

THE ENRICHMENT OF SELLERS AS A JUSTIFICATION FOR VERTICAL RESTRAINTS: A RESPONSE TO CHICAGO'S SWIFTIAN MODEST PROPOSAL

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Perhaps the single greatest value I ascribe to the papers by Professors Comanor¹ and Flynn² is that they remind us that too much currently fashionable learning has consisted of efforts to disregard the obvious, common-sense characterizations of business practices that, on their surface, restrict competition and are designed to raise prices or to prevent price discounting. In many ways, Professor Comanor confirms that common-sense, literal understandings of vertical restraints are supported by economic evidence and logic. Professor Flynn confirms that those same understandings are consistent with the jurisprudence of the Sherman Act.

In thinking about the intent of the framers of the antitrust laws with respect to vertical restraint agreements, and reviewing the papers on the topic, I was inspired by two recent concrete, anecdotal events. The first event was the passage of a bill by the Georgia legislature that would have absolutely prohibited vertically integrated oil companies from opening retail gas stations.³ The Georgia legislature acted primarily in response to the urging of a retail dealers' association which cited allegedly coercive, unpoliced vertical conduct by suppliers, allegedly designed to achieve vertical integration.

The second event was the reaction of many of my foreign LL.M. students during an antitrust seminar devoted to recent lower court developments. In discussing recent vertical restraint cases, students were particularly interested in a recent Ninth Circuit decision in which the court

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¹ Comanor, *Vertical Arrangements and Antitrust Analysis*, 62 N.Y.U. L. Rev. 1153 (1987).

² Flynn & Ponsoldt, *Legal Reasoning and the Jurisprudence of Vertical Restraints: The Limitations of Neoclassical Economic Analysis in the Resolution of Antitrust Disputes*, 62 N.Y.U. L. Rev. 1125 (1987). The cited conference paper was originally authored by Professor Flynn alone. Any comments about it in this Essay are directed to the version presented at the conference by Professor Flynn.

³ Georgia S. Bill No. 177 (1987). "Gasoline Marketing Retail Sales: Prohibitions" was passed by both houses of the Georgia legislature but vetoed by Governor Harris on March 20, 1987.

blithely, and without citing any Supreme Court authority, announced that vertical price fixing was *not* per se illegal and was not unreasonable unless it could be or it was proven to have an anticompetitive effect throughout a defined product and geographic market.⁴ My foreign students reacted with unusually open cynicism, claiming that antitrust law specifically, and the ability of democratic government to regulate capital in general, were illusory at best, and perhaps fraudulent.

The inferences I draw from these two anecdotes are:

1. Assuming a majoritarian political process truly prevails, legislatures will, as they have throughout history, impose more intrusive, less efficient forms of regulation if traditional antitrust policing does not occur or is unsuccessful; and

2. Those who rely primarily upon the alleged efficiency goals of antitrust—even if their reliance is justified in particular cases—ignore history and political science to our long-term disadvantage. Moreover, an overly permissive attitude toward facially anticompetitive business conduct plays into the hands of either industrial policy proponents or critical legal studies adherents here and abroad, and will undermine our free market.

With that background, I turn to the papers at hand. Both Professors Comanor and Flynn attack so-called conventional wisdom: the incorporation of neoclassical economics, or perhaps a libertarian deference to business judgment, into the law of vertical restraints. They do so in different styles, and I was impressed by both.

I have tried to synthesize several basic points from each paper and then subject them to liberal reinterpretation. Professor Comanor begins with the obvious premise—perhaps too understated—that vertical restraints by definition restrict some competition. They have a purpose and effect that is, to a certain extent, literally anticompetitive. Furthermore, Professor Comanor writes, studies prove that when a vertical restraint is imposed on a product, prices to consumers usually increase, often across product lines. This result should not be surprising to scholars familiar with the debate over the fair trade laws during the 1930s, when the singular purpose of those laws and of vertical price fixing was to protect independent, less efficient retailers' profit margins.⁵ The question then is, given that vertical restraint agreements undeniably restrict some competition and raise consumer prices, on what basis are vertical restraints defended so routinely today, assuming the Sherman Act⁶ is in

⁴ See *49er Chevrolet, Inc. v. General Motors Corp.*, 803 F.2d 1463 (9th Cir. 1986).

