'ROUND AND 'ROUND ON RPM

Should a manufacturer be allowed to set the price at which a retail store can sell its product? The Supreme Court decided in 1911 that it should not: under the Sherman Act, the Court said, that sort of "resale price maintenance" (RPM) is illegal. Later, in the mid-thirties, Congress passed legislation permitting states to legalize RPM by passing "fair trade" laws. It withdrew that permission in 1975.

Recently, the Supreme Court's flat ban on resale price maintenance has come under increasing fire from economists and antitrust enforcers. The critics argue that in many, or even most, instances the practice is a spur to competition and efficiency rather than a restraint. Both the Justice Department and the Federal Trade Commission proposed last fall that the ban be lifted in favor of a "rule of reason" test—under which courts would judge the competitive impact of RPM on a case-by-case basis. Congress countered in November by passing an appropriations rider that bars the Justice Department and the FTC from spending funds on any activity intended "to overturn or alter the per se prohibition. . . ." The Court is addressing some aspects of the RPM controversy in the case of Monsanto *v.* Spray-Rite, *which it now has under review.*

The essays that follow are adapted from a colloquium held during AEI's Public Policy Week in December 1983. The authors offer recommendations on how to treat RPM—ranging all the way from per se legality (Frank Easterbrook) through rule-of-reason (James C. Miller III) to the current per se illegality (Robert Pitofsky). First, however, Phillip Areeda sets the stage with a discussion of some of the legal and historical issues at stake in the controversy.

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The State of the Law

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MY PURPOSE HERE IS to outline the legal background of "resale price maintenance"—a practice by which a supplier dictates the prices charged by dealers reselling his product. I will attempt to do so with the Olympian detachment for which Harvard is, of course, so famous—and leave the nitty-gritty of whether the practice is good or bad to my colleagues Frank Easterbrook, Robert Pitofsky, and James Miller III.

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I can present this issue in terms of two tensions in the law, created by two pairs of legal rules. One tension is that between the Supreme Court's decisions in *Dr. Miles Medical Co.* v. *John V. Park & Sons Co.* (1911) and in *Continental T.V.* v. *GTE Sylvania* (1977). The second tension—which is not directly involved

in the legal status of resale price maintenance but which, as a practical matter, may be fundamental—is that between *Dr. Miles* and *United States* v. *Colgate* (1919) as to when two parties can be found to have conspired in restraint of trade.

THE POSITION of U.S. antitrust law on resale price maintenance was set by *Dr. Miles* in 1911. The Supreme Court held that resale price maintenance arrangements constitute "unreasonable restraints of trade" and are therefore categorically illegal. The Court rested on two interrelated factual (or economic) premises for that decision. The first premise was that a "vertical" price-fixing agreement between a manufacturer and its dealers on the price the latter would charge for the manufacturer's product has the same market impact as a "horizontal" agreement among the dealers themselves to fix that price. Both kinds of agreements, the Court said, eliminate price competition among retailers selling that brand. Given that horizontal price-fixing among the dealers of a product was, and is, illegal per se—that is, illegal always (or virtually always)—the Court reasoned that vertical price-fixing ought to be governed by the same rules.

The Court's second, and related, premise was that retail price-fixing does not serve any legitimate interest of the manufacturer. In other words, once the manufacturer sells its product to a wholesaler, it should have no interest in what happens to the product further down the distribution chain. The manufacturer, as the Justices put it, "having sold its product at prices satisfactory to itself, the public is entitled to whatever advantages may be derived from competition in the subsequent traffic."

The next three articles will agree that the Court's two premises, at least so categorically stated, were wrong. Vertical price-fixing *is* different from horizontal price-fixing, and the manufacturer *does* have an interest in some circumstances in what happens down the distribution chain. However, there is one telling point to be made in defense of the Supreme Court's *Dr. Miles* ruling: though economically wrong, it was probably historically correct. Over the years, the primary impulse for resale price maintenance has come from organized retailers, such as the National Association of Retail Druggists. Although they might have been motivated by the desire to prevent "free riders" (which my colleagues will describe), I am willing to make the broad-brush judgment that their main purpose was to eliminate competition among themselves. This does not necessarily mean that resale price maintenance is always an instrument of dealer market power. But the Supreme Court of 1911 was responding to its own identification—and probably an accurate one—of the dealer interest the practice was serving at that time.

