"'Vertical Restraints: An Examination of American and European Rules'

By Raphael Martin Campbell

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ABSTRACT

Vertical restraints are arrangements concluded between undertakings operating at different levels of the manufacturing or distribution chain which restrict the conditions under which goods are purchased or sold. This work examines the antitrust treatment of these restraints in Europe and the United States of America.

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RMC

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TABLE OF ABBREVIATIONS

Am Ec Rev	*American Economic Review*
Antitrust L Ec Rev	*Antitrust Law and Economics Review*
Antitrust LJ	*Antitrust Law Journal*
Antitrust B	*Antitrust Bulletin*
Bell J Ec	*Bell Journal of Economics*
Cal L Rev	*California Law Review*
Ch Div	*Chancery Division*
Cir	*Circuit Court of Appeals (preceded by figure indicating Circuit concerned)*
CLP	*Current Legal Problems*
CMLR	*Common Market Law Reports*
CML Rev	*Common Market Law Review*
Col L Rev	*Columbia Law Review*
Corn L Rev	*Cornell Law Review*
ECJ	*European Court of Justice*
Ec J	*Economic Journal*
ECLR	*European Competition Law Review*
ECR	*European Court Reports*
EFLR	*European Food Law Review*
EIPR	*European Intellectual Property Review*
EL Rev	*European Law Review*
F	*Federal Reporter*
F 2d	*Federal Reporter 2nd series*
F 3rd	*Federal Reporter 3rd series*
FILJ	*Fordham International Law Journal*
Fordham Corp L Inst	*Fordham Corporate Law Institute*
F Supp	*Federal Supplement*
Harv L Rev	*Harvard Law Review*
Harv Intl LJ	*Harvard International Law Journal*
ICLQ	*International and Comparative Law Quarterly*
J Ind Ec	*Journal of Industrial Economics*
JO	*Journal Officiel des Communantes Européenes*
KB	*Kings Bench*
LIEI	*Legal Issues in European Integration*
Mich L Rev	*Michigan Law Review*
MLR	*Modern Law Review*
NYUL Rev	*New York University Law Review*
OJ	*Official Journal of the European Communities*
Rand J Econ	*Rand Journal of Economics*
Stan L Rev	*Stanford Law Review*
Swiss Rev ICL	*Swiss Review of International Competition Law*
Texas LR	*Texas Law Review*
U Chic LR	*University of Chicago Law Review*
U Penn LR	*University of Pennsylvania Law Review*
Yale LJ	*Yale Law Journal*
YEL	*Yearbook of European Law*

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INTRODUCTION

Vertical restraints are arrangements between undertakings operating at different levels of the manufacturing or distribution chain which restrict the conditions under which goods are purchased or sold. At first glance one might suspect these restraints are worthy of little note. After all, they lack the headline grabbing potential of mergers or acquisitions. Nothing, however, could be further from the truth. The antitrust treatment of vertical restraints has been the subject of much debate which has occasionally assumed the character of religious zealotry.

Vertical restraints have both procompetitive and anticompetitive effects on competition. Their use can solve problems of inefficiency. Supplier and dealer free riding problems, which result in sub-optimal investment, can be overcome through the imposition of exclusive dealing or purchasing obligations, fixing resale prices (RPM) and territorial allocation. Certification problems can be overcome by restricting the sale of products to selected outlets or to exclusive dealers with a reputation for selling high quality products. Territorial allocation can also be used to attract new dealers and encourage investment especially if the supplier wishes to penetrate new markets. Hold up problems can be overcome by allowing the investor, whether supplier or dealer, to appropriate the benefit of its investment. Finally, although by no means exhaustively, vertical restraints may be utilised to create brand image through the creation of uniformity and quality standards by the use of selected or franchised outlets.

Conversely, these types of restraints may also have a variety of anticompetitive effects. RPM and territorial allocation may eliminate or reduce intrabrand competition, facilitate horizontal collusion between dealer or supplier and indirectly effect interbrand competition. Exclusive dealing or purchasing and tying arrangements may precipitate market foreclosure because suppliers are prevented from selling to buyers contractually bound to one supplier. In store competition is also prevented as the outlet is obliged to sell a single brand. In fact, tying may also result in buyers paying more for the tied product.

In the US most vertical restraints are now examined under a rule of reason analysis underpinned by a market power filter. In historical terms, however, they were treated less leniently. Many of these restraints were considered to be illegal *per se*. This treatment was predicated upon property law and the so-called ancient rule on alienation. Once a manufacturer sells its product, it no longer has any right to control subsequent dispositions. The American judiciary found refuge in this traditional legal concept rather than the foreign concept of economic analysis. Over time, however, the position changed. Debate over the legislative intent of the antitrust laws was resolved, for the time being, in favour of economic efficiency. This resulted in the acceptance of economic analysis by the judiciary and the proposition that provided interbrand competition exists, restrictions on intrabrand competition should be tolerated.

In the EU one of goals of competition, arguably the primary goal, is that of market unification. In historical context market unification has been seen as vital to *inter alia* European stability, wealth maximisation and efficiency. Central to this process is the integrative thrust of cross-border trade. From the outset, therefore, vertical restraints have been treated with circumspection. After all, it is pointless preventing Member States from imposing market partitioning measures only to permit private undertakings to perpetuate national boundaries through their vertically imposed agreements.

Admittedly, the objective of market unification often peacefully coexists with that of efficiency. Often, however, they collide. It is the resolution of this collision which gives EU law its distinctive character. Because competition policy in the EU performs this unique function greater importance is attached to intrabrand competition. The latter is seen as a vehicle for promoting market integration. Indeed, provided the EU embraces market unification as a goal, whether it be a primary goal or otherwise, the distinctiveness of its law in this area will continue to exist.

In the US parallel federal and state antitrust legislation exists. However, the Sherman Act 1890, Clayton Act 1914 and the Federal Trade Commission Act 1914 are the main federal statutes prohibiting anticompetitive behavior including restraints of trade, monopolising, attempts to monopolise and unfair competition. In the EU Articles 81 (ex 85) and 82 (ex 86) of the Treaty of Rome 1957 are concerned with restrictions of competition and abuse of dominance respectively. The European Commission, unlike the federal antitrust enforcement agencies, is empowered, by virtue of the bifurcation in Article 81 (ex 85), to grant exemption from the provision of Article 81(1) (ex 85(1)) under Article 81(3) (ex 85(3)).

In the US federal antitrust matters are enforced either privately or publicly. With regard to private enforcement, legal proceedings may be brought by one or more plaintiffs, State attorneys acting *parens patriae* on behalf of injured claimants or through class actions. Suits may be pursued on a contingency fee basis and injunctive relief and treble damages are available. Public enforcement falls to either the Department of Justice (DOJ) or the Federal Trade Commission (FTC). Agreement between the two agencies clearly divides their respective antitrust responsibilities. The DOJ is empowered to bring both criminal and civil proceedings and a variety of remedies are available. In the case of the FTC injunctive relief, cease and desist orders and consent decrees are available. Appeals can be made to higher Courts on points of law.

The decentralised, complaints based system of the US contrasts with the centralised, notification based system in Europe. At the heart of this system lies the European Commission. Complaints can be made directly to the Commission or to the national Courts of the various Member States. Although the present system is currently in the process of reform undertakings must either draft their vertical agreements to conform with the provision of block exemptions or notify them in the hope of gaining negative clearance or exemption. Appeals can be made to the Court of First Instance which has jurisdiction in matters of competition. A further appeal can be made to the Court of Justice on points of law. In the case of the Court of Justice the national Courts of Members States can also refer questions by way of the preliminary reference procedure. Interestingly, unlike the US, dissenting judgments are not permitted in the EU. In many respects it is the dissenting judgments of the US judiciary which contribute to the lively American debate.

The discussion is organised as follows. Chapter 2 considers the ideology of vertical restraints and the way in which policy aims or goals have impacted upon the development of the law in both the US and Europe. Chapter 3 examines the treatment of RPM in the US and EU. Chapter 4 deals with territorial allocation on both sides of the Atlantic. Chapters 5 and 6 describes the approach adopted to exclusive dealing or purchasing and tying respectively. Chapter 7 considers, briefly, the reforms currently being undertaken in the EU.

In 1999 the ratification process of the Treaty of Amsterdam (ToA) was finally concluded. While the ToA introduced a range of substantive changes it also renumbered all of the Articles of the Treaty on European Union (TEU) and the European Community (EC) Treaty. The practice adopted here, is to refer to both numbers and to indicate in parentheses the old Treaty numbers.

THE IDEOLOGY OF VERTICAL RESTRAINTS

I. INTRODUCTION

Over the years antitrust scholars have debated the proper function and purpose of antitrust and this debate has focused primarily, although not exclusively, on the treatment of vertical restraints. The latter seem to arouse more passion than any other area of antitrust. In the US a number of competing schools exist, each promoting their own particular solutions to antitrust dilemmas and each contributing to the ideological debate. The Critical Legal Studies approach, which is Socialist in orientation, contends that those in power exploit the law to maintain their own power base at the expense of the weak. According to this view Congressional intent indicates that antitrust was designed to prevent such exploitation.[1] The Industrial Policy advocates take the view that American social, political and economic institutions have outgrown antitrust. Business and Government should align more closely and through industrial planning set about making the economy more competitive. More recently, public choice theorists suggest that antitrust is not concerned with advancing public interest. Politicians enact laws to benefit powerful interest groups and policy results from political bargains between the two groupings.[2] Two main competing schools, however, have significantly impacted upon the development of US antitrust. While

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[1] See R.M. Unger, "The Critical Legal Studies Movement", (1983) 96 *Harv L Rev* 561. For a brief description of the cyclical nature of US antitrust theories see T. Frazer, "Competition Policy After 1992: The Next Step", (1990) 53 *MLR* 609, 617.

[2] W.H. Page, "Microsoft and The Public Choice Critique Of Antitrust", (1999) 44 *Antitrust B* 5.

inter-school differences exist in certain areas, there is in each of the main schools a broad range of consensus. Between the two approaches there are broad differences which reflect differences in social and political philosophy.[3]

The "traditionalist" approach adopts a liberal philosophical stance.[4] Adherents to this view believe that antitrust is multidimensional embracing concerns relating to access, process and pluralism. For the traditionalist, vertical restraints are not always procompetitive and may be imposed for strategic anticompetitive purposes. By failing to recognise, for example, that consumers are not one homogeneous grouping the imposition of such restraints may benefit marginal consumers to the detriment of inframarginal consumers. The latter may be required to pay for services they do not require.[5] Accordingly, the standard of *per se* illegality should be applied to these restraints or at least they should be presumed illegal. These standards promote uniformity, predictability and efficiency.[6]

In the late 1970s a view of antitrust (at one time considered highly idiosyncratic) entered mainstream academic thought and legal jurisprudence. The Chicago School purported to offer a unified and cohesive approach to antitrust based upon a conservative or libertarian philosophy. For Chicagoans the sole purpose or function of antitrust is the protection of efficiency and consumer welfare. The gradual rise and dominance of the concept of efficiency in the US can be attributed to a number of

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[3] E.M. Fox, "Consumers Beware Chicago", (1986) 44 *Mich LR* 1714.

[4] This approach is referred to under many names reflecting its rather scattered, diverse and eclectic nature. Its nomenclature includes realist, populist and Jeffersonian. See E.M. Fox, "The Modernization Of Antitrust: A New Equilibrium", (1981) 66 *Corn L Rev* 1140, 1143.

[5] W.S. Comanor, "Vertical Price-Fixing, Vertical Market Restrictions, And The New Antitrust Policy", (1985) 98 *Harv L Rev* 983, 992.

[6] J.F. Ponsoldt, "The Enrichment Of Sellers As Justification For Vertical Restraints: A Response To Chicago's Swiftian Modest Proposals", (1987) 62 *NYUL Rev* 1161, 1170-71.

factors including the high inflation rates in the 1970s, low productivity and dramatic increases in the market shares of German and Japanese products.

Antitrust should not be diluted with concerns for equity, fairness or any other matters of a distributive nature. Underpinning this notion is the conservative philosophy that markets work best if left alone; strategic business behaviour is rare and market entry relatively easy; market power is difficult to obtain and any business behaviour which survives over a period of time must be presumed efficient as the market punishes inefficiency. Antitrust should be non-interventionist, minimalist and proscribe only that activity which results in inefficiency or output restriction. According to this approach, vertical agreements are procompetitive and welfare enhancing and should be legal *per se*. While this minimum prescription has attracted many critics it has been highly influential in the development of US antitrust policy.[7]

In Europe competition policy has never been seen solely in terms of economic efficiency.[8] It retains a multifunctional character.[9] Not only is it concerned with safeguarding the economic efficiency of the system but it also embraces wider concerns. It is linked to the concepts of democracy, pluralism and the need to diffuse economic power which may threaten the political and economic freedoms of market participants.[10] These concerns have surfaced, for example, in the need to protect small and medium sized undertakings (SMEs). Above all, competition policy has been used in conjunction with a raft of measures to achieve market unification.[11] This policy

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[7] Criticism has focused upon the narrow brand of economics employed by Chicagoans and the models underlying assumption of rationality and use of rigid deductive logic.
[8] D.G. Goyder, *EC Competition Law* (3rd edn, Oxford, 1998) Ch. 3.
[9] EC Commission, *Fifteenth Report on Competition Policy: 1985* (Brussels, 1986) p. 11.
[10] D.J. Gerber, "Constitutionalizing The Economy: German Neo-Liberalism, Competition Law And The 'New' Europe", (1994) *42 American Journal of Comparative Law* 25, pp 35-38.
[11] C.D. Ehlermann, "The Contribution Of EC Competition Policy To The Single Market", (1992) 24 *CML Rev* 257.

objective has had important ramifications not only for substantive focus but also for institutional framework and competencies.[12] In terms of substantive focus, however, greater attention has been directed to vertical arrangements. Traditionally, these restraints have been seen as posing the greatest risk to market unification. As a result they have been treated more strictly in Europe than in domestic legal systems. This substantive focus has resulted in a barrage of criticisms.[13] It is no surprise, therefore, that the Commission published its 1997 Green Paper on Vertical Restraints relating to substantive and systemic change.