⁵ See generally H.R. Rep. No. 421, 100th Cong., 1st Sess., reprinted in 53 *Antitrust & Trade Reg. Rep. (BNA)* No. 1340, at 763, 765 (Nov. 12, 1987) (discussing history of fair trade laws and their ultimate repeal).

⁶ 15 U.S.C. §§ 1-7 (1982).

part a "consumer welfare" prescription, as well as a regulator of the competitive process?

Two quite different explanations appear in the "conventional wisdom," and it is important to note their difference. The lower courts are primarily defending vertical restraints on one concept of "efficiency," and academic theoreticians on another. Professor Comanor's piece gently pokes holes in both.

First, it is said by courts today that in reality vertical restraints are procompetitive and efficient because they reduce sellers' costs.⁷ But Professor Comanor tells us that, in fact, vertical restraints usually make prices rise. If that is so, "efficiency" gains either do not exist or are not passed on to the retailer or to the consumer, and the market as a whole remains less price competitive and not more efficient.

On the other hand, certain theorists tell a quite different story in defending vertical restraints, based upon a different concept of efficiency that does not incorporate competition. Yes, vertical restraints make prices to consumers rise, but that is *good* in itself—it increases aggregate societal wealth, mostly in the hands of sellers. If a consumer pays more for a product, he must value it more—so he is not worse off. Most important, sellers would not impose vertical restraints unless demand *also* increased and the demand curve for the product was thus pushed out by its higher price. So more products are sold at a higher price, allocative efficiency is increased, and everyone is better off. Professor Comanor's response to this theorizing is twofold:

1. When the vertically restrained product is sold by retailers who sell multiple products, particularly in the case of department stores, studies show that the demand curve often is not in fact significantly pushed out. High-price retailers, in fact, often use their superior bargaining power to coerce vertical restraints upon manufacturers to protect their profit margins at a net efficiency loss; and

2. Where the theory *is* justified by reality—where vertical restraints increase price and also increase demand (as in *Continental T.V., Inc. v. GTE Sylvania Inc.*),⁸ often because more consumers prefer quality-certified products to discount products—the conclusion that consumers are "better off" simply disregards differences among consumers and differences among retailers; it fatuously equates the "allocative efficiency" construct with "consumer welfare." The positive economics conclusion that a person is "better off" transferring more of his money to a seller for the same product to make the seller wealthier demands a

⁷ See, e.g., *Isaksen v. Vermont Castings, Inc.*, 825 F.2d 1158, 1161 (7th Cir. 1987) (Posner, J.).

⁸ 433 U.S. 36 (1977).

more direct political evaluation and confrontation by the courts.

Indeed, recent lower court vertical restraint decisions have not upheld vertical restraints on the ground that requiring consumers to pay more to sellers for the same product was a legitimate goal of antitrust. Nor did any decision cite evidence to refute the facts that vertical restraint agreements literally restrict competition and may have raised prices to consumers. Instead, the lower courts seem to be saying simply that vertical restraint agreements are not “significantly” anticompetitive, and courts should defer to the wisdom, or business judgment, of the defendants who imposed such agreements because the rational businessman would not maintain conduct that was inefficient.⁹

Such libertarian deference to business judgment as consistent with the public interest, in the guise of construing the Sherman Act, brings me to Professor Flynn’s paper. Professor Flynn attempts to fill in the philosophical, historical, and political background of the Sherman and Clayton Acts. Basically, the poet Flynn is saying to Judge Bork, in particular, who is responsible for much of the theorizing summarized above, “the Emperor has no clothes.” Liberally interpreted, Professor Flynn says that neoclassical economists and libertarian lawyers and judges are guilty of two sins: ignoring or redefining reality and legislative history in ways that would embarrass most scholars in other fields, and effectively validating the critical legal studies assertion that majority rule incorporated in law is meaningless—power is everything.

First, in general, Professor Flynn tells us that in examining the legality of vertical restraints, we must consider the congressional purposes embodied in the Sherman and Clayton Acts—which he says clearly are multivalued, as demonstrated by numerous legal historians and scholars before him. Professor Flynn concludes that the premise of neoclassical economists reviewing vertical restraints—that increasing aggregate wealth in the hands of sellers (that is, wealth redistribution to sellers) is the single goal of the Sherman Act—is simply wrong.

