

433 U.S. at 44 (citations omitted).

37. 372 U.S. at 263. *See* note 26 *supra* and accompanying text.

38. 388 U.S. at 374.

marketplace."[39]

Noting that under its marketing system Schwinn sold its bicycles to distributors for ultimate resale to retailers, the Court held that

> [o]nce the manufacturer has parted with title and risk, he has parted with dominion over the product, and his effort thereafter to restrict territory or persons to whom the product may be transferred—whether by explicit agreement or by silent combination or understanding with his vender—is a per se violation of § 1 of the Sherman Act.[40]

Presumably, the Court chose the first alternative suggested by *White Motor* as a proper result for nonprice vertical restrictions.[41]

The per se rule announced in *Schwinn* has been criticized as "the most egregious error in all of antitrust."[42] It also prompted judicial attempts to minimize or distinguish it "in ways that are a tribute to judicial ingenuity."[43] At its best, the language in *Schwinn* created many openings through which subsequent decisions have avoided its harsh per se approach.

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39. *Id.* at 374-75. The Court stated:

> Schwinn sought a better way of distributing its product: a method which would promote sales, increase stability of its distributor and dealer outlets, and augment profits. But this argument, appealing as it is, is not enough to avoid the Sherman Act proscription; because, in a sense, every restrictive practice is designed to augment the profit and competitive position of its participants. Price fixing does so, for example, and so may a well-calculated division of territories. The antitrust outcome does not turn merely on the presence of sound business reason or motive. Here, for example, if the test of reasonableness were merely whether Schwinn's restrictive distribution program and practices were adopted "for good business reasons" and not merely to injure competitors, or if the answer turned upon whether it was indeed "good business practice," we should not quarrel with Schwinn's eloquent submission or the finding of the trial court. But our inquiry cannot stop at that point. Our inquiry is whether, assuming nonpredatory motives and business purposes and the incentive of profit and volume considerations, the effect upon competition in the marketplace is substantially adverse.

Id. at 375 (citation omitted).

40. 388 U.S. at 382. The Court's failure to apply the rule of reason prompted criticism. *See* notes 35-36 *supra*.

41. In *White Motor*, the Court suggested that vertical territorial restrictions may or may not have the same effect as horizontal division of markets. 372 U.S. at 263. However, the Court did suggest that such restrictions "may be too dangerous to sanction." *Id.* The *Schwinn* Court appears to have relied upon this guidance:

> Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it. Such restraints are so obviously destructive of competition that their mere existence is enough.

388 U.S. at 379 (citations omitted).

42. Handler, *Twenty-Five Years of Antitrust*, 73 COLUM. L. REV. 415, 458 (1973). Professor Handler noted that, in *Schwinn*, Justice Fortas based his decision on the assumption that vertical territorial restrictions violated "the ancient rule against restraints on alienation." 388 U.S. at 380. To Professor Handler, this clearly ignored history and the common law which had applied the rule of reason to vertical restriction. 73 COLUM. L. REV. at 458.

43. Robinson, *Recent Antitrust Developments: 1974*, 75 COLUM. L. REV. 243, 272 (1975).

Essentially, two major criticisms of *Schwinn*, aside from its result, formed the bases for subsequent decisions. Regarding which rule applies to post-sale restrictions on distributors, the Court held that "[u]nder the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it."[44] In *Tripoli Co. v. Wella Corp.*,[45] the circuit court held that the language in *Schwinn* was limited to its facts and, in the present case, there was more than merely post-sale territory and customer restriction.[46] Therefore, the restraint was to be examined under the rule of reason.[47]

Second, in *Schwinn* the Supreme Court noted the district court's finding that Schwinn had been "firm and resolute"[48] in its enforcement of its territory and customer restrictions.[49] Subsequent decisions have distinguished *Schwinn*, holding that territorial and customer restrictions are not per se illegal unless they have been enforced by the manufacturer in a "firm and resolute" manner.[50] These problems led to the Court's reconsideration of *Schwinn*.

IV. CURRENT TREATMENT OF NONPRICE VERTICAL RESTRICTIONS

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

The most recent Supreme Court decision brings the applicable

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44. 388 U.S. at 379 (citations omitted).