This Chapter examines the ideological approaches underlying the treatment of vertical restraints in the US and EU and how their respective approaches have affected the development of the law.

II. VERTICAL RESTRAINTS IN THE US

A. The Chicago School

1. Certain Fundamental Tenets

The writings of Bork, Posner and Easterbrook are widely identified and associated with the Chicago School. Their scholarship and jurisprudence provide cogent examples of Chicago School thinking. The Chicago School operates in the "classical

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[12] D.J. Gerber, "The Transformation Of European Community Competition Law", (1994) 35 *Harv Intl LJ* 97.

[13] See *inter alia* H.H.P. Luggard, "Vertical Restraints Under EC Competition Law: A Horizontal Approach?", (1996) 17 *ECLR* 166; B.E. Hawk, "System Failure: Vertical Restraints and EC Competition Law", (1995) 32 *CMLRev* 973; C. Bright, "Deregulation of EC Competition Policy: Rethinking Article 85(1)", in B.E. Hawk (ed.), *Annual Proceedings of the Fordham Corporate Law Institute (1994): Antitrust In A Global Economy* (1995).

economic tradition running from Smith to Marshall".[14] Its policy prescription is one of non-interventionism and minimalism. Its design is to get government off the back of business enterprise.[15] For Chicagoans, competition must be understood in terms of consumer welfare or economic efficiency.[16] The goal of antitrust is, therefore, wealth maximisation by means of economic efficiency. Distributive concerns such as equity and fairness should not form part of antitrust analysis. As Bork suggests antitrust has a built-in preference for material prosperity, but it has nothing to say about the way prosperity is distributed.[17] For Chicagoans there is no support for the assertion that antitrust embodies broad social, political or ethical objectives. Indeed, Bork asserts that Congress passed the antitrust laws to serve the sole goal of allocative efficiency. Other proponents, notably Posner and Easterbrook, suggest that whether congressional intent was focused on the sole goal of allocative efficiency, antitrust laws should be interpreted in that manner in any event.

From this standpoint, antitrust laws are primarily concerned with the efficient workings of the market. That which is inefficient is presumed to be anticompetitive and should be proscribed by the law. To include other non-economic goals would render antitrust untenable, resulting in wealth destruction through the inhibition of efficiency, increased accumulation of governmental powers to cater for the need for increased governmental incursions into the private business sector and, ultimately, the replacement of the free market with that of regulated markets.[18] The consideration of non-economic concerns would ultimately protect the inefficient from the rigours of competition.

[14] R.A. Posner, "The Chicago School of Antitrust Analysis", (1979) 127 *U Penn LR* 925, 932.
[15] E.M. Fox and R. Pitofsky, "The Antitrust Alternative", (1987) 62 *NYUL Rev* 931.
[16] R.H. Bork, *The Antitrust Paradox* (Reprint, New York, 1993) p.427.
[17] Ibid 90.
[18] R.H. Bork, note 16 above, 423.

For adherents to the Chicago School, allocative and productive efficiency determines the level of society's wealth. Allocative efficiency refers to the placement of resources into the economy and productive efficiency relates to the effective use of those resources by individual undertakings. The task of antitrust is to improve allocative efficiency without impairing productive efficiency. Economic analysis is the means by which this task is achieved.

One of the fundamental tenets of the Chicago School is that of price theory. At its most basic, business if acting rationally, does not act in a random manner. Business activity is directed towards profit maximisation and the most efficient business is the one that has experienced the most success in the market. Chicagoans, however, recognise that profits may be made by means other than efficiencies. Profit may be made by taking advantage of tax loopholes or by means of output restriction in an attempt to gain monopoly profits.[19] The task of antitrust, therefore, is to identify and prohibit those forms of business activity whose net effect is output restricting. That activity which is neutral should be left untouched. There are no grey areas. If business activity is not neutral in its effects, it can only be either efficient or inefficient. As Bork writes, if a practice does not raise "... a question of output restriction (inefficiency) ... we must assume that its purpose and therefore its effect are either the creation of efficiency or some neutral goal. In that case the practice should be held lawful".[20] To attempt to regulate, by means of antitrust law, that which is either efficient or neutral is to suppress the freedom or autonomy of the producer to

[19] R.H. Bork, note 16 above, 122.
[20] Ibid.

serve the consumer in ways that the consumer desires. The producer or manufacturer, in serving its own interests, serve the interest of the consumer.[21]

Chicago's distinctive approach is also reflected in its treatment of strategic behaviour. For Chicagoans, strategic behaviour is much like the unicorn or dragon, much talked about but never seen. Barriers to market entry or investment rarely exist.[22] In fact, market entrants will generally flow to those areas where the greatest profits can be made. Generally, those barriers which do exist are usually created by governmental interference usually in the form of patent rights or business regulation. To redress this problem, government should generally refrain from market intervention. Chicagoans generally view predatory practices as counter-productive. In fact, a business acting in such a manner is acting inefficiently. The predator ultimately becomes the prey in that it "... loses money during the period of predation and if he tries to recoup it later by raising his price, new entrants will be attracted, the price will be bid down to the competitive level, and the attempt at recoupment will fail".[23] A more rational and efficient form of activity would be to buy out the competitor rather than engage in a price war that results inevitably in financial loss. The fact that an independent competitor is lost to the market is not necessarily, for Chicagoans, a cause for concern. No longer do they concur with the view that higher market concentration can be equated with lessened competition. As Easterbrook suggests, this thesis posits "... that you could test whether competition was feasible from the structure of the market, if the top four firms had fifty per cent or so of the sales we should abandon hope of competition ... unless the government should be able to break up the largest firms and

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[21] F.H. Easterbrook, "Vertical Arrangements And The Rule of Reason", (1984) 53 *Antitrust LJ* 135, 147.
[22] See, for example, H. Demsetz, "Barriers to Entry", (1982) 72 *Am Ec Rev* 47; J.S. McGee, "Predatory Price Cutting: The Standard Oil (N.J.) Case", (1958) 1 *JL Ec* 137.
[23] R.A. Posner, note 14 above, 927.

restore workable competition".[24] For Chicagoans, a result of decades of grubbing about in data has disproved the structure-conduct-performance paradigm. Such an atomistic concept of competition is simply a longing for a world in which artisans made leather artefacts in tiny shops. Market concentration is only problematic if it results in monopoly or gives rise to market cartelisation.

Chicago's distinctive approach is also manifest in its analysis of cartels, monopolisation and mergers. Chicagoans assert, in accordance with traditional classical economics, that Cartels are susceptible to both internal and external pressure. In effect, they carry their own seeds of destruction. Such fragility usually means that in the long-term consumer welfare will not be harmed. However, cartel activity which reduces output and inflates prices is inefficient and should be condemned by antitrust. This net, however, should not be cast too wide, in fear of catching those cartels which accomplish efficiency goals because their function is not to restrict output or raise prices.

With regard to monopolisation, Chicagoans adhere to the policy that all business organisations ought to be free to compete. This is so, even if the outcome of this competition results in the destruction of independent business organisations. The process is one of competitive struggle reflected in the desire to be the best and ultimately the victor. Antitrust should only be concerned when monopolist act inefficiently by encouraging output restriction and price raising. Such acts are of no benefit to consumer-welfare.

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[24] F.H. Easterbrook, "Workable Antitrust Policy", (1986) 84 *Mich L Rev* 1696, 1698.

With regard to mergers, Chicagoans assert that there is no reason to argue that "... internal expansion is more competitive or more desirable than expansion by merger. The firm, in its own interest will make the best choice for consumers".[25] Antitrust law, therefore, should intervene only were the merger creates a market share that raises the likelihood of a significant restriction of output. Indeed Chicagoans assert that competitors will only challenge those mergers which are procompetitive, efficient and, therefore, legal. Mergers which fail to satisfy these criteria are rarely challenged. As a result of self-interest the competitor remains silent. If the merger results in an increase in the price of certain products the competitor is likely to benefit from the price rise and increase its own profitability.

In a nutshell, Chicagoans assert, that the object of antitrust is to protect consumer welfare by protecting efficiency. A law designed to protect non-economic goals is inefficient. Antitrust is not concerned with protecting equity or fairness. It is not concerned with the protection of the small business organisation. To attempt to do so breeds inefficiency by subsidy. This directly effects consumer welfare and amounts to a "tax" on progressive, efficient and effective business. Competitiveness is effectively undermined. In the words of Judge Posner, the "... welfare of a particular competitor who may be hurt as the result of some trade practice is not the concern of federal antitrust laws".[26]

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[25] R.H. Bork, note 16 above, 207-208.
[26] *Roland Machinery Co v Dresser Industries*, 749 F.2d 380, 394 (7th Cir. 1984).

2. Restricted Dealing Is A Way to Compete[27]

Per Se Legality

So far, consideration has been given only to some of the more fundamental concepts of Chicago. An awareness of these concepts assists in the understanding of Chicagoans approach to vertical restraints. For the most part, adherents to Chicago, consider vertical restraints to be very rarely anticompetitive. They are simply a means to compete. Whilst Chicagoans recognise that the vertical elimination of rivalry has proved troublesome for the Courts, such competitive elimination is merely a means of creating efficiency in distribution and the orderly marketing of products. The major protagonists, Bork, Posner and Easterbrook argue that every vertical restraint imposed by a producer or manufacturer should be completely lawful. Posner stipulates that

> "... economic theory ... teaches that a manufacturer will (unilaterally) restrict distribution only in order to be more competitive. It gains nothing by reducing competition in the distribution of its product though it may gain from redirecting that competition from price to service".[28]

[27] F.H. Easterbrook, "Vertical Arrangements And The Rule Of Reason", (1984) 53 *Antitrust LJ* 135, 140.
[28] R.A. Posner, "The Next Step In The Antitrust Treatment Of Restricted Distribution: *Per Se* Legality", (1981) 48 *U Chi L Rev* 6, 23.

Moreover,

> "Given the absence of either theoretical or empirical grounds for condemning purely vertical restrictions as anticompetitive, to declare vertical restrictions in distribution legal per se would serve both to lighten the burden of the courts and to lift a cloud of debilitating doubt from practices that are usually ... procompetitive".[29]

For Posner, *per se* legality, should include both price and non-price vertical restraints. In his view, resale price maintenance should still be the subject of evolving antitrust standards which may warrant declaring such a practice legal *per se*.[30] He suggests, therefore, that the implementation of that rarely used antitrust technique - *per se* legality - would both simplify the law and make it economically more rational.

Easterbrook adopts similar reasoning. He states quite categorically that no

> "... practice a manufacturer uses to distribute its products should be the subject of serious antitrust attention. It should make no difference whether the manufacturer prescribes territories, customers, quality standards, or prices for its dealers.

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[29] Ibid.
[30] Ibid 24.

> It should make no difference whether the manufacturer 'ties' products together in a bundle, employs full-line forcing or exclusivity clauses. ... It should make no difference whether the restrictions are set by contract or by manufacturers' ownership of the retail outlets, the most 'extreme' form of control. They are all the same".[31]

Restricted dealing should be welcomed as being of benefit to consumers. It should not be considered in the same light, for example, as the antitrust treatment of cartels. They have nothing in common. Restricted dealing is not a form of market displacement. It is, in reality, the market at work. Retailers, for example, agree to conduct their business in a manner specified by the manufacturer just as an employee does within an integrated firm. Easterbrook, echoes Posner's sentiments, in that he too suggests that as both price and non-price vertical restraints have similar economic impacts, they should be treated symmetrically.

For Bork, the argument that there is no more reason to permit the producer to eliminate dealer rivalry than there is to permit retailers to eliminate such rivalry by agreement among themselves is wrong. He contends that when a producer or manufacturer,

> "... wishes to impose resale price maintenance or vertical division of reseller markets, or any other restraints upon the rivalry of resellers, his motive cannot be the restriction of output and,

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[31] F. H. Easterbrook, note 27 above, 135.

> therefore, can only be the creation of distributive efficiency. That motive should be respected by the law".[32]

By way of example Bork makes reference to the case of *US v Addyston Pipe and Steel*.[33] Here vertical elimination of rivalry was made by a railroad company when it engaged another company to provide sleeping car facilities for the railroad. In order to secure the necessary capital investment and the provision of services, the railroad company agreed to exclude any other company from providing the same facilities on the same line. In Bork's view, a comparative judgment was made as to the cost of the railroad company providing this service and that of the sleeping car company. The decision to use the latter indicates that it was the most cost-effective way of providing this service. This decision ultimately provided a net benefit to consumers.

In attempting to create distributive efficiency a producer attempts to retain control over its costs. The cost of distribution to a producer is a price which is equal to the difference between wholesale price and retail price. The producers desire is to keep this cost as low as possible consistent with effective and efficient distribution. If achieved, the retail price is not overly inflated. In this sense, Chicagoans argue, that *producer's and consumer's interests are one and the same*. The producer wants to sell as much product as possible. This is achieved by keeping retailers margins low, which is ultimately in the consumers interest. Their interests are inextricably linked, and as price and non-price vertical restraints are beneficial to consumer welfare they should be completely lawful.