Professor Flynn continues that as a matter of science, jettisoning facts that conflict with a theory by suggesting that events described in a trial record “could not have happened” or are “seldom a problem” is simply Alice-in-Wonderland economics and ultimately leads to anti-majoritarian politics.

On a more concrete and specific level, toward the end of his paper, Professor Flynn recognizes the basic premise of Professor Comanor’s piece: vertical restraints facially restrict some competition, often increase

⁹ See, e.g., *Garment Dist., Inc. v. Belk Stores Servs., Inc.*, 799 F.2d 905 (4th Cir. 1986); *Morrison v. Murray Biscuit Co.*, 797 F.2d 1430 (7th Cir. 1986); *Westman Commission Co. v. Hobart Int’l, Inc.*, 796 F.2d 1216 (10th Cir. 1986).

price by reducing retail discounting, are created by sellers expressly for those purposes, and so, under existing law, should be presumptively illegal. Proof that a vertical restraint has been maintained, preventing price competition to some degree, demonstrates that in reality the defendants in a particular case do have market power—power over price—regardless of the predictions of neoclassical theory. Proof of the existence of the restraint, according to Professor Flynn, should shift the burden to the sellers to rebut the presumption by showing that the restraint indeed increases demand for and output of the product, and thus does not affect the consumer's ability to shift preference among substitutable products, should he prefer to pay a lower price. Correspondingly, when a plaintiff can show that the defendant's implementation of a vertical distribution restraint has caused prices to increase throughout a market, the defendant's rebuttal evidence would be inadequate. Professor Flynn's use of burden shifting would effectively incorporate for vertical restraints the law recently established for horizontal restraints by the Supreme Court's recent decisions in *NCAA v. Board of Regents*¹⁰ and *FTC v. Indiana Federation of Dentists*.¹¹

Professor Flynn's use of presumptive illegality for vertical restraints is consistent with his unstated premise that a vertical restraint cannot be defended on the simple ground that it allows sellers to enrich themselves by causing consumers to pay more for the same product.

My one difference with Professor Flynn, which I have demonstrated by my recent testimony before the House Judiciary Committee in favor of H.R. 585,¹² the "Freedom from Vertical Price-Fixing Act of 1987," is that I would codify the rule of per se illegality for vertical price fixing. My reasons for such a codification are that vertical price fixing, although perhaps benign in a few cases, is almost always anticompetitive in purpose and effect and never procompetitive. Furthermore, the often-stated reasons for "per se" treatment of business conduct are more valid today than ever before, in view of the confusion or unwillingness to defer to congressional intent that prevails throughout the judiciary.

The use of a per se rule: (1) promotes uniformity in decision making, reinforcing the existence and respect for the rule of law; (2) creates predictability and provides notice to the business community concerning rules policing its conduct, thereby eliminating the inefficiency caused by

¹⁰ 468 U.S. 85 (1984).

¹¹ 476 U.S. 447 (1986).

¹² Testimony of James F. Ponsoldt before the House Comm. on the Judiciary, Feb. 26, 1987 (on file at New York University Law Review). H.R. 585 was approved by the House of Representatives on November 9, 1987. See House Passes Legislation to Reaffirm Per Se Rule for RPM, *Revise Monsanto*, 53 *Antitrust & Trade Reg. Rep. (BNA) No. 1340*, at 743 (Nov. 12, 1987).

uncertainty; and (3) creates efficiencies in litigation, making it less expensive and time consuming to resolve controversies, even if occasionally harmless or "victimless" conduct is punished.

In conclusion, we need to recognize again, as we did in the 1930s during the fair trade law debate, that vertical restraints facially restrict competition to some extent to protect the profit margins of sellers. They often are in conflict with the primary goal of antitrust, which is to maintain a competitive process—rivalry—as a market regulator to eliminate the inefficient or non-innovative and to protect economic opportunity for all. In most cases, we should enlighten the debate concerning efficiency justifications by shifting to sellers the burden of proving the existence of efficiencies and their relevance to maintaining a competitive market in particular cases. The currently prevailing permissive, noninterventionist ideology simply is not consistent with the goals of antitrust law.