45. 286 F. Supp. 264 (E.D. Pa. 1968), *aff'd*, 425 F.2d 932 (3d Cir. 1970).

46. 425 F.2d 936. In *Tripoli*, the manufacturer of beauty and barber supplies restricted sales by distributors to professional consumers due to the potential dangerous nature of the products if applied by nonprofessionals. This restriction was held not to be a per se violation of the Sherman Act:

> Here there is more, and the restraints are of a different order. Tripoli does not charge that it or any other Wella distributor is confined, in reselling, to a specific territory. Nor does Tripoli charge that it or any other Wella distributor is confined to reselling to "franchised" beauty or barber shops. The restraint is on a wholesale distributor's reselling products intended for professional application to non-professional retail end users.

Id. Accord, Jack Winter, Inc. v. Koratron Co., 375 F. Supp. 1, 63 n.87 (N.D. Cal. 1974) (secret agreement between patentee and manufacturer restricting legal actions for patent infringement was not an unreasonable restraint on trade); Carter-Wallace, Inc. v. United States, 449 F.2d 1374, 1380 (Ct. Cl. 1971) (patent licensee agreement requiring patent licensee to resell patented drug product only in combination with other drugs was not violative of antitrust laws).

47. 425 F.2d at 936.

48. 237 F. Supp. 323, 342 (N.D. Ill. 1965).

49. 388 U.S. at 372.

50. *See* Knutson v. Daily Review, Inc., 383 F. Supp. 1346, 1367-68 (N.D. Cal. 1974), *aff'd in part and rev'd in part*, 548 F.2d 795, 806 (9th Cir. 1976), *cert. denied*, 433 U.S. 910 (1977); Colorado Pump & Supply Co. v. Febco, Inc., 472 F.2d 637, 639 (10th Cir. 1973); Janel Sales Corp. v. Lanvin Parfums, Inc., 396 F.2d 398, 406 (2d Cir. 1968).

mode of analysis for nonprice vertical restrictions full circle. In *Continental T.V., Inc. v. GTE Sylvania, Inc.*,[51] a franchised retailer challenged a restriction imposed by the manufacturer on the location from which the products could be sold. The Court viewed this case as an opportunity to re-examine its decision in *Schwinn*.

Sylvania, a television manufacturer, attempted to boost its market share of national television sales by phasing out its wholesale distributors and making direct sales to a small, select group of franchised retailers. One goal of this new system was to reduce intrabrand competition which, in turn, would encourage more aggressive retailers to become franchised. To further promote this goal, Sylvania limited the number of franchises in any given area and required each to make sales only from the location or locations at which it was franchised. These areas were nonexclusive territories and Sylvania reserved the right to add retailers in any area in which the existing retailer had failed to develop a market.[52]

Continental T.V. was a franchised retailer of Sylvania televisions in the San Francisco area. As a result of its dissatisfaction with sales in that area, and over Continental's protests, Sylvania franchised an additional retailer at a location in close proximity to that of Continental.[53] Continental requested, but was denied, permission to open a store in Sacramento. Subsequently, however, Continental transferred Sylvania merchandise to a new store in that area. Shortly thereafter, Sylvania's credit department reduced Continental's credit substantially, whereupon Continental withheld payment to Sylvania's finance company. Sylvania then terminated Continental's franchise.[54]

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51. 433 U.S. 36 (1977), *aff'g* 537 F.2d 980 (9th Cir. 1976).

52. 433 U.S. at 38.

53. In retaliation, Continental cancelled a large Sylvania order and placed a large order with a competing brand manufacturer. *Id.* at 39.

54. *Id.* at 39-40. The circuit court found that, unlike the territorial restrictions in *Schwinn*, Sylvania had imposed location restrictions on its dealers. These were restrictions on vendors, while the territorial restrictions in *Schwinn* applied to vendees. 537 F.2d at 990. Furthermore, *Schwinn* was distinguished on the effect of its restrictions.