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[32] R.H. Bork, note 16 above, 289.
[33] 85 Fed. 271 (6th Cir. 1898).

Possible Criticisms

Vertical restraints, therefore, are simply a means of restricting intrabrand competition and stimulating interbrand competition and provided the latter remains healthy such restraints are procompetitive. Critics of this view, however, argue that restricted dealing may simply be used as a guise to mask producer or dealer cartels.[34] This may occur, for example, when dealers agree amongst themselves to fix prices. Worried about the possibility that dealers may cheat on their agreement the dealers collectively impose pressure upon the producer to impose, for example, resale price maintenance. If the producer agrees and imposes such a restraint it can be effectively used to police the dealer cartel. Any dealer reducing its prices becomes immediately transparent. Alternatively, producers may agree to curtail their distributors business activities to confined areas. What, ostensibly, seems to be restricted vertical dealing, is in effect, a guise to mask a horizontal market division agreement among producers.

Chicagoan's, however, view these possibilities as remote. They respond by making a number of observations. With regard to dealer cartels, Chicagoans, acknowledge the possibility of their existence.[35] They are, however, rare in number and very fragile in nature. Moreover, why should producers collude with dealers? Where such pressure is being exerted, they can and often do, complain to the enforcement agencies. Furthermore, these arrangements are not "purely" vertical. They contain an horizontal element. This criticism should not be allowed to detract from the *per se* legality argument. Easterbrook also suggests that the industry must be one in which the dealer

[34] Such possibilities have emerged in US case law. In *Eiberger v Sony Corp of America* 622 F. 2d 1068, the District Court found a price fixing conspiracy among Sony's dealers.
[35] See, for example, *Eastern States Retail Lumber Dealers' Association v US* 234 U.S. 600 (1914); *US v General Motors Corporation*, 384 U.S. 127 (1966).

can form a cartel.[36] In his view, retail markets are notoriously difficult to cartelise. They have free entry and retailing is about as close to an atomistic market as you can get. Posner suggests, as entry is generally cheap and rapid the maintenance of dealer cartel price structures would prove extremely difficult.[37] Other factors, Chicagoans assert, make the likelihood of dealer cartels only remote possibilities. They are, they argue, easily detected. Enforcement authorities need only direct their investigations to those markets where vertical distribution is frequently used. Such concentrated efforts make detection easier. Additionally, because of the large numbers and disparate interests involved, such cartels are difficult to administer. There may, for example, be a need for open meetings which may require high visibility advertisements. Thus, evidence of the cartels existence may be readily found. Such considerations have led Easterbrook to conclude, quite emphatically, that the "... conditions for restricted dealing to be a useful part of a dealers' cartel just do not exist very often".[38]

The objection to the *per se* legality of vertical restraints on the basis that they create or facilitate producer or manufacturer cartels, in the view of Chicagoans, is insubstantial and ill-founded. Indeed, Chicagoans assert that if dealer cartels are relatively rare, manufacturers' cartels are rarer still. For the latter to exist all manufacturers of a specific product type must agree to use the same vertical restraint. As Easterbrook suggests, it will not do to get "... just one manufacturer of toothpaste to adopt restricted dealing. All or almost all must do so. If there are holdouts, non-co-operating dealers can sell the holdouts product for less. That would destroy the cartel".[39] It has also been suggested that manufacturing cartels may use RPM as a means of enforcing and

36 F.H. Easterbrook, note 27 above, 141.
37 R.A. Posner, note 28 above 24.
38 F.H. Easterbrook, note 27 above, 142.
39 Ibid 142-143.

policing cartel arrangements. There are, however, difficulties with this particular view.[40] Firstly, retailers may still sell products at the maintained price and receive secret rebates from the producer. Secondly, the producer may, alternatively, sell to distributors at discounted prices and insist that the retailers sell at the maintained price. The discount is retained by the retailer as reimbursement for promoting that particular product at the expense of other cartel members. As a means of policing cartels RPM is not particularly effective. As Bork writes "... (t)he signs of cheating will not be lowered retail prices, which are easy to detect, but heightened retail sale efforts, which is far more difficult to prove and trace".[41] Moreover, the use of an industry wide pattern of RPM may simply attract the enforcement agencies making cartel arrangements easily detectable. Chicagoans are dismissive of the criticism that purely vertical restraints may be used as a guise to mask either producer or dealer cartels.

For Chicagoans the imposition of vertical restraints is designed to promote efficiencies in distribution. Restricted dealing not only promotes the interests of producers but also the interests and welfare of consumers. They are so rarely anticompetitive that automatic condemnation would pick up far too many procompetitive restraints to be worthwhile. A vertical restraint, however, which contains horizontal elements is not a pure vertical restriction. These restraints should be dealt with under the conventional rules applicable to horizontal conspiracies.

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40 R.H. Bork, note 16 above, 293-294.
41 Ibid 294.

The Free Rider Concept

A number of procompetitive justifications are offered in support of vertical restriction. Most are offshoots of the free rider concept developed by Telser. Building on earlier studies[42] Telser attempted to explain why producers might wish to engage in "fair trade" or resale price maintenance[43]. A producer stands to sell more products if there is price competition amongst its dealers. Where it sets a floor to its resale prices, it seems to be embracing a policy that runs counter to its own interests. Telser's contribution was to describe the rationale behind such motivation.

Telser recognised that the need for RPM arose only where there is separate ownership of the firms of production and distribution. He also acknowledged that it was commonly believed that the chief explanation for RPM was that retailers imposed upward vertical pressure on the producer to impose such arrangements. For Telser, this argument fell apart when producers themselves imposed resale prices.

Telser proffered two explanations. Firstly, he suggested RPM could be used as a means of policing manufacturers' cartels. Secondly, his primary explanation focused on the distributors role of service provision. Telser contended that RPM altered inter-store price differentials. By providing the same profit margin to all its dealers, manufacturers hoped to induce retailers to single out its product for special pre-sale treatment. Competition is no longer based on price but on service. These special services include, for example, pre-sale product demonstrations and promotional

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[42] See, for example, W.S. Bowman, "Prerequisites and Effects of Resale Price Maintenance", (1955) 22 *U Chi L Rev* 825; B.S. Yamey, "The Origins of Resale Price Maintenance: A Study of Three Branches of Retail Trade", (1952) 62 *Ec J* 522.
[43] L.S. Telser, "Why Should Manufacturers Want Fair Trade?", (1960) 3 *JL Ec* 86.

advertising. Increased service provision, however, results in higher product pricing. The provision of these services, therefore, is only beneficial to the producer provided it increases sales so as to outweigh the detrimental effects of the increased charges.[44]

Telser also maintained that as these services were "special", some retailers would have good reason not to provide the service but sell the product at discounted prices. An unstable position emerges,

> "Sales are diverted from the retailers who do provide the special services at the higher prices to retailers who do not provide the special services and offer to sell the product at the lower price. The mechanism is simple. A customer, because of the special services provided by one retailer, is persuaded to buy the product. But he purchases the product from another paying the latter a lower price. In this way the retailers who do not provide the special service get a free ride at the expense of those who have convinced consumers to buy the product".[45]

If the manufacturer is correct in its assumption that these services are required at the point of sale to increase the sales of its product (the product, for example, may be new on the market or involves new technology which needs to be explained) the producer must prevent the diversion of sales from service providers to non-service providers who enjoy a "free-ride" on the back of the former. This is accomplished, Telser asserts, by establishing a minimum retail price that guarantees a minimum gross mark

[44] Ibid 89-91.
[45] Ibid 91.

up and forces retailers to compete by providing services with the product and not by price reductions.[46]

Telser also recognised that certain services could not be subject to free rides.[47] He also acknowledged that if these services were sold directly to the consumer, the problem of free riding would be overcome. This would also be the case if the producer simply refused to sell to the non-service provider. However, Telser dismissed these solutions because, in his view, each so-called solution had its own inherent problems. Selling the service directly to the consumer presented problems in relation to devising an appropriate system of charging. It may be difficult to develop a scale of charging in relation to the varying level of special services required by each consumer. Refusing to sell to non-service providers, in Telser's view, would only solve the problem of free riding if the problem of transhipment could be solved. That is bootleg sales from service providers to non-service providers. While acknowledging the possibility of other solutions, Telser argued, that the best solution to free riding was the imposition of vertical restraints in the form of RPM. For Chicagoans, however, this theory was applied equally to *non-price* vertical restraints.

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[46] Ibid 92.

[47] A consumer could not purchase a product from one distributor and expect it to be delivered or repaired by another.

B. The Traditionalists - Poets Practising Poetry[48]

1. Certain Fundamental Tenets

"One of the fiercest and most persistent debates in American jurisprudence concerns the proper goals and objectives of antitrust policy".[49] To a large extent this debate has focused on the legality of vertical restraints. To fully appreciate the implications of the debate, however, it is necessary to understand some of the more fundamental concepts of Chicago's opponents. Unlike adherents to the Chicago School, the traditionalists regard antitrust as embracing broader non-economic political and social policy considerations. For the traditionalist, Bork's interpretation and assessment of the legislative history of antitrust at best strained credulity.[50] Antitrust was not designed solely to protect or maximise consumer welfare. It was designed to protect a bundle of values. Indeed, Posner's and Easterbrook's assertions that antitrust should in any event, irrespective of its legislative history, be utilised solely to protect consumer welfare is disingenuous as it simply fails to give effect to the policies mandated by Congress.[51] Congress, according to the traditionalist, in formulating antitrust law adopted a multi-valued or multi-goal approach. Those who suggest otherwise are simply "... in the same boat as the rest of us - practising 'poetry'".[52] It is not surprising that these ideological tensions have fuelled the constant battle over the goals of antitrust. To a great extent the vagaries and inconsistencies in US antitrust enforcement is merely a reflection or manifestation of this conflict.

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[48] Bork, rather disparagingly referred to those who believed that antitrust embraced non-economic goals as "Poets".
[49] T. Frazer, *Monopoly, Competition and the Law* (2nd edn, London, 1992) p.1
[50] H. Hovenkamp, "Antitrust Policy After Chicago", (1985) 84 *Mich L Rev* 213, 217.
[51] J.J. Flynn and J.F. Ponsoldt, "Legal Reasoning And The Jurisprudence Of Vertical Restraints: The Limitations Of Neo-classical Economic Analysis In The Resolution Of Antitrust Disputes", (1987) 62 *NYUL Rev* 1125, 1137.
[52] Ibid, 1140.

The belief that Congress adopted this multi-valued or multi-goal approach to antitrust is reflected in various academic writings. Hovenkamp, for example, quite categorically states that the

> "... legislative histories of the various antitrust laws fail to exhibit anything resembling a dominant concern for economic efficiency".[53]

Indeed, he expressly criticises the neo-classical efficiency model for failing to take account of preferences which consumers do not express in monetary terms. For Hovenkamp people do value

> "... such things as the diffusion of privately held economic or political power or the preservation of small business opportunity".[54]

These concerns are prominent in the legislative history of antitrust and reflect the American people's concern with the large amounts of political and economic power wielded by large corporations. They merely reflect the people's desire to preserve process, pluralism and diversity which is reflected in the continued existence of small business.

While traditionalists may disagree over the importance or significance to be attached to certain goals, they all warn that allocative efficiency should not eclipse other non-

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[53] H. Hovenkamp, note 50 above, 249.
[54] Ibid 242.

economic goals.[55] Pitofsky aruges, for example, that the legislative history of the Sherman Act has produced vague and inconsistent strands of legislative intent. Subsequent antitrust statutes should, in his view, be interpreted to incorporate political values.[56] The latter embraces a number of concerns. Firstly, industrial concentration is inherently undesirable for political as well as economic reasons. In Pitofsky's view, Congress exhibited clear concern that an economic order dominated by a few industrial giants could overthrow democratic institutions during times of domestic unrest. Secondly, antitrust is concerned with the enhancement of individual liberty. Individuals should have freedom of action and this implies freedom to compete. The competitive process should not be fraught with barriers to market access. Finally, Pitofsky contends that there is a need to follow a "correct" antitrust strategy in order to ensure that governmental interference in the competitive process is balanced and non-invasive.[57]

Schwartz has also documented Congressional concern for creating an atomistic competitive process and an antitrust policy that embraces the concept of justice. For Schwartz, the interests of justice, should prevent the ready acceptance of the dogma of economics.[58] Possible economic gains should not be the exclusive or decisive criteria in resolving antitrust disputes. Traditionalists, he suggests, should not yield freely, to the dogma that antitrust protects competition and not competitors. In fact, he finds clear evidence of Congressional intent to create procedural protection for distributors.[59] He

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[55] See, *inter alia*, E.M. Fox, "The Modernization Of Antitrust: A New Equilibrium", (1981), 66 *Corn L Rev* 1140; K.G. Elzinga, "The Goals Of Antitrust: Other Than Competition And Efficiency, What Else Counts?", (1976-77) 125 *U Penn LR* 1191; H.M. Blake and W.K. Jones, "In Defense Of Antitrust", (1965) 65 *Col L Rev* 377.
[56] R. Pitofsky, "The Political Content Of Antitrust", (1979) 127 *U Penn LR* 1051.
[57] Ibid 1052-1060.
[58] L.B. Schwartz, "'Justice' And Other Non-Economic Goals Of Antitrust", (1979) 127 *U Penn LR* 1076.
[59] Ibid.

also provides a substantial list of Federal Statutes concerned with the welfare of small business. The goal of justice, therefore, is inherent in antitrust and this requires protection for the small and large business alike.