Following the *Dr. Miles* decision, other distribution restraints were examined in terms of how closely they resembled resale price maintenance. When a manufacturer limited the territories in which his dealers could sell or the customers to whom they could sell, the prosecutors argued that this elimination of competition among dealers in a given brand should be subject to the same per se rule outlawing resale price maintenance. This argument essentially succeeded in *United States* v. *Arnold Schwinn & Co.* (1967), in which the Supreme Court came very close to declaring such territorial and customer restrictions automatically unlawful, too. However, ten years later in *Sylvania,* the Court overruled *Schwinn* and held that customer and territorial restrictions were to be judged on their merits in each case according to the "rule of reason." The cases that have come after *Sylvania* have generally been very hospitable to customer and territorial restrictions and have generally ruled them lawful.

The apparent state of the current law on this issue is that resale price maintenance is unlawful per se, while customer and territorial restrictions are governed by the rule of reason —which has amounted almost to per se legality.

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Clearly there is tension between these two propositions, at the level of both principle and litigation. The tension at the level of principle

is that customer and territorial restrictions eliminate competition among dealers who sell a particular brand no less than does resale price maintenance. Furthermore, the kinds of justifications offered for customer and territorial restrictions—for example, the manufacturer's "legitimate" interest in preventing free riders—are comparable, though not necessarily identical, to the kinds of justifications offered for resale price maintenance. Indeed, it is often argued that *Sylvania*'s hospitality toward customer and territorial restrictions should make resale price maintenance legitimate as well. The Supreme Court may further enlighten us this spring in the pending case of *Spray-Rite* v. *Monsanto*, but so far it has been willing to live with this tension. In upholding customer and territorial restraints in *Sylvania*, the Court said explicitly that it was not changing the rule on resale price maintenance.

At the level of litigation, the tension manifests itself in the following way. Suppose that a manufacturer of personal computers believes that selling computers requires special promotional effort in showing customers how the computer works, differentiating it from rival products, and the like—all of which is expensive. Suppose also that the manufacturer's Chicago dealer decides to sell by mail. As a result, a customer may shop at a Boston store, take the time of the sales people there, get their advice, and then buy from a mail order house at a lower price—which the latter can afford because he does not have sales personnel demonstrating the product. The Boston dealer complains to the manufacturer, who anticipates that continued mail order operations would impair future sales and so stops selling his product to that Chicago dealer. The latter then initiates an antitrust suit alleging (1) that the manufacturer terminated him because he undercut the price of the Boston dealer and (2) that this amounts to vertical price-fixing, which is unlawful per se. The manufacturer characterizes his behavior as a customer or territorial restraint to be tested by *Sylvania*'s more hospitable rule.

Of course, both statements—apart from their legal conclusions—are true. Clearly, the practice is both a way of controlling resale price and a way of implementing a restrictive distribution policy. And the curiosity of this legal situation in which *Dr. Miles* and *Sylvania* exist side by side is that the law is simultaneously uttering two propositions that the layman, uninstructed in the law's fine distinctions, might regard as inconsistent. The lower courts have enormous trouble applying this pair of legal rules, because virtually any customer or territorial restriction, presumptively lawful, will have a price effect, presumptively unlawful. Whatever one might think of the wisdom of condemning resale price maintenance, it is evident that we need to define more precisely than the law now does when and how those rules apply.