> [T]here are very clear and substantial differences between the effect of the restrictions in *Schwinn* and the effect of those of Sylvania. In *Schwinn* a wholesale distributor was foreclosed from selling Schwinn products to any purchaser located outside his exclusive territory; thus, intrabrand competition (i.e., competition between sellers of the same brand) was wholly destroyed. A potential purchaser of Schwinn products at the wholesale level could look to only one source of the product—the authorized dealer for his territory. No other wholesaler could compete by offering a lower price or better service to the same purchaser. In marked contrast, Sylvania franchised at least two dealers in the major markets and each Sylvania dealer was *free to sell to any buyer he chose*—preserving intrabrand competition and allowing to every potential purchaser of Sylvania products a reasonable choice between several competing dealers.

As in *Schwinn*,[55] the *Sylvania* Court characterized the restrictions as vertical.[56] Further, the Court was unable to distinguish the facts in *Sylvania* from the situation in *Schwinn*,[57] even though *Sylvania* did not involve restrictions imposed by a dual distributor. However, acting upon Sylvania's suggestion that *Schwinn* should be reconsidered, the Court acknowledged that there was a need for clarification of the law and that this justified reconsideration of the per se principle announced in *Schwinn*.[58]

It was noted that, in *Schwinn*, "[t]he pivotal factor was the passage of title: All restrictions were held to be *per se* illegal where title had passed, and all were evaluated and sustained under the rule of reason where it had not."[59] Breaking from this reasoning, the *Sylvania* Court stated that there was no basis for the *Schwinn* distinction between sale and nonsale transactions.[60] As a result, it concluded that this distinction did not justify application of a per se rule in one and a rule of reason in the other.[61] Consequently, the rule of reason was reinstated as the proper mode of analysis for vertical restrictions[62] and the per se rule stated in *Schwinn* was overruled.[63]

Id. (emphasis in original). Based on these essential distinctions, the court held that *Schwinn* was not controlling and the location restrictions were to be analyzed under the rule of reason. *Id.* at 1001.

55. *See* note 36 *supra* and accompanying text.

56. 433 U.S. at 51 n.18.

57. *Id.* at 45. "Thus, the *Schwinn per se* rule applies unless Sylvania's restriction on location falls outside *Schwinn's* prohibition against a manufacturer's attempting to restrict a 'retailer's freedom as to where and to whom it will resell the products.'" *Id.* at 45-46 (citations omitted).

58. *Id.* at 47.

59. *Id.* at 52.

60. As for *Schwinn*'s emphasis upon the passage of title to the goods, the *Sylvania* Court held:

> It appears that this distinction between sale and nonsale transactions resulted from the Court's effort to accommodate the perceived intrabrand harm and interbrand benefit of vertical restrictions. The *per se* rule for sale transactions reflected the view that vertical restrictions are "so obviously destructive" of intrabrand competition that their use would "open the door to exclusivity of outlets and limitation of territory further than prudence permits." Conversely, the continued adherence to the traditional rule of reason for nonsale transactions reflected the view that the restrictions have too great a potential for the promotion of interbrand competition to justify complete prohibition. The Court's opinion provides no analytical support for these contrasting positions. Nor is there even an assertion in the opinion that the competitive impact of vertical restrictions is significantly affected by the form of the transaction. Nonsale transactions appear to be excluded from the *per se* rule, not because of a greater danger of intrabrand harm or a greater promise of interbrand benefit, but rather because of the Court's unexplained belief that a complete *per se* prohibition would be too "inflexibl[e]."

Id. at 52-54.

61. *Id.* at 57.

62. *Id.* at 59.

63. *Id.* at 58. However, the Court cautioned that it did not "foreclose the possibility that particular applications of vertical restrictions might justify *per se* prohibition under *Northern Pacific Ry. Co.* But we do make clear that departure from the rule-of-reason standard must be based

B. *Aftermath of* Sylvania

As in *White Motor* and *Schwinn*, the decision in *Sylvania* has led to divergent results in the lower courts, especially regarding nonprice territorial and customer restrictions imposed upon distributors and dealers by a dual distributor. The question the Supreme Court has failed to address is whether nonprice restrictions imposed by a dual distributor are vertical, hence subject to a rule of reason analysis, or whether they are horizontal and per se illegal.[64] Restated, in light of *Sylvania*, the issue becomes whether that decision applies only to purely vertical restrictions or whether it is equally applicable to restrictions imposed by a dual distributor.[65]

Nonprice restrictions imposed by a dual distributor have both horizontal and vertical characteristics. Since the manufacturer is also acting as a distributor, imposition of territorial and customer restrictions resemble proscribed horizontal division of markets. At the same time, the restrictions are imposed upon distributors by the dual distributor which is operating in its manufacturing capacity. Thus, the restrictions assume the characteristic of vertical restrictions. In either case, the resulting effect upon interbrand-intrabrand competition is the same.