Fox also rejects the notion that antitrust should be confined solely to economic objectives. To confine antitrust in this way is a direct contradiction of the history and language of its statutes as well as its developed case law. She, therefore, rejects the notion that non-economic objectives impair efficiency and that they cannot be rationally incorporated into clear antitrust principles.[60]

Antitrust should reflect its concerns with power dispersion, competitive opportunity and consumer satisfaction. In fact, a most succinct enumeration of antitrust goals is provided by Fox. She states

> "Antitrust should serve consumers' interests and ... other, established, non-conflicting objectives. There are four major historical goals of antitrust, and all should be continued to be respected. These are: (1) dispersion of economic power, (2) freedom and opportunity to compete on the merits, (3) satisfaction of consumers, and (4) protection of the competition process as a market governor".[61]

For the traditionalist then, antitrust is rooted in a preference for pluralism, access to markets, freedom of trade and freedom of choice. It is these goals which have

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[60] E.M. Fox, note 55 above, 1140.
[61] Ibid 1182.

important consequences for the manner in which traditionalists believe vertical restraints should be treated.

The traditionalists also attack the assumptions underlying the rational actor model of Chicago. Business behaviour, is not always rational or as outcome orientated as Chicagoans assert. In direct contrast, traditionalists proffer the theory of "satisficing". A business organisation acts through its personnel. These individuals have their own idiosyncrasies, motives and attitudes. Often a persons motives may conflict with business goals. Managers, for example, may arrive at certain decisions to secure personal power, protect an existing power base or even secure short term profits at the expense of long term gains. Management may even "satisfice" when it sets long term goals or short term objectives. The theory posits that managers will set goals or objectives at such levels that are readily obtainable. To set goals too highly may result in failing to achieve them. The interests of the owners of capital (shareholders) and the managers of capital may not, therefore, be mutually consistent. This, may mean that managers are induced to enter into business behaviour that is contrary to consumer interests. Obviously, this theory contrast with the economic model of Chicago which is based on rationality and profit maximisation. For the traditionalist, Chicago's model is too static and based on deductive logic. These deductions are based on the models unproven assumptions and are then applied to business reality. For traditionalists, this deductive logic fails to square with reality. In fact, the model amounts to

> "... an analytical meat cleaver which ignores noneconomic assumptions and fails to draw noneconomic inferences. The result: a form of

> 'tunnel vision' intolerant of any questioning of its assumptions or tampering with its predictions through the observation of facts".[62]

Adherents to the traditional view argue that a more creative and inductive analysis based on a multi-valued antitrust policy should be used. In terms of vertical restraints, for example, Chicago's model simply measures the effects of certain practices on price or output and ignores the fact that the market may be affected by external events. The application of such a static model often causes the Courts to ignore the obvious. Thus, Chicagoans argue, that the imposition of vertical restraints are designed to obtain efficiency. What other explanation is feasible? This is substantiated when, for example, a manufacturer of television sets imposes location or territorial restraints and its market share and output increases from 2 to 5 percent. For Chicagoans, this is strong evidence to conclude that the imposition of the restraint is procompetitive. Traditionalist, by contrast, look to other possibilities. They are not fettered to the neo-classical economic model. An increase in market share may have come about for a number of reasons, the manufacturer may simply produce a superior television set or its cost management may be more efficient. Alternatively, the producer may be benefiting from lower costs of production as a result, for example, of having the television sets manufactured abroad. Antitrust laws, for the traditionalist, are both dynamic and process orientated. They deal, or should deal, with business reality.

It is apparent, that the two major competing schools of antitrust continue to have broad policy differences. These differences are also reflected in their differing approaches to market concentration, barriers to entry, strategic behaviour and their respective

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[62] J.J. Flynn, "The 'Is' and 'Ought' Of Vertical Restraints After *Monsanto Co v Spray-Rite Service Corp.*", (1986) 71 *Corn L Rev* 1095, 1130.

treatment of cartels, mergers and attempts to monopolise. With regard to market concentration they continue to disagree over the significance of concentration and the wisdom of deconcentration. Chicagoans reject economic theory which posits high market concentration yield less competition. For them, excessive profitability in concentrated markets cannot persist without attracting new entrants which will ultimately precipitate a reduction in prices to new competitive levels. The arrival of new entrants, ultimately deconcentrates the market. By contrast, the traditionalists reject these contentions. Undertakings, in concentrated markets, avoid price competition by employing "conscious parallelism". This results in abnormal profits being earned. Moreover, abnormal profits are indicative of barriers to entry which help sustain profitability and prevent the responsiveness of market incumbents to consumer needs. These traditionalist concerns were particularly reflected in the antitrust era of the Warren Court. Influenced by Harvard economists, it essentially took a prointerventionist stance.[63] It was concerned with deconcentrating oligopolistic markets and with protecting small firms from larger rivals on the basis that a large number of small firms would give rise to lower prices than a relatively small number of larger firms. In short, a different economic model was used which reflected the major concerns of the traditionalist.

The traditionalist also reject the Chicagoan notion of barriers to entry. For Chicagoans, barriers to entry are costs which must be borne by a firm seeking market entry but which are not borne by firms incumbent in the industry.[64] According to Chicagoans, for example, capital outlay cannot amount to a barrier to entry. All market participants must incur this. Traditionalists reject this notion. Any fact or condition that makes

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[63] See, for example, J.S. Bain, "Economies of Scale, Concentration, And The Condition Of Entry In Twenty Manufacturing Industries", (1954) 44 *Am Ec Rev* 15.
[64] H. Demestz, "Barriers To Entry", (1982) 72 *Am Ec Rev* 47, 48.

efficient entry less likely or more difficult is relevant. Any consideration that allows existing market incumbents to raise prices above costs without attracting entry is of importance. Strategic business behaviour is a reality which may prevent the flow of investment. Hence, the cost of advertising or the cost of capital borrowing may amount to barriers to entry. In fact, for the traditionalist, the cost of market exit may also amount to a barrier to entry. On entering a market, a business organisation will generally consider the cost of exit. Thus, for example, a proportion of capital outlay on certain fixed assets may be recoverable on exit. Certain capital expenditure, however, will not be recoverable as it is a sunk cost. If sunk costs are anticipated to be prohibitively high, this may amount to a barrier to entry.

The stark differences in approach between the two major competing schools of antitrust, is also reflected in their divergent approach to strategic behaviour. Unlike Chicagoans, traditionalists take the view that strategic business behaviour does occur.[65] For adherents to Chicago, strategic behaviour is irrational because it is not always profit maximising. Traditionalists, however, assert that strategic behaviour can take two main forms. It can relate to pricing or raising a competitors costs. With regard to pricing, traditionalists acknowledge that it is sometimes difficult to distinguish between a low pricing strategy and predatory pricing. However, predatory pricing does occur and it is designed to chill competition, deter expansion by existing market incumbents, deter market entry or precipitate market exit. Traditionalists also assert that competitors try not to provoke dominant firms with a reputation for predatory behaviour. Indeed, potential entrants may be reluctant to enter a market which contains a well-known predator. In the short term, consumers may benefit from such behaviour. In the long

[65] O.E. Williamson, "Predatory Pricing: A Strategic And Welfare Analysis", (1977) 87 *Yale LJ* 284, 292-295.

term, however, healthy competition is reduced and consumers lose as a result of the inevitable price rises.

Strategic behaviour may also involve the manipulation of rivals' costs. Normally this behaviour is directed by a dominant undertaking or group of undertakings against smaller businesses. The object is to impose higher costs upon the smaller businesses, even though the strategising firm may also have to bear these higher costs initially The effects of this type of business behaviour may be two-fold. Firstly, it may act as a barrier to entry. Secondly, the imposition of higher costs on smaller business, reduces profitability (as the costs need to be absorbed) and ultimately may result in competitors leaving the market. As Hovenkamp suggests as "... a strategy of raising rivals' costs can be both profitable and less risky than predation and it can occur in a wider variety of markets".[66] It is more profitable in that profits flow in immediately and less risky in that the market looks quite normal. Thus, for example, a dominant company may contractually tie distributors to itself in order that its product reaches the market effectively and efficiently. This forecloses the use of these distributors, presumably chosen on the basis of their efficient methods of working, to other smaller companies. The latter may have to use less efficient distributors thereby imposing additional costs which reduces profitability. Ultimately, such a subtle strategy may assist in the smaller producers leaving the market.

Having considered some of the major differences in approach to antitrust by the main schools, it is not surprising therefore that their approach to monopolisation, mergers and cartels differ fundamentally. For the traditionalist, Congress feared a monarchy of

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[66] H. Hovenkamp, note 50 above, 275. See also in this context T.G. Krattenmaker and S.C. Salop, "Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price", (1986) 96 *Yale LJ* 209.

business. Hence the development of the law against monopolisation. While the law may respect monopoly achieved by superior products and by a company's ability to respond to consumer's demand, it nevertheless realises that monopoly is rarely thus achieved. For the traditionalist, therefore, the law against monopolisation was designed to protect the competitive process. In so doing it protects smaller business from strategic behaviour and ultimately the consumer. With regard to mergers, the traditionalist argues, that the law was designed to prevent undue economic concentration in the hands of the few. Thus, in highly concentrated markets the law will condemn mergers which increases concentration by reducing the number of competitors. Unlike Chicagoans, the traditionalist do not view cartels as being of a fragile nature. Cartels can and do survive both internal and external pressure. Their survival results, ultimately, in harm to the competitive process. As such antitrust law should roundly condemn them. Their ability to restrict output and increase price is obviously to the detriment of society and the welfare of consumers.

2. Vertical Restraints - The Traditionalist Viewpoint

Chicagoan's emphasise the politically conservative or libertarian message of business autonomy. The traditionalist, in contrast, emphasise the liberal message of preservation of the competitive process. Not surprisingly, therefore, vertical restraints are frequently viewed as anticompetitive because by their very nature they interfere with this process. The imposition of such restraints can be used, for example, to prevent price competition. By preventing distributors from making independent pricing decisions, such restraints prevent competition on the merits and the maintenance of a robust competitive process. Dealers should remain free to engage in discount distribution and the competitive process should remain open, free and atomistic.[67]

Traditionalist attack the veracity of the neo-classical models assumptions relating to vertical restraints. For them, recalcitrant reality simply does not accord with the dictates of their model. To attempt to explain such restraints on the sole basis of efficiency and rationality amounts to an attempt to jam the square peg of business reality into the round hole of their model. For the traditionalist, the concepts of rationality and efficiency are "... not empirically or politically verified and (are) asserted without reference to other disciplines that have studied human behaviour".[68] Vertical restraints are not necessarily imposed, therefore, on the basis of rationality or efficiency. Restraints may be imposed for strategic anticompetitive purposes. They may be used, for example, to raise barriers to entry in the face of new competition. For the traditionalist, therefore, the neo-classical model is simply used to protect the contract rights of the proponent of the restraint without regard for the rights of others. In fact, wealth is simply transferred from consumers, to the party imposing the restraint. In this respect, traditionalist argue, that the very essence of Chicago's model is at odds with Congressional intent in its passage of antitrust law. Antitrust law is designed to prevent such wealth transference.[69]

[67] See, for example, R. Pitofsky, "In Defence Of Discounters: The No-Frills Case For A *Per Se* Rule Against Vertical Price Fixing", (1983) 71 *Geo LJ* 1487.
[68] J.J. Flynn and J.F. Ponsoldt, "Legal Reasoning And The Jurisprudence Of Vertical Restraints: The Limitations Of Neo-classical Economic Analysis In the Resolution of Antitrust Disputes", (1987) 62 *NYUL Rev* 1125, 1132.
[69] See in this context, R.H. Lande, "Wealth Transfers As The Original And Primary Concern Of Antitrust: The Efficiency Interpretation Challenged", (1982) 34 Hastings *LJ* 65.

Free Riding - A Critique

Not only do traditionalists attack the underlying veracity of Chicago's model, they also assert that Chicagoans overstate the importance of the free-rider concept. In the view of traditionalists its empirical significance is modest.[70] WS Comanor, for example, identifies those areas in which consumers and producers interests conflict and asserts that the imposition of vertical restraints may actually harm the interests of consumers. As a consequence, therefore, vertical restraints should be subject to close antitrust scrutiny.[71] Comanor suggests that the conventional theory of free riding fails to recognise the differences between consumers regarding their preferences for dealer provided services. Where consumer differences exist producers and consumer interest may not coincide. Comanor makes a distinction between "marginal" and "inframarginal" consumers. Marginal consumers are those who may or may not buy a product depending on its price. Thus, improvements in product quality which inflate product price may result in a refusal by marginal consumers to purchase the product. If, however, in the view of marginal consumers an increase in service or quality makes the product more appealing, the product will still be bought irrespective of any price increase. In contrast "inframarginal" consumers are relatively insensitive to product price fluctuations. If an increase in price is needed to fund increases in service or product quality they will not necessarily buy any less of the product. These consumers purchase according to tradition. Not surprisingly, therefore, marginal consumers determine whether product improvement or services increase sales and as a consequence manufacturer's profitability.[72] If marginal consumers value the increased

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[70] F.M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance* (3rd edn, Boston, 1990) p.593.
[71] W.S. Comanor, "Vertical Price Fixing, Vertical Market Restrictions And The New Antitrust Policy", (1985) 98 *Harv L Rev* 983.
[72] Ibid 991.

services which a producer attempts to achieve by imposing vertical restraints, they will continue to buy the product and increase the manufacturer's profits. Consumer welfare, however, depends on how a vertical restraint effects the interests of *all* consumers and not simply marginal consumers. Indeed, it is quite conceivable that welfare losses to inframarginal consumers may exceed the welfare gains to marginal consumers. As Comanor and Kirkwood write,

> "... (w)hen this possibility is recognised, the link between the interests of producers and consumers - presumed by (Chicagoans) to hold in a purely vertical context is effectively broken".[73]

The mere fact, therefore, that producers impose such restraints does not necessarily imply that they serve all consumers interests. This, of course, contrast quite pointedly with the assertions of Chicago that the interests of the manufacturer and the consumer are the same. Comanor also asserts that a large number of inframarginal consumers (because they are traditional purchasers of the product) are "knowledgeable" consumers. Thus, where marginal consumers want pre-sale services and producers accordingly impose vertical restraints to achieve this, inframarginal consumers with product knowledge, are purchasing services that the majority of consumers do not want.[74] Such services are being oversupplied in relation to consumer needs and social welfare is not enhanced. The only possible winners are new consumers who have been attracted to the market as a result of the increased marketing.