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LET ME NOW ILLUSTRATE how this confusion is magnified by the second tension I mentioned, the one between *Dr. Miles* and the *Colgate* case. Price restraints are condemned by Section 1 of the Sherman Act only where they are embodied in a "contract combination or conspiracy" between two parties. That requirement is satisfied when a manufacturer and dealer agree on the resale price that will be charged. But *Colgate* posed the following issue: Suppose the manufacturer simply says to the dealer, I don't want an agreement or a promise, I just want you to know that if you charge less than a dollar for my toothpaste or whatever, I won't supply you with any more of it. In short, the manufacturer uses the threat of termination to enforce a "unilateral demand." The *Colgate* case held that resale price maintenance brought about

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through mere threat or mere termination was not an agreement. I will not pursue the merits of the decision except to note that it may strike the lay mind as somewhat odd that a result achieved by a promise is unlawful while the very same result achieved by a threat of termination is allowed.

Many judges have also thought it odd. The *Colgate* rule has been so widely eroded that most lower courts—the Supreme Court has not spoken definitively on this—hold that a manufacturer reinforcing any kind of restricted distribution policy by terminating recalcitrant dealers has "conspired" with somebody. Now observe the consequences of pressing this idea. It is generally supposed that a manufacturer can choose, if he wishes, to sell his goods at wholesale to Saks Fifth Avenue and not to K-Mart because he thinks Saks will best preserve the image he wants for his goods. But suppose that Saks decides overnight, in a change of corporate management, to become a K-Mart. When the manufacturer ceases to supply the transformed Saks, it will sue, claiming that the manufacturer is practicing resale price maintenance. And many courts would so hold.

There is a further wrinkle that is involved in *Spray-Rite*. Recall my computer example. When the mail order house starts selling computers at discounted prices in Boston, the Boston dealer complains to the manufacturer that before long it will not be able to afford to demonstrate the product anymore. If the manufacturer cuts off the mail order house, the latter will allege, among other things, a conspiracy between the manufacturer and the complaining dealer. (I put aside the metaphysics of what a conspiracy means between the manufacturer and a third party that has no influence, control, power, domination, or ability to give a relevant quid pro quo to the manufacturer.) The legal issue is now couched in terms of whether a conspiracy can be found between the manufacturer and the complaining dealer.

This conspiracy issue, as well as the *Colgate* problem, makes it unclear what a manufacturer may or may not do. One could resolve the uncertainty by extending *Sylvania* to resale price maintenance and testing all distribution restraints according to the rule of reason. Short of that, one could define more precisely what constitutes an agreement. Uncertainty would be reduced by confining *Dr. Miles* to cases where manufacturers specified prices in a relatively clear-cut way and enforced them through agreement or perhaps even through threat of termination, and thereby excluding my hypothetical Saks case or my hypothetical computer case.

THIS SUFFICES by way of introduction and leaves to my colleagues in this colloquium to discuss the differences between horizontal and vertical agreements, the kinds and persuasiveness of justifications for manufacturer restrictions on distribution, and the ancillary dangers that resale price maintenance will promote either dealer power or collusion among manufacturers.

The answers will prove to be quite complex. For example, the free-rider concern is real, but the desire to preserve product image may be the more important explanation. Perhaps, consumers ought not to be deprived of images, but protecting image may not be a sufficient virtue to offset the danger that resale price maintenance may be serving anticompetitive dealer interests. To be sure, an organized dealer cartel can be prevented. But there may be other forms of dealer pressure which cannot independently be forbidden or prohibited under the statute. Or a manufacturer, anticipating dealer pressure, may adopt resale price maintenance without any observable dealer action that the law can deal with.

The difficulty of resolving these questions makes it tempting to rely on such easy answers as "Congress has already decided" or "let the market rule." But in repealing an antitrust exemption for state-approved resale price maintenance in 1975, Congress decided only that resale price maintenance will be governed by federal antitrust law as distinct from state law. Congress left the content of that federal law where it has always been, namely in the hands of the courts. Nor does the "unrestrained" market rule universally. Antitrust law allows manufacturers to restrain dealer freedom in many ways—by, for example, specifying hours of operation, minimum inventories, or warranty service requirements. Of course, there are reasons to distinguish different kinds of restraints, as my colleagues in this colloquium will now proceed to do. ■