Currently, there is a split between the lower courts as to the proper test which should be applied in a dual distribution arrangement. Those courts which have applied the per se rule tend to emphasize the horizontal characteristics of the restrictions.[66] In support of this position, an analogy is made to *United States v. McKesson & Robbins*,[67] where the Court held that fair trade agreements[68] between a manufacturer-

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upon demonstrable economic effect rather than—as in *Schwinn*—upon formalistic line drawing." *Id.* at 58-59.

64. *Sylvania* did not alter the long-standing rule that horizontal nonprice restrictions are per se illegal. 433 U.S. at 50 & n.16, 57 & n.27. *See also* United States v. Topco Assoc., Inc., 405 U.S. 596 (1972); United States v. Sealy, Inc., 388 U.S. 350 (1967).

65. This question necessarily arises from the fact that both *White Motor* and *Schwinn* involved a dual distribution arrangement. *See* note 17 *supra*.

66. *See* American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3d Cir. 1975); Pitchford v. PEPI, Inc., 531 F.2d 92 (3d Cir. 1975); Hobart Bros. Co. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir. 1973); Interphoto Corp. v. Minolta Corp., 295 F. Supp. 711 (S.D.N.Y.), *aff'd per curiam*, 417 F.2d 621 (2d Cir. 1969). *See also* Dougherty v. Continental Oil Co., 579 F.2d 954 (5th Cir. 1978), *vacated on other grounds*, 591 F.2d 1206 (5th Cir. 1979).

67. 351 U.S. 305 (1956). McKesson & Robbins, a wholesale distributor which also manufactured its own brand of drugs, refused to sell its drugs to independent wholesalers who had not entered into fair trade agreements with it. Many of its wholesalers in direct competition with McKesson & Robbins' own wholesale division signed these agreements whereby they agreed to resell the products at the wholesale price fixed by the manufacturer.

68. Fair trade agreements are similar to resale price maintenance in that they establish the minimum or maximum price at which the manufacturer's products will be sold. Vertical agree-

wholesaler and its independent wholesalers amounted to price-fixing agreements between competitors. The Court emphasized that the trade agreements involved were between parties competing at the same functional market level.[69]

Those courts which applied the per se rule to nonprice restrictions imposed by a dual distributor have, impliedly, extended the decision in *McKesson & Robbins*. Typical of these decisions is *Hobart Bros. Co. v. Malcolm T. Gilliland, Inc.*[70] in which the court held that the effect of any agreement to impose territorial restrictions by a dual distributor is "to eliminate competition" between the manufacturer and its distributors on the distribution level.[71] Therefore, though these agreements appeared to impose vertical restrictions, they were held to be horizontal. The court concluded that "[s]uch an arrangement must be treated as it operated in practice rather than 'as arranged by skillful drafting.' "[72] *Sylvania* is distinguishable from these cases on the ground that in *Sylvania*, the Court was dealing with vertical restrictions only and not restrictions imposed by a dual distributor.[73]

At the same time, some courts have chosen to emphasize the vertical aspects of such restrictions, resulting in the application of the rule of reason.[74] Each court approached the characterization problem differently yet each reached the conclusion that the restrictions were vertical. The court's treatment of the restrictions in *Abadir & Co. v. First Mississippi Corp.*[75] represents a unique approach to the characterization

ments of this sort may be established either consensually or by the manufacturer's refusal to deal with those distributors who refuse to abide by the prices. *See* ANTITRUST ADVISOR § 2.25 (2d ed. C. Hills 1971).

69. 351 U.S. at 313.