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[73] W.S. Comanor and J.B. Kirkwood, "Resale Price Maintenance and Antitrust Policy", (1985) 3 *Contemporary Policy Issues* 9, 13.

[74] For critical comments on Comanor's approach, see L.J. White, "Resale Price Maintenance And The Problem Of Marginal And Inframarginal Consumers", (1985) 3 *Contemporary Political Issues* 17, 18-19.

Comanor's searching criticisms of the free-rider concept are also echoed by others. Pitofsky caustically attacks the concept and states quite vehemently

> "... it should be made exactly clear who these 'free riders' are. They are the discounters of modern American marketing: low overheads, high volume sellers who aggressively compete as to price. Until the recent ideology about free riders became fashionable they were regarded as the very heart of a free market competitive system".[75]

Moreover, Pitofsky asserts, that the ability of discounters to supply low priced products results not from a failure to provide desired services, but from an ability to provide services more efficiently. Why then, Pitofsky asks, should producers imposing such restraints be allowed to put the "no frills discounters" out of business? Producers should not be allowed to decide the mix of product and service. They should be left to the competitive process itself. Indeed, Pitofsky asserts, that there are always less restrictive alternatives to the imposition of vertical restraints. Where producers want, for example, additional services to be provided by their distributors they can always contract separately for their provision. This, Pitofsky argues, is both feasible and cost effective.

Further criticism is also directed at the concept of free riding. Scherer finds it "... a little hard to swallow".[76] In his view economists have come to realise that the theory of free riding can only carry limited weight. In a large number of cases the concept just does not fit the real world. On goods that are frequently purchased or where producers

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[75] R. Pitofsky, note 67 above, 1493.
[76] F.M. Scherer, "The Economics of Vertical Restraints", (1983) 52 *Antitrust LJ* 687, 694.

have strong brand image, free riding is less likely. Advertising pulls the item through the stores rather than the service provision of the distributors. Free riding is, perhaps, more likely on technically complex items. Scherer, however, is unsure as to the extent of the problem in this area. Indeed, he places emphasis on the consumer's need for post purchase service. That is, if the product is purchased from high price, high service stores the consumer is more likely to obtain quick, reliable post purchase service if the item proves faulty later on. He states,

> "I suspect that a lot of consumers think this way: that, rather than getting the pre-sale service and then going off to a discount house, they will buy from the higher-price house and be sure they are going to get decent service. So, even here, it is not clear that the free rider problem is all that important".[77]

While Scherer expresses the view that vertical restraints may, in certain circumstances, be procompetitive, he also expresses certain reservations. Firstly, vertical restraints may reduce efficiency the more competitors service provision simply cancels each other out. The provision of services, therefore, may not add to overall demand. Distributors simply resort to cannibalising each others sales. The more this occurs the less efficient the restraint becomes. Secondly, in highly concentrated markets producers are more likely to pursue a high price - high margin strategy. Ultimately, this restricts consumer choice in that product range is reduced. The restraint, therefore, is not efficiency enhancing. Finally, such restraints may reduce efficiency in that the more high prices attract new market entrants, without causing a commensurate increase

[77] Ibid 705.

in market volume, existing business will be "squeezed" in terms of their output, causing them to lose scale economies.[78]

The Traditionalist Viewpoint and Its Implications For Policy

For the most part, traditionalists assert, vertical restraints should be treated more harshly than Chicagoan analysis suggests. Policy makers should be cautious about relaxing *per se* standards of illegality. In certain circumstances, however, limited change may be possible. Traditionalists recognise that these restraints can either enhance or diminish consumer welfare. However, in the interests of judicial economy, it would be inappropriate to apply a rule of reason analysis on a case by case basis. Even though this may occasionally give rise to improper results, general policy standards should be set and applied to vertical restraints.[79] Comanor, therefore, makes a distinction between established and non-established products. Established products are those products with which large numbers of consumers place little emphasis upon obtaining product information. In these circumstances stringent antitrust standards should be applied to vertical price and non-price restraints alike.[80] There should either be a "direct" *per se* prohibition or some *modified* form of rule of reason analysis applied. In the latter case, for example, the *defendant* would be required to show that the restraint actually benefited consumers. In short, a shift in the burden of proof. In the case of non-established products or products of new market entrants, exceptions to the *per se* rule deserves serious consideration. These restraints are less likely to reduce consumer welfare because product novelty creates demand for information. In such circumstances vertical restraints should be permissible or treated leniently in a *modified*

[78] Ibid 704.
[79] W.S. Comanor, note 71 above, 1001.
[80] Ibid 1001-1002.

rule of reason analysis. The new entrant exception or "safe harbour£ finds favour with many.[81] With regard specifically to RPM, Sharpe argues that most instances of RPM is inspired by upward vertical dealer pressure exerted on producers.[82] He maintains that most RPM has adverse economic consequences. As such it should remain unlawful *per se*. However, he argues in favour of a new entrant exception for a limited period of time for new manufacturers. He states that the "... new entrant, through the use of RPM, may gain access to dealer outlets during the early life cycle of a new product without impairing retail competition".[83]

Flynn and Ponsoldt assert that these restraints limit the freedom of distributors and the public to choose from whom they may wish to buy or sell.[84] By definition, then, such restraints limit commercial rivalry which is fundamental to the competitive process. There should, in their view be a rebuttable presumption that these restraints violate the antitrust laws. Such an approach, they suggest, provides the flexibility for a reasonable evaluation of fact and policy.[85]

In short "... *per se* rules are (to be) treated as evidentiary presumptions of illegality, with rebuttability depending on the degree to which private agreements displace the competitive process".[86] In the case of vertical price fixing a relatively conclusive presumption of illegality is justified. Such restraints interfere with the ability of retailers to compete on the merits and ultimately result in higher prices. In the words of Flynn and Ponsoldt, such restraints enable "... the proponent of the restraint to

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[81] See, for example, T.R. Overstreet and A.A. Fisher, "Resale Price Maintenance And Distributional Efficiency: Some Lessons From the Past", (1985) 3 *Contemporary Political Issues* 43.

[82] B.S. Sharp, "Comments on Marvel: How Fair Is Fair Trade?", (1985) 3 *Contemporary Political Issues* 37, 38.

[83] Ibid 42.

[84] J.J. Flynn and J.F. Ponsoldt, note 68 above, 1147.

[85] Ibid 1148.

[86] Ibid.

suppress distributor competition on price, denying the right of the independent distributors to succeed or fail on the competitive merits".[87] In effect, a denial of those rights which antitrust laws were designed to protect. Similar considerations are also to be applied in regard to maximum price fixing and vertically induced refusals to supply.[88] The type and amount of evidence which will rebut the presumptions of illegality is a matter, ultimately, to be determined by the Courts. With regard to non-price verticals a similar presumption of illegality should be applied. However, in certain circumstances, vertical customer, location or territorial restraints may produce public benefits or be of such significance to a seller and its products that the presumption should yield.[89] Thus, customer location or territorial restraints may be justified in limited circumstances to protect the public in the distribution of dangerous products or when there is a need for new entrants into a concentrated market or if they are used as a means to ensure the provision of necessary repair or warranty services. Finally, in those circumstances where no presumption of illegality exists a rule of reason analysis may be applied by the Court.

III. VERTCIAL RESTRAINTS IN THE EU

A. The Goals Of Competition Policy

In Europe competition policy has never been seen in terms of narrow economic principles serving only the goal of efficiency. From the outset the primary objective

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[87] Ibid.
[88] J.J. Flynn, note 62 above, 1144.
[89] Ibid 1145.

has been that of market unification.[90] The 1956 Spaak Report, one of the preparatory works upon which the EEC Treaty was based insisted that European unification would raise living standards, promote stability, expansion and assist in the development of relations between Member States. Market unification, therefore, served political and economic ends. Politically, further European conflagration became difficult as Member States markets became increasingly intertwined. Economically, an integrated market encouraged *inter alia* rapid industrial regeneration and retooling, enabling Europe to compete on the global market and regain its independence from the financial purse strings of the US. Indeed, European business could benefit from economies of scale and scope. Central to this process has been the rules on competition. Designed to supplement the four freedoms[91] Articles 81 (ex 85) and 82 (ex 86) were included in the Treaty to prevent private undertaking, either through collusion or abuse of market power, from reconstructing barriers to interstate trade. Thus frustrating the market integrative imperative.

While the primary function of policy has been that of market unification other traditional competition issues have not been ignored. Competition policy has been seen, therefore, as a means of satisfying individual and collective needs. When operating satisfactorily, competition performs three functions "... a resource allocation function, by encouraging better use of available factors of production, so that firms' technical efficiency is increased and consumers' wants better satisfied; an incentive function, by stimulating firms to better their performance relative to their competitors;

[90] See, *inter alia*, D.G. Goyder, *EC Competition Law* (3rd edn., Oxford, 1998) Ch. 2; C.D. Ehlermann, "The Contribution Of EC Competition Policy To The Single Market", (1992) 29 *CMLRev* 257; B. Van der Esch, "EEC Competition Rules: Basic Principles And Policy Aims", (1980) 7 *LIEI* 75; D.W. Urwin, *The Community of Europe: A History of European Integration Since 1945* (2nd edn., London, 1995) Ch.1.

[91] Free Movement of Goods, Services, Workers and Capital.

and an innovative function, by encouraging the introduction of new products in markets and the development of new production processes and distribution techniques".[92]

In addition to these concerns, competition policy in Europe has also been intimately linked to the concepts of democracy and pluralism. In particular, the diffusion of economic power which can threaten individual political freedom and the economic freedom of market participants.[93] The need to maintain a competitive and atomistic market structure has surfaced in the authorities concern to preserve equity and fairness in the market place. The Commission has been concerned, therefore, to ensure Member States do not favour their own economic operators through inter alia the dissemination of State Aids. Nor, indeed, should Member States favour State run undertakings to the detriment of private undertakings. A traditional concern of the Commission has been its willingness to protect small and medium sized undertakings (SMEs). While these undertakings perform a valuable function in the economies of all Member States (providing a valuable source of employment) this is particularly the case in the so-called "Southern States" (Greece, Italy, Spain and Portugal) where outlet density and family owned business is high![94]

In sum, competition policy in Europe has a multidimensional character. Although market unification has occupied a central role other traditional concerns have also been influential. Often these concerns are inextricably linked to the goal of integration.

[92] EC Commission, *Fourteenth Report on Competition Policy: 1984* (Brussels, 1985) p.11.
[93] D.J. Gerber, "Constituionalizing The Economy: German Neo-Liberalism, Competition Law And The 'New' Europe", (1994) *42 American Journal of Comparative Law* 25, 36-37.
[94] EC Commission, *Green Paper on Vertical Restraints In EC Competition Policy* COM (96) 721 final, pp. 7-8.

Where, however, they clash the goal of market unification has invariably taken precedence giving European competition policy its distinctive character.

B. Market Integration, Institutional Structures, Competences And Substantive Focus

The goal of market unification influenced the development of institutional structures, power distribution and substantive focus. In the early stages of the Common Market, Member States interpreted the rules on competition.[95] Not surprisingly, fears of inconsistency and lack of uniformity of interpretation soon arose. These new rules were, after all, "... novel and almost revolutionary requiring changes to ingrained habits and patterns of economic conduct".[96] Market unification, therefore, necessitated the centralisation of power in the hands of a single institution. In 1962 the Council placed the Commission at the heart of this process by enacting Regulation 17.[97] In so doing, Member States were obliged to occupy a position on the periphery.[98] While Member States are able to apply Article 81(1) and (2) (ex 85(1) and (2)) and Article 82 (ex 86) this is only the case provided the Commission has not commenced its own investigations (Article 9(3) Regulation 17). In this regard the Commission has been furnished with wide ranging powers including the right to request information from undertakings (Article 11), the right to conduct on-site investigations (Article 14) and the right to obtain assistance from Member States in conducting investigations (Article 13). Regulation 17 also identifies the circumstances giving rise to the opening of

[95] G.W. Kelleher, "The Common Market Antitrust Laws: The First Ten Years", (1967) 12 *Antitrust B* 1219.
[96] I. Forrester and C. Norall, "The Laicization Of Community Law, Self-Help And The Rule Of Reason: How Competition Is And Could be Applied", (1984) 21 *CMLRev* 11, 13.
[97] OJ 1962 204.
[98] A. Deringer, "The Distribution Of Powers In The Enforcement Of The Rules Of Competition Under The Rome Treaty", (1963) 1 *CMLRev* 30.

investigations. Once instituted the Commission may conclude matters formally by way of comfort letter. Formal decisions are generally not the most efficient way to deal with a large number of individual cases.[99] Regulation 17, also enhanced and expanded the Commission's role by virtue of Articles 9(1) and 4(2). The former provides that only the Commission can issue exemptions under Article 81(3) (ex 85(3)). The latter introduced the notification procedure and exemption became contingent upon application to the Commission.

The process of centralisation resulted in the Commission being inundated with notifications, most of which related to vertical restrictions. This left the Commission unbalanced and overburdened.[100] To alleviate this mass problem, Regulation 19/65 was enacted by the Council which empowered the Commission to declare by way of Regulation that Article 81(1) (ex 85(1)) did not apply to certain bilateral agreements exhibiting specific characteristics. In effect, the Commission was granted the power to legislate through the issuance of block exemptions. In the area of distribution, Commission Regulation 67/67, dealing with exclusive distributorships and purchasing obligations, was enacted. In the 1980s this was replaced by Commission Regulations 1983/83 (exclusive distribution) and 1984/83 (exclusive purchasing). Commission Regulation 4087/88 of November 1988 was enacted in relation to franchising. The effect of these Regulations was to provide business with an approved arena in which they could pursue their day to day commercial activities without the fear of infringing the competition rules. It is the combination of these functions which has led to

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[99] On average the Commission makes 20 decisions per year and receives 250 notifications. See EC Commission's, *Green Paper On Vertical Restraints In EC Competition Policy*, COM (96) final 721, p.54.

[100] D.G. Goyder, *EC Competition Law* (3rd edn., Oxford, 1998) p.579.

complaints that the Commission acts in an investigative, legislative and adjudicative fashion.[101]

The European Court of Justice also adopted a central role in the competition system. Indeed, the relationship which developed between the Court of Justice and the Commission, particularly during the embryonic stages of development, was crucial to market unification. Both institutions shared a common vision and goal. During the so-called days of Eurosclerosis, when the momentum of integration seemed to reach a halt, the Court of Justice provided intellectual leadership and the main integrative thrust. Unfettered by precedent the Court of Justice adopted an integrative driven teleological methodology. Problem resolution was based upon the perceived *spirit* of the Treaty and where market unification required a specific outcome this was generally forthcoming.[102] The Court of Justice illuminated the path upon which the Commission was to travel and refused to handicap it by interpreting its jurisdiction and powers on a technical or narrow basis.[103] In the 1973 case of *Continental Can*,[104] for example, the Court looking though its teleological lens upheld the Commission's view that Article 82 (ex 86) applied to mergers. Where undertakings strengthen their existing dominant position through mergers, so that the degree of market control acquired substantially obstructs competition, this strengthening amounts to an abuse within the context of Article 82 (ex 86).[105]

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101 W. Sauter, *Competition Law And Industrial Policy In The EU* (Oxford, 1997) p. 126.
102 H. Rasmussen, "Between Self Restraint And Activism: A Judicial Policy For The European Court", (1988) 13 *EL Rev* 28.
103 See D.G.Goyder, note 100 above, 580.
104 Case 6/72 *Europemballage and Continental Can v Commission* [1973] ECR 215, [1973] CMLR 199.
105 Ibid 224-225.

It is important to stress, however, that the relationship between the Court of Justice and the Commission has been dynamic, evolutionary and subject to change. In particular, the judicial activism of the Court of Justice in pursuit of market integration has changed as the Court has been obliged to work within the confines of judicial precedent, rather than laying down general policy statements or principles for guidance. Institutional changes has also been brought about by the creation of the Court of First Instance with overall jurisdiction for competition matters.[106] The judicial landscape has changed as the role of the Court of Justice is limited to hearing appeals from the Court of First Instance on points of law and to answering questions put to it by the Courts of Member States.

In terms of substantive focus the Court of Justice and the Commission concentrated their attentions on private vertical arrangements. The latter were perceived as presenting the greatest risk to market integration. Arrangements between manufacturer and supplier, particularly if exclusivity was involved, could give rise to market compartmentalisation.[107] Relationships of an horizontal nature, at least initially, attracted less attention because they were perceived to be less related to market unification.[108] In any event the Commission wanted to ensure that European business could grow to compete with its American counterparts. Often co-operation between SMEs was necessary to ensure their survival in the increasingly global market. The fear of interfering with national champions and the possible political repercussions was

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[106] In this context see B. Vesterdorf, "The Court Of First Instance Of The European Communities After Two Full Years In Operation", (1992) 29 *CML Rev* 897; H.G. Schermers, "The European Court Of First Instance", (1988) 25 *CML Rev* 541.
[107] J.M. Ellis, "The Legality Of Exclusive Distributorships Under Common Market Antitrust Laws", (1964) 9 *Antitrust B* 775.
[108] See D.G. Goyder, note 100 above, 578.

reflected in the lack of application of Article 82 (ex 86). Indeed, it was not until the end of the 1960s that authorities got to grips with horizontal arrangements.[109]

The Court's approach to vertical arrangements is graphically illustrated in the case of *Consten-Grundig*.[110] Here, in examining the exclusive distribution arrangements of a German manufacturer on the French market, the Court concluded that Article 81 (ex 85) applied not only to horizontal arrangements but also to arrangements of a vertical nature. The latter could simply restore national divisions in trade between Member States. Importance was attached to intrabrand competition because of its market integrative effect. The fact that restraints on intrabrand competition might stimulate interbrand competition was no reason to permit such restraints to escape the clutch of Article 81(1) (ex 85(1)). The Court emphasised that these arrangements may threaten market integration rather than competition *per se*.

Subsequent case law reveals the extent to which vertical restraints, which either directly or indirectly fragment the market, are condemned. Case law relating to direct bans on exports is voluminous as both the Commission and the Courts have treated such restraints with short shrift.[111] Perhaps one of the most succinct statements which the Court of Justice has provided in this area is in the case of *Miller International Schallplatten GmbH v Commission*.[112] This case involved the inclusion of an export ban (clause 5) in an exclusive dealing arrangement between Miller and its exclusive distributor for Alsace Lorraine, Sopholest of Strasburg. The Commission concluded

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[109] See, for example, Case 48/69 *ICI v Commission* (Dyestuffs) [1972] ECR 619, [1972] CMLR 557.
[110] Cases 56, 58/64 *Consten and Grundig v Commission* [1966] ECR 299, [1966] CMLR 418.
[111] See (*inter alia*) Comm. Dec. 78/696 *Arthur Bell and Sons Ltd* OJ 1978 L235/15, [1978] 3 CMLR 298; Comm. Dec. 91/532 *Viho Europe BV v Toshiba Europa* OJ 1991 L287/39, [1992] 5 CMLR 180; Case T-43/92 *Dunlop Slazenger International Ltd. v Commission* [1994] ECR II-441; Case T-77/92 *Parker Pen v Commission* [1994] ECR II-549; Case T-66/92 *Herlitz AG v Commission* [1994] ECR II-531.
[112] Case 19/77 [1978] ECR 131, [1978] 2 CMLR 334.

that this provision fell foul of Article 81 (ex 85) and the Court of Justice, in rejecting Miller's appeal, stated "... by its very nature, a clause prohibiting exports constitutes a restriction on competition, whether it is adopted at the instigation of the supplier or of the consumer since the agreed purpose of the contracting parties is the endeavour to isolate a part of the market".[113] This is the case, of course, unless the vertical agreement affects competition and trade between Member States only to an insignificant extent. In which case, as in *Volk v Vervaecke*,[114] absolute territorial protection will be held to be outside the parameters of Article 81 (ex 85).

More recently, the case of *Bayer-Adalat*[115] shows the extent to which the Commission is prepared to stretch the outer boundaries of Article 81(1) (ex 85(1)). Bayer AG, a German undertaking based in Leverkusen, manufactures under the *Adalat* trade name a range of medicinal products including a calcium antagonist used in the treatment of cardiovascular diseases. In most Member States the price of pharmaceuticals is set directly or indirectly by national authorities. Differences in the methods of price calculation[116], ease of transportation and product demand gave rise to strong commercial incentives to engage in parallel trade. The Commission found that measures taken by Bayer France and Bayer Spain, in an attempt to thwart parallel imports particularly into the UK, amounted to an export ban. An agreement was found to exist between Bayer's French and Spanish subsidiaries and their respective wholesalers. The latter, in the view of the Commission, reduced the amounts ordered from their suppliers in an attempt to align themselves with amounts considered by Bayer to accord with the requirements of their domestic markets. This reflected the

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[113] Ibid 148.
[114] Case 5/69 [1969] ECR 295, [1969] CMLR 273.
[115] Comm. Dec. 96/478 OJ 1996 L201/1.
[116] In 1991 Adalat 20 mg was sold in Spain at prices between 35-47% less than the UK. In France the same product sold at prices of 24% less than the UK.

wholesaler's acquiescence in the export ban and furnished the bilateral action necessary to implicate Article 81 (ex 85). However, all the evidence supplied to the Commission indicated that the wholesalers used various methods to obtain supplies for export through co-ordinated action and refusals to inform Bayer's subsidiaries of product destination. Nevertheless, a fine of 3 million ECU was imposed and Bayer was required to inform its subsidiaries that exports were permitted.

In March 1996 Bayer appealed to the Court of First Instance arguing, in the main, that it did not engage in any bilateral action. At the same time, pending outcome of the case on the merits, it successfully applied for interim relief.[117] Interestingly, the Court felt predisposed to say that Bayer's arguments on the merits were not manifestly devoid of all foundations.[118] In Bayer's view it was merely exercising its unilateral right to refuse to supply certain wholesalers. If it was unable to pursue this strategy its UK based subsidiary would lose turnover of DM 100 million resulting in job losses.

Export bans are the most obvious form of market compartmentalisation. Other disincentives, however, can have similar effects. Refusal to honour guarantees on products imported into a Member State by parallel means can render an agreement incompatible with Article 81 (ex 85). This may amount to "... a substantial barrier to the normal development of trade within the Community".[119] The Commission applied these principles in the *Zanussi* case.[120] Here an Italian manufacturer of domestic electrical appliances required work to be undertaken only by its importing subsidiary. Additionally, any product alterations (for compliance with national electrical safety

[117] Case T-41/96R [1996] ECR II-381, [1996] 5 CMLR 417.
[118] Ibid 400.
[119] EEC Commission, *Seventh Report on Competition Policy: 1977* (Brussels, 1978) pp. 24-25.
[120] Comm. Dec. 78/922 OJ 1978 L322/26, [1979] 1 CMLR 81.

standards) had to be made with the consent of the subsidiary. Purchasers from parallel importers were placed at a disadvantage as they could not benefit from the guarantee. The Commission refused negative clearance until Zanussi revised the terms of its guarantee. However, in 1984 in the case of *Hasselblad (GB) Ltd v Commission*[121] the Court of Justice held that it was perfectly legitimate for Hasselblad (GB) Ltd, the sole distributor for Victor Hasselblad's photographic equipment in the UK, to combat parallel imports by offering a better and wider range of after sale services to its own customers. This included offering a 24-hour repair service and an extra 12 months guarantee provided this did not deprive customers of parallel importers the service to which they were entitled. In 1985 in the case of *ETA Fabriques d'Ebauches v DK Investment SA*[122] the Court of Justice confirmed the efficacy of this approach.

Charging higher prices on products intended for export (dual pricing or price discrimination) has been condemned by Court and Commission alike.[123] This practice arose in the case of *Distillers v Commission.*[124] As a result of price controls in the UK and discriminating tax legislation in other Member States the price of Distillers' products were significantly lower in the UK than in other Member States. In order to combat parallel trading, Distillers offered price discounts to its British customers on all products sold within the UK. However, customers intending to export these products were required to pay the gross price which was higher than the prices paid by Distiller's sole distributors in other Member States. In Distiller's view this enabled its distributors to compete in terms of price with parallel importers whilst allowing them to meet the heavy costs of sale promotion. The Commission concluded that this system

[121] Case 86/82 [1984] ECR 883, [1984] 1 CMLR 559.
[122] Case 31/85 [1985] ECR 3933, [1986] 2 CMLR 674.
[123] See, for example, Comm. Dec. 70/332 *Kodak* OJ 1970 L147/24, [1970] 3 CMLR D19; Comm. Dec. 72/403 *Pittsburg Corning Europe* OJ 1972 L272/35, [1973] CMLR D2.
[124] Case 30/78 [1980] ECR 2229, [1980] 3 CMLR 121.

simply resulted in the isolation of the UK market. In the view of the Commission, Distillers could promote its product in other Member States using other means, rather than creating impediments to parallel trading. It could, for example, allow for the costs of promotion by its distributors in the prices charged to them. The matter was appealed to the Court of Justice and the latter held that the arrangement was ineligible for exemption as it had not been properly notified.

Other provisions have also been condemned when used as instruments of market compartmentalisation. These include *inter alia* the exchange of price lists and market information, an obligation placed upon dealers to maintain a register of purchasers names, addresses and product serial numbers when used to trace the source of parallel imports, the provision of finance to enable dealers to buy back cheaper priced products imported by parallel means[125] and the withdrawal of bonuses due to be paid because of out of territory sales.[126]

C. Critical Observations

The Commission's current approach to vertical restraints has attracted vociferous criticism. Essentially the criticism may be distilled into two broad categories - those relating to substantive focus and those relating to system administration. A frequent criticism of the Commission's substantive approach to Article 81(1) (ex 85(1)) has been the importance it has attached to mechanistic or formalistic interpretation. In particular restrictions on conduct as opposed to effects on competition have been sufficient to implicate Article 81(1) (ex 85(1)). As a result, the Commission has failed

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[125] Case 86/82 *Hasselblad v Commission* [1984] ECR 883, [1984] 1 CMLR 559.
[126] Comm. Dec. 92/261 *Newitt/Dunlop Slazenger Int* OJ 1992 L131/32.

to engage in any meaningful economic analysis within its context preferring instead to conduct this under Article 81(3) (ex 85(3)).[127] In this regard, Hawk is critical of the Commission's approach to exclusive distributorships, exclusive purchasing and selective distribution.[128] In 1995 the CBI[129] and UNICE[130] urged the Commission to adopt a more nuanced approach based on economic analysis. In the view of the CBI vertical arrangements, absent export prohibition and price restrictions, should not fall within Article 81(1) (ex 85(1)) provided the supplier does not have market power. The First European Competition Forum held in 1995 added its voice to the growing criticism.[131] Overall, it concluded that the Commission's current substantive approach imposed unrealistic burdens upon European Industry and had detrimental effects on economic progress as well as the reputation of the institutions of the Community.