70. 471 F.2d 894 (5th Cir. 1973).

71. *Id.* at 899. *Accord*, Interphoto Corp. v. Minolta Corp., 295 F. Supp. 711 (S.D.N.Y.), *aff'd*, 417 F.2d 621 (2d Cir. 1969).

72. 471 F.2d at 899.

73. *See, e.g.*, Pitchford Scientific v. PEPI, Inc., 435 F. Supp. 685, 688 (W.D. Pa. 1977), *on remand from* 531 F.2d 92 (3d Cir. 1975). In *Sylvania*, the Court warned that "[t]here may be occasional problems in differentiating vertical restrictions from horizontal restrictions originating in agreements among the retailers. There is no doubt that restrictions in the latter category would be illegal *per se* . . . ." 433 U.S. at 58 n.28.

74. *See* Copy-Data Systems, Inc. v. Toshiba America, Inc., 1981-2 Trade Cas. ¶ 64,343 (2d Cir. 1981); Abadir & Co. v. First Mississippi Corp., 651 F.2d 422 (5th Cir. 1981); Donald B. Rice Tire Co. v. Michelin Tire Corp., 483 F. Supp. 750 (D. Md. 1980), *aff'd*, 638 F.2d 15 (4th Cir. 1981); Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001 (5th Cir. 1981); Cowley v. Braden Indus., Inc., 613 F.2d 751 (9th Cir. 1980); H & B Equipment Co., Inc. v. International Harvester, 577 F.2d 239 (5th Cir. 1978); Krehl v. Baskin-Robbins Ice Cream Co., 1979-2 Trade Cas. ¶ 62,806 (C.D. Cal. 1979). *See also* First Beverages, Inc. v. Royal Crown Cola Co., 612 F.2d 1164 (9th Cir. 1980).

75. 651 F.2d 422 (5th Cir. 1981). First Mississippi, a producer of fertilizer and chemicals, distributed its products through its own employees but used brokers to reach certain customers

problem in a dual distribution situation. Stating that "[t]he rationale for each *per se* rule is an economic analysis of the agreement,"[76] the court enumerated the "potential economic advantages" to the supplier who imposes restrictions upon distributors.[77] The "test" proposed for determining whether a restriction is vertical or horizontal in a dual distribution arrangement was whether "the party imposing the agreement has the potential economic advantages typically available to a supplier in a vertical market-distributing agreement. If these potential economic advantages are absent, then the agreement is horizontal."[78]

Other decisions have focused upon the source of the restrictions so that restrictions imposed by a manufacturer are vertical even though the manufacturer may be a dual distributor.[79] Still other courts have

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and to develop new markets. First Mississippi agreed to sell urea, an inorganic chemical used for fertilizer and industrial use, to Abadir, a broker, with the understanding that the urea would only be resold for use in Asia. Upon discovering that Abadir had sold the urea without any limitation, First Mississippi refused to deliver any of the compound. *Id.* at 424.

76. *Id.* at 426.

77. *Id.* at 426-27. In this regard, the court pointed out that

> [w]hile horizontal market distributing agreements have no significant potential advantages to the participants other than a reduction in competition, vertical market-distributing agreements do have significant potential economic advantages which are legitimate. The distributor or distributors on whom such agreements are imposed are only benefitted by a reduction in competition. But the supplier imposing such agreements has several potential economic advantages which are legitimate: attracting competent and aggressive retailers, inducing retailers to engage in promotional activities, market-distribution efficiency, and maintaining control over the safety and quality of the product. Furthermore, unless some legitimate advantage is truly necessary, a supplier will not have any interest in imposing such an agreement on its distributors. A supplier will normally prefer stiff competition among its distributors. This keeps the distributors' selling prices as low as possible, thereby maximizing the manufacturer's sales.

Id. (citations and footnotes omitted). *Accord,* Copy-Data Systems, Inc. v. Toshiba America, Inc., 1981-2 Trade Cas. ¶ 64, 343 (2d Cir. 1981). *See* Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. at 55.