A number of criticisms are also levelled at the Commission's current administrative approach. The notification process, it is alleged, is time consuming, inefficient, costly and results in legal uncertainty. Companies internal resources are tied up in preparation for notification which adds to transaction costs particularly as expensive legal advice is usually required. In fact, if compliance costs are too high business behaviour may become distorted as it seeks to pursue alternative commercial strategies. A lack of human resources means that there is an inevitable delay in processing notifications. Undoubtedly, files are shelved receiving little or no attention. Companies may continue to operate agreements, therefore, without certainty as to the outcome of their notifications. While this may not unduly perturb some undertakings,

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[127] B.E. Hawk, "System Failure: Vertical Restraints And EC Competition Law", (1995) 32 *CML Rev* 973.
[128] Ibid 975.
[129] CBI, *Loosening The Strait-Jacket: CBI Proposals For Reform Of The Scope And Administration of Article 85* (1995).
[130] UNICE, *Modernising EU Competition Policy* (1995).
[131] L. Laudati, "The First European Competition Forum: Vertical Restraints", (1995) 5 *Competition Policy Newsletter* 7.

others may find this oppressive, particularly, if large capital investment is involved. Those agreements which are processed face a number of possible outcomes which, according to Bright, depends more upon the personal views of the case officer than a consistent application of the rules.[132] This results in legal uncertainty as parties to agreements are afforded an opportunity to renege from agreements or renegotiate their terms. Ultimately, the reputation of the Community's institutions are tarnished. After all, a system which makes so much dependent upon the issuance of exemptions which it is unable to deliver is open to criticism.[133] It is argued, therefore, that the current system should be "scrapped" as it exhibits no redeeming virtues.

In the interest of balance it should be noted that the Commission has utilised a number of measures to alleviate some of its administrative problems. The block exemptions have enabled business to cast their agreements in accordance with a pre-approved mould, increasing legal certainty and reducing the need for notification. Admittedly, undertakings unwilling or unable to mould their agreements still risk delays in obtaining approval. Opposition procedures have been introduced to improve efficiency.[134] The use of block exemptions, however, is not without criticism. The most frequently heard criticisms are that the block exemptions lack flexibility, have a straightjacket effect and are over-regulatory. Adjusting commercial arrangements to fit pre-approved moulds may undermine incentives to reach agreements or result in the alteration of original bargaining positions. Interpreting these Regulations is time consuming, costly and results in formalism taking precedence over economic analysis.

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[132] C. Bright, "Deregulation Of EC Competition Policy: Rethinking Article 85(1)" in B.E. Hawk (ed.) *Annual Proceedings of The Fordham Corporate Law Institute 1994: Antitrust In A Global Economy* (1995).
[133] I. Forrester and C. Norall, "The Laicization Of Community Law: Self-Help And The Rule Of Reason: How Competition Law Is And Could be Applied", (1984) 21 *CML Rev* 11, 16.
[134] See Regulation 4087/88, Article 6(1).

Time is spent on textual exegesis rather than determining the market impact of the arrangement. Other streamlining measures have been introduced including *inter alia* altering Form A/B to elicit greater information from the parties and an increased willingness, on the part of the Commission, to settle matters and to accept undertakings from the parties involved.[135]

D. Possible Solutions

Commentators proffer a number of other possible reforms designed to assist the Commission in matching resources to priorities. They include (i) the introduction of a rule of reason analysis (ii) decentralisation and (iii) greater selectivity over the choice of cases assumed by the Commission.[136] For some the only possible solution to the problems created by the Commission's over expansive approach, is a reduction in the scope of its approach to Article 81(1) (ex 85(1)) through a US style rule of reason.[137] In support of this view they point to the case law of the Court of Justice in the *STM Case*[138], *Maize Seeds*[139], *Pronuptia*[140] and *Delimitis.*[141] Korah argues that in Europe "... there is no agreement as to what objectives should be pursued by competition policy".[142] Market unification has simply been elevated, in her view, into a "... goal in itself, more important than efficiency".[143] Perceived "ex ante" (before the agreement is

[135] See *Pelikan/Kyocera* (1996) 3 *ECLR* R57 and *Digital's* Press Release IP/97/868 of October 10 1997. The difficulties with these practices is that they receive little or no publicity other than a brief press release which is often inadequate to serve as a precedent.
[136] See D.G. Goyder, note 100 above, 593.
[137] See, *inter alia*, V.Korah, "EEC Competition Policy - Legal Form Or Economic Efficiency", (1986) *CLP* 85; C.W.F. Baden Fuller, "Economic Issues Relating To Property Rights In Trademarks: Export Bans, Differential Pricing, Restrictions On Resale and Repackaging", (1981) 6 *EL Rev* 162; J.S. Chard, "The Economics Of Exclusive Distributorship Arrangements With Special Reference To EEC Competition Policy, (1980) *Antitrust B* 405.
[138] Case 56/65 *Société Technique Minière v Maschinenban Ulm* [1966] ECR 235, [1966] 1 CMLR 357.
[139] Case 258/78 *Nungesser v Commission* [1982] ECR 2015, [1983] 1 CMLR 278.
[140] Case 161/84 *Pronuptia v Schillgalis* [1986] ECR 353, [1986] 1 CMLR 414.
[141] Case C-234/89 *Delimitis v Henninger Brau* [1991] ECR I-935, [1992] 5 CMLR 210.
[142] V.Korah, note 137 above, 85.
[143] Ibid 91.

concluded by the parties) vertical agreements may be seen to be procompetitive including arrangements involving absolute territorial protection.[144] Excessive concern with passive and parallel trading is, therefore, misplaced. Firstly, transport costs, a lack of after sale service, concerns over legal redress in the event of faulty goods and regulatory constraints mean that parallel imports cannot be a consistent source of supply. Secondly, information technology is bringing about structural change in methods of distribution. Product distribution based on "Just in Time" (JIT) principles and Quick Response logistics (QR) is bringing about fully integrated supply chains based on mutual dependence and co-operation. What is of fundamental importance, therefore, is interbrand competition between fully integrated competing structures. Not unsurprisingly the Commission is constantly urged to dispense with its parallel importer rationale in favour of the free rider rationale.[145] A US style rule of reason approach in which economic analysis is given primacy would enable the Commission to do this.

In contrast others contended that such an approach should be resisted.[146] Those advocating such change fail to give due consideration to the significance of market integration. As Whish and Sufrin assert

> "(e)ven if this is not a goal approved by all observers, to call for the application of the competition rules in a way which ignores it is

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[144] Ibid 94.

[145] L. Gyselen, "Vertical Restraints In The Distributive Process: Strength And Weakness Of the Free Rider Rationale Under EEC Competition Law", (1984) 21 *CML Rev* 647.

[146] See, *inter alia*, H. Schroter, "Vertical Restriction Under Article 85 EC: Towards A Moderate Reform Of Current Competition Policy. Antitrust Analysis Under Article 85(1) and (3)", in B.E. Hawk (ed.), *Annual Proceedings Of the Fordham Corporate Law Institute (1987) Antitrust In A Global Economy* (1988); J.F. Verstrynge, "Current Antitrust Policy Issues In the EEC: Some Reflections On the Second Generation Of Competition Policy", in B.E. Hawk (ed.), *Annual Proceedings Of the Fordham Corporate Law Institute (1984) Antitrust and Trade Policies In International* Trade (1985).

fundamentally to misconstrue the context in which (European) law is applied".[147]

In any event, as a result of bifurcation of Article 81 (ex 85) there already exists in Article 81(3) (ex 85(3)) an explicit provision to exempt agreements. There is no such provision in US antitrust law which has to deal with the matter implicitly by virtue of a rule of reason analysis. To incorporate an implicit process, some assert, would destroy the equilibrium between Article 81(1) (ex 85(1)) and Article 81(3) (ex 85(3)) rendering the latter provision meaningless. While opponents of the rule of reason accept that the Courts have adopted a nuanced approach, they reject the suggestion that they have adopted a rule of reason analysis. The Community Courts have simply been developing their own jurisprudence on a case by case basis.[148] This has not involved an attempt to determine whether a restraint is procompetitive by weighing restrictions on intrabrand competition as against a strengthening of interbrand competition. This type of analysis is more appropriate "... in a large, integrated and highly competitive market like that of the United States".[149] Indeed, even within the US there are those which reject the minimalist approach advocated by Chicago.

As the Courts of Member States and competition authorities have increased their experience and expertise in matters of competition there have been increased calls for decentralisation.[150] Indeed, private antitrust action before national Courts, as in the US, is seen as a way of assisting the Commission in the reduction of its workload.

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[147] R. Whish and B. Sufrin, "Article 85 And The Rule Of Reason", (1987) 7 *YEL* 1, 37.
[148] R. Whish and B. Surfin, *Competition Law* (3rd edn, London, 1993) p. 209.
[149] EEC Commission, *Thirteenth Report on Competition Policy: 1983* (Brussels, 1984) p. 35.
[150] C.D. Ehlermann, "Implementation Of EC Competition Law By National Antitrust Authorities", (1996) 17 *ECLR* 88; A.J. Riley, "More Radicalism, Please: The Notice On Cooperation Between National Courts And The Commission In Applying Articles 85 and 86 of the EEC Treaty", (1993), 14 *ECLR* 91; J. Shaw, "Decentralisation And Law Enforcement In EC Competition Law", (1995) 15 Legal Studies 128.

However, the process of decentralisation has been slow. The public route of complaint to the Commission has its attractions in that it is less financially onerous, the Commission has wide investigatory powers and formal remedies are applicable throughout the Community. However, in 1992 the Court of First Instance in *Automec II*[151] affirmed the right of the Commission to reject complaints on the basis of lack of Community interest provided adequate legal remedy is available before national Courts. In 1993 the Commission's Notice on Cooperation Between National Courts provided guidelines for national courts in applying Community Competition Law.[152] In its Notice the Commission acknowledged that its lack of resources required it to prioritise cases according to Community interest. Low priority cases should be dealt with by national Courts which, unlike it, could award damages and costs to injured parties. In 1997 the Commission also published its Notice on Cooperation between National Competition Authorities emphasising the role to be played by the latter in monitoring and enforcing the law.[153] Finally, whilst decentralisation reduces workload and dilutes power concentrations it also reduces the ability of the Commission to pursue its own ends and increases the risk of inconsistencies.[154]

More radically, some suggest, the time has now come for the Commission to be more selective in the issues it deals with. In particular, with the Single Market virtually in place, focus should be redirected away from vertical restraints, for so long intimately connected with market unification. After all, where a market is integrated the goal of integration loses its force. It is important to emphasis, however, that the Commission

[151] Case T-24/90 *Automec v Commission* [1992] ECR II - 2223, [1992] 5 CMLR 431.
[152] OJ 1993 C39/06, [1993] 5 CMLR 95.
[153] OJ 1997 C313/3, [1997] 5 CMLR 884.
[154] D.J. Gerber, "The Transformation Of European Community Competition Law?", (1994) 35 *Harv Intl LJ* 97, 141.

has also addressed other anticompetitive issues including horizontal agreements,[155] Governmental interference with competition[156] and merger controls.[157] In 1997, however the Commission published its Green Paper on Vertical Restraints which set out the Commissions proposals for refocusing its approach in this area. Included in its proposals was the introduction of a market power filter based on market share. Interestingly, a rule of reason option was not included, nor any proposals for the reform of the Commission's sole right to grant exemptions under Article 81(3) (ex 85(3)). These matters will be considered in the Chapter 7.

IV. CONCLUSION

From the 1970s the sole function or purpose of US antitrust has been the promotion of efficiency and the maximisation of wealth. Concerns relating to the distribution of that wealth or the accomplishment of other non-economic goals are considered the proper subjects of other laws. Admittedly, this has not always been the case and the current approach is often criticised for its neglect of goals which some consider should inform the antitrust debate. This focus on efficiency has had ramifications for the development of US law relating to vertical restrictions. In a fully integrated market interbrand competition is seen as central to wealth maximisation. Restrictions on intrabrand competition, to the extent they overcome problems of free riding, stimulate

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[155] S.B. Hornsby, "Competition Policy In The 80's: More Policy Less Competition", (1987) 12 *EL Rev* 79.

[156] See in this context, C.D. Ehlermann, "The Contribution Of EC Competition Policy To The Single Market", (1992) 29 *CMLRev* 257, 274-277. With regard to the effects of State owned undertakings on the competitive process and the activation of Article 86 (ex 90) see, Case C-41/83 *Italy v Commission* [1985] ECR 873, [1985] 2 CMLR 368; Case C-41/90 *Hofner-Elser v Macrotron* [1991] ECR 1979, [1993] 4 CMLR 306; Case C-202/88 *France v Commission* (Terminal Directives) [1991] ECR I-1223; Case C-320/91 *Paul Corbeau* [1993] ECR 2533, [1995] 4 CMLR 621.