78. 651 F.2d at 427. If horizontal, then the agreement is per se illegal even though the manufacturer/supplier is the source of the restriction. *See* United States v. Topco Assoc., Inc., 405 U.S. 596 (1972); United States v. Sealy, Inc., 388 U.S. 350 (1967); United States v. General Motors Corp., 384 U.S. 127 (1966); Sandura Co. v. FTC, 339 F.2d 847 (6th Cir. 1964).

79. *See* Donald B. Rice Tire Co. v. Michelin Tire Corp., 483 F. Supp. 750, 754 (D. Md. 1980). On appeal, however, the circuit court affirmed the lower court decision but rejected "any implication . . . that a restraint may always be regarded as vertical if it is imposed by the manufacturer." Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15, 16 (4th Cir. 1981).

The district court rejected "a functional analysis directed at the impetus, purpose, and effect of the restrictions." 483 F. Supp. at 74. It viewed any such analysis as a method of characterizing restrictions as vertical or horizontal, as duplicative of the rule of reason analysis for determining the legality of the restraints. Consequently, it preferred to combine the horizontal/vertical inquiry with the application of the rule of reason. *Id.* In the circuit court's view, a distinction should be drawn between

> a conspiracy among dealers and their supplying manufacturer for the purpose of retail price maintenance that would benefit the dealers and one involving the same parties but redounding primarily to the benefit of the manufacturer as a result of increased intrabrand competition. A restraint imposed by the former conspiracy would be horizon-

taken the position that the distributor is an "agent" of the manufacturer and, therefore, not a competitor of the manufacturer even though the latter is engaged in dual distribution.[80]

V. Discussion

In a dual distribution marketing system, such as that in *White Motor* and *Schwinn*, the manufacturer not only operates at a different market level than its distributors and retailers, but, by making direct sales to retailers and large accounts, also operates at the same market level as a distributor. Therefore, nonprice territorial and customer restrictions imposed upon distributors and retailers by a dual distributor have both vertical and horizontal characteristics. In *Sylvania*, the Court stated that it was dealing with vertical restrictions[81] and it could find no basis upon which to distinguish that case from the situation presented in *Schwinn*.[82] This assertion illustrates the basic misconception under which the Court has operated.

The *White Motor* and *Schwinn* Courts failed to recognize that the manufacturers involved were dual distributors and proceeded to deal with the restrictions as though they were imposed in a purely vertical situation.[83] Consequently, *Sylvania*, in overruling *Schwinn's* sale-nonsale distinction and substituting the rule of reason for the per se rule in a non-dual distribution situation, can logically apply only to nonprice restrictions which are purely vertical. The remaining question then becomes whether *Sylvania* has any application to similar restrictions employed by a dual distributor.

If *Sylvania* is to apply to these types of restrictions, then two interrelated problems must be resolved. Where the manufacturer does not distribute its goods directly, the general approach is to characterize any restrictions which it may impose upon its distributors as vertical merely by identifying the manufacturer as the source of the restrictions. However, where the manufacturer is operating in a dual capacity through

tal in nature and *per se* illegal, while one imposed by the latter would be vertical and analyzed under the rule of reason.

638 F.2d at 16.

80. Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001, 1005 (5th Cir. 1981).

81. 433 U.S. at 51 n.18.

82. *Id.* at 46.

83. This problem in *White Motor* is discussed at note 27 *supra*. In *Schwinn*, bicycles were sold to distributors for resale to franchised retailers, but Schwinn also made direct sales to some retailers. 388 U.S. at 370.

direct distribution of its products and its network of independent distributors, the *Sylvania* approach to the characterization problem loses its simplicity. If the restrictions are characterized as vertical, then the horizontal aspects are ignored. Likewise, if the restrictions are characterized as horizontal, then the fact that the manufacturer is the source of the restrictions is diminished.

In resolving the issue, it appears that the "demonstrable economic effect" standard of *Sylvania*[84] can be applied to the threshold issue of the proper characterization of the restrictions, much the same way that the *Sylvania* Court applied it to discard *Schwinn's* "formalistic line drawing" in determining the legality of vertical restrictions. Several factors are relevant to this inquiry, which, though similar to those espoused in *Abadir & Co. v. First Mississippi Corp.*,[85] should take into consideration the effects of such restrictions upon interbrand and intrabrand competition.

Since a manufacturer's motivation for imposing territorial and customer restrictions vary, courts should attempt to isolate those that are relevant to each particular case. Generally, a manufacturer will impose such restrictions in order to obtain certain efficiencies in its distribution system with a view towards maintaining or improving its market power relative to its competitors. In *Abadir*, the court labeled these as "potential economic advantages"[86] which included "attracting competent and aggressive retailers," preventing free riders by "inducing retailers to engage in promotional activities," and "maintaining control over the safety and quality of the product."[87] If the party employing the restrictions in question obtains these economic advantages which a manufacturer normally has, then the restrictions are vertical and subject to the rule of reason. If not, then they are horizontal and illegal per se.[88]

One advantage to this characterization approach is that it takes into consideration the vertical and horizontal aspects of dual distribution restrictions. In addition, it encourages an analysis based upon economic effect at each critical stage and not simply after a restriction is characterized as vertical.

One objection to this method is that the analysis is duplicated in

84. 433 U.S. at 58-59.
85. 651 F.2d 422 (5th Cir. 1981). *See also* notes 76-78 *supra* and accompanying text.
86. 651 F.2d at 427.
87. *Id.*
88. *Id.*

the rule of reason analysis to determine the legality of vertical restrictions.[89] This should not be a serious objection,[90] since the purpose served by each step is different. Under this two step analysis, the court must focus its attention upon two separate objectives. Initially, the court's primary concern is whether the restrictions are vertical or horizontal. If the court finds that the restrictions were not intended to provide the manufacturer with the benefits of legitimate marketing efficiencies, then the logical conclusion is that they were intended to have no effect except the restriction or elimination of competition. These restrictions should be labeled horizontal and per se illegal.

However, if the court's analysis reveals that the restrictions were intended to enhance the manufacturer's marketing system by promoting legitimate market efficiencies, then these restrictions should be deemed vertical. The logical economic effect of these restrictions is to promote the manufacturer's interbrand competitive position by reducing competitive rivalry among its distributors.

Once the court determines that the restrictions are vertical, it should then focus on whether the restraint on trade caused by the restriction is reasonable. Though this analysis under the rule of reason may involve consideration of the same factors involved in the initial characterization step, the court's emphasis is now on the legality of the restrictions and not the motivation behind them. In this regard, additional factors should be considered which bear upon the economic effect of the restrictions. Included among these are whether the restrictions have enabled a company to enter the market or remain in business, whether the manufacturer is able to enter into a new market, or whether the restrictions have served to protect a manufacturer from aggressive competition.[91] If such benefits are realized, then the restrictions should be upheld as reasonable. However, if the economic benefits do not result, then the court should conclude that the application of the vertical restrictions justifies per se treatment as having a "pernicious effect on competition."[92]

This two-step economic analysis provides a court with a flexible method of analyzing nonprice territorial and customer restrictions in a

89. Donald B. Rice Tire Co. v. Michelin Tire Corp., 483 F. Supp. 750, 754 (D. Md. 1980), *aff'd*, 638 F.2d 15 (4th Cir. 1981).

90. *See* Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15, 16 (4th Cir. 1981), *aff'g*, 483 F. Supp. 750 (D. Md. 1980).

91. 372 U.S. at 263.

92. 433 U.S. at 58.

dual distribution system. Furthermore, it gives necessary consideration to the dual aspect of such restrictions. It is in this sense that *Sylvania* may be applied in those cases involving a dual distributor.

VI. CONCLUSION

Nonprice restrictions employed by a dual distributor should not be held per se illegal simply due to their restraining effect upon intrabrand competition. Nor should they be subject to a rule of reason analysis simply because they are imposed upon the distributors by the dual distributor-manufacturer. Instead, future decisions should look to the efficiencies which result from use of the restrictions and, accordingly, whether this was the primary motive or intent of the dual distributor in imposing the restrictions. Such an approach allows the courts to employ a per se rule when the effect of the restrictions on competition is so pernicious that they lack any redeeming virtue. At the same time, however, it permits flexibility since application of the per se rule or the rule of reason will, on a case by case basis, be based upon demonstrable economic effect.

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