[157] The principal weakness in the Court's judgment in *Continental Can* was that it did not empower the Commission to prohibit concentrations giving rise to the creation of new dominant positions. Regulation 4064/89 (OJ 1989 L393/1) which came into force in September 1990, gave the Commission such powers. See M. Siragusa and R. Subiotto, "The EEC Merger Control Regulations: The Commission's Evolving Case Law", (1991) 28 *CMLRev* 877.

interbrand competition. In applying a rule of reason analysis the US authorities are more tolerant of these restrictions.

In Europe, however, competition policy has always had wide policy objectives. From the outset, there has always been the task of balancing contradictory objectives. Not only has European Competition Policy been concerned with efficiency it had also embraced equity and fairness in the market place. Above all, market unification has been central to policy. Unlike domestic legal systems, therefore, importance has been attached to intrabrand competition because of its market integrative effect. Parallel trading and passive selling is encouraged. Substantive focus has centred on agreements or restraints designed to fragment the market. More recently, as the Single Market reaches completion, questions about the proper function and purpose of competition policy have been asked. In particular whether a more economic based approach to vertical restraint should be adopted. Economic analysis should be welcomed. However, this does not mean that concerns associated with market integration will not arise in the future. The "... *du jure* integration of the Community's market does not automatically create *de facto* integration".[158] In short, incentives will continue to exist to encourage undertakings to increase profitability through market compartmentalisation. Finally, the expected expansion of the EU eastwards may also reinvigorate the integrative imperative.

[158] See D.J. Gerber, note 154 above, 145.

3

RESALE PRICE MAINTENANCE

I. INTRODUCTION

"Occasionally, issues of modest importance in themselves became symbolic of a broader difference of view between contending schools or ideologies".[1] Over the years resale price maintenance (RPM), which is really only of modest legal significance, has proved to be contentious and controversial in that it encapsulates the very essence of competing ideological views of antitrust. RPM arises when manufacturer and dealer agree to set a floor on resale prices in order to prevent price-cutting. In contrast, vertical *maximum* price fixing sets a ceiling on resale prices to prevent dealer price-gorging. While a degree of consensus exists amongst economists over the impact of *maximum* price fixing there is little agreement over the issue of *minimum* price fixing. For some RPM is essentially procompetitive and should be legal *per se*. The advocates of this approach stress that RPM can only be anticompetitive if it encourages horizontal collusion. This, however, rarely occurs and can be attacked as a separate violation of the antitrust laws. RPM is designed to create efficiency and not to limit output. As Bork writes "(w)hen a manufacturer wishes to impose resale price maintenance ... (its) motive cannot be the restriction of output and therefore can only be the creation of distributive efficiency".[2] In contrast, others suggest that any restrictions placed on the freedom of independent outlets

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[1] R. Pitofsky, "In Defense of Discounters: The No-Frills Case for A *Per Se* Rule Against Vertical Price Fixing", (1983) 71 *Geo LJ* 1487.
[2] R.H. Bork, *The Antitrust Paradox* (Reprint, New York, 1993) p.289

to determine their own pricing policy strikes at the very heart of the competitive process. In particular, it strikes a blow at those outlets whose marketing strategies embrace the concept of high turnover, low price and low service provision. Ultimately, according to this view, RPM arrests the development of product distribution.

A number of procompetitive justifications have been advanced for the imposition of RPM. It is argued, firstly, that RPM guarantees profit margins and insulates the dealer from competitive activity designed to erode margins between wholesale and retail prices. Historically, traditional outlets (chemists, grocers) faced this erosion as a result of the arrival of pre-packaged branded products and large chain stores capable of selling products at a discount as a result of bulk purchasing.[3] Secondly, RPM facilitates market entry. The lure of generous profit margins attracts outlets, which might not otherwise be available, to market the products of new or prospective suppliers. Thirdly, this type of restraint can be used to divert competition from price to service provision. In so doing it overcomes the problem of sub-optimal dealer investment by preventing intrabrand free riding. Consumers benefit because they receive a mix of price competition and service provision.[4] Fourthly, the imposition of resale prices prevents large retail outlets from driving locally owned outlets out of business because of their inability to compete on price. Local communities are not deprived therefore, of cultural diversity and competition at the retail level. Finally, prestigious and reputable outlets perform the role of product certification.[5] By stocking a particular brand the outlet certifies that it is a product of repute and quality. RPM prevents outlets from selling products as loss leaders in order to

[3] B.S. Yamey, "The Origins of Resale Price Maintenance: A Study Of Three Branches of Retail Trade", (1952) 62 *Ec J* 522.
[4] L.S. Tesler, "Why Should Manufacturers Want Fair Trade?", (1960) 3 *JL Ec* 86.
[5] H.P. Marvel & S. McCafferty, "Resale Price Maintenance and Quality Certification", (1984) 15 *Rand J Econ* 346.

increase store traffic. This might damage the reputation of the product and limit its access to other stores, as high service providers will be reluctant to stock a product being sold elsewhere at discounted prices.

In contrast others point to the possible anticompetitive effects of RPM. Firstly, if such a practice becomes widespread, discount stores may be unable to obtain well known, high quality branded products. This may form an obstacle to the internal growth and spread of such outlets depriving consumers of new and innovative alternatives in product distribution.[6] Secondly, it seems the restriction on intrabrand price competition results in the general elevation of prices to the final consumer. Thirdly, the general applicability, significance and frequency of the free rider rationale is questioned. As consumers generally pay for post sale services the concept of free riding relates primarily to pre-sale services. The need for RPM to induce this type of service provision is questionable. Producers can charge for their services, on a refundable fee basis, depending on whether the product is purchased or not. Alternatively, manufacturers can pay the dealer to provide the requisite services. Indeed, informative advertising can also reduce the need for pre-sale services. RPM may simply result in knowledgeable consumers paying for a service they do not require. The restraint, therefore, advances sectional interests to the detriment of the totality of consumer welfare.[7] Fourthly, RPM acts as a disincentive to innovate and create efficiencies in product distribution. It, therefore, protects the inefficient from their inefficiencies. Finally, it may be used as an instrument to police dealer and manufacturers' cartels.[8]

[6] R.L. Steiner, "The Nature of Vertical Restraints", (1985) 30 *Antitrust B* 143.
7 W.S. Comanor & J.B. Kirkwood, "Resale Price Maintenance and Antitrust Policy", (1985) 3 *Contemporary Policy Issues* 9.
[8] S.I. Ornstein, "Resale Price Maintenance and Cartels", (1985) 30 *Antitrust B* 401.

In spite of the on-going economic debate the US treats *horizontal* and vertical *minimum* price fixing as *per se* violations of the Sherman Act. Recently, the Supreme Court changed its stance over *maximum* price fixing concluding that these arrangements should be analysised under the rule of reason. In the EU the imposition of resale prices falls foul of Article 81(1) (ex 85(1)) EC and is invariably ineligible for exemption. The following sections the way in which the law in the US and EU has developed.

II. THE LAW AND PRACTICE OF RPM IN THE US

A. Minimum Resale Price Maintenance

RPM in both historical and legal terms is of relatively recent origin. Its common law background, while rather mixed and unsettled, seems to indicate that such price restraints were initially protected by the law.[9] However, early American case law under the Sherman Act 1890 reversed the position. In 1908, for example, the case of *Bobbs-Merill Co v Isidor Strauss & Nathan Strauss*[10] came before the Supreme Court. The appellants brought an action against the respondents trading as RH Macy & Co to restrain the sale of a copyrighted novel entitled "The Castaway" from being sold at retail at less than one dollar for each copy. Printed below the usual copyright was a notice inserted by the appellants to the effect that no dealer was licensed to sell the book below the maintained price. Any such sale would be treated as an infringement of copyright. The respondents, however, sold the books for 89 cents per copy. It was held by the Court that the copyright

[9] See, for example, *Fowle v Park* 131 U.S. 88 (1889); *John D Park & Sons Co v National Wholesale Druggists' Ass'n* 175 N.Y. 1, 67 N.E. 136 (1903); *Elliman v Carrington* (1901) 2 Ch. Div. 275. For a brief review of the Common Law background to RPM see J.C. Peppin, "Price Fixing Agreements Under the Sherman Anti-Trust Law", (1940) 28 *Cal L Rev* 297.

[10] 210 U.S. 339 (1908).

statute secured to the copyright holder the right to sell the books. This privilege, however, was exercised and extinguished by the holder upon sale. The Court also emphasised that it was not the purpose of the law to grant the further right to qualify the title future purchasers may acquire by means of such printed notices affixed to books. This would simply secure privileges not intended to be included in the copyright statute.

In 1913 the Court of Appeals of the District of Columbia presented a question to the Supreme Court relating to the right of a patentee to limit by notice the price at which a patented article may be resold. In the case *of Bauer & Cie and the Bauer Chemical Co v James O'Donnell*[11] Bauer & Cie, a Berlin company, owned a patent relating to a product known as "Sanatogen". The German company traded in the United States under the name Bauer Chemical Company. This New York based company sold the product to both trade and public bearing a notice to the effect that it should not be sold at a price below one dollar. Any sale in violation of this notice was to be treated as a patent infringement, rendering such persons liable to injunction and damages. James O'Donnell, the owner of a drug store, purchased the product from the New York based company. To increase profitability he sold the product below the stipulated price. In consequence the appellants severed business relations. However, he still managed to obtain the same product from jobbers in the District of Columbia and continued to embrace his price cutting marketing strategy. The question before the Supreme Court, in essence, was whether O'Donnell's business activities constituted a patent infringement. The Court answered the question in the negative stating

[11] 229 U.S. 1 (1913).

> "... it was the intention of Congress to secure an exclusive right to sell, and there is no grant of a privilege to keep up prices and prevent competition by notices restricting the price at which the article may be resold".[12]

While these cases indicate the general attitude of the Supreme Court to such restraints, they were nevertheless primarily concerned with the construction of particular statutes. The first case, however, specifically concerned with RPM to reach the Supreme Court was that *of Dr Miles Medical Co v John D Park & Sons Co.*[13] Here Dr Miles Medical Corporation, based in Indiana, was engaged in the manufacture and sale of proprietary medicines prepared by means of a secret formula and identified by distinctive packaging, labels and trademarks. Its business practice was to distribute its products through wholesalers or jobbers and retail druggists. As a result, however, of cut rate price competition from Department stores, the corporation felt its business sales and reputation had suffered. To protect its sales and goodwill the corporation developed a method of controlling the sales and marketing of its remedies. It required its 400 wholesale dealers and 25,000 retail dealers to enter into purported contracts of agency. Thus distributors, if selling to another party for the purpose of resale, were obliged to sell only to approved dealers. Furthermore, sales could only be made at prices dictated by the manufacturer. John D Park & Son, however, refused to enter into any such arrangement. In consequence they could not become an approved dealer. In spite of this, they still managed to procure the said proprietary medicine and sell it below the maintained price.

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[12] Ibid at 17.
[13] 220 U.S. 373 (1911).

The complainants alleged that John D Park & Son had maliciously interfered with its contractual relationships with third parties. It had done so by procuring medicines for sale at cut prices and by inducing those who had become approved dealers to violate their contractual restrictions.

The US Supreme Court, however, affirmed the decision of the US Circuit Court of Appeals, which dismissed the complainant's action. It did so for a number of reasons. First, the Supreme Court stated that the contracts described as agency were, in effect, contracts of sale disguised in the mask of agency. In the words of Mr Justice Hughes

> "... the advantage of established retail prices primarily concerns the dealers. The enlarged profits which would result from adherence to the established rates would go to them, and not to the complainant. ... If there be an advantage to the manufacturer in the maintenance of fixed retail prices, the question remains whether it is one which he is entitled to secure by agreement restricting the freedom of trade on the part of dealers who own what they sell. As to this the complainant can fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavoured to establish the same restrictions, and thus to achieve the same result, by agreement with each other".[14]

In short, the imposition of RPM by producers, simply prevents intrabrand price competition in much the same way as an illegal horizontal combination of distributors.

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[14] Ibid at 407.

As horizontal price fixing is illegal *per se*, it follows that vertical price fixing should also be unlawful. The Court also seems to have based its judgment on the tenets of property law. It observed that simply because a producer decides to manufacture and sell a particular product, that in itself, does not confer upon that producer the right to impose every sort of restriction. Quoting from the case of *Park v Hartman*[15] the Court stated

> "... a general restraint upon alienation is ordinarily invalid. The right of alienation is one of the essential incidents of a right of general property in movables, and restraints upon alienation have been generally regarded as obnoxious to public policy, which is best subserved by great freedom of traffic in such things as pass from hand to hand. General restraints in the alienation of articles, things, chattels except when a very special kind of property is involved ... have been generally held void".[16]

Once a producer has sold its product at prices which are satisfactory to itself the consumer is then entitled to whatever advantage may be gained from subsequent competition. The importance of property law, in relation to vertical restraints, was also emphasised in the 1967 Supreme Court case of *US v Arnold, Schwinn & Co.*[17] Admittedly, this case was concerned with non-price vertical restraints. Nevertheless, the Supreme Court was at pains to emphasise that when a "... manufacturer parts with dominion over (its) product or transfers risk of loss to another, he may not reserve control over its destiny or the

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[15] 12 L.R.A. (N.S.) 146, 153 Fed. 24.
[16] 220 U.S. at 440.
[17] 388 U.S. 365 (1967).

condition of its resale".[18] To be otherwise would amount to a violation of the ancient rule against restraints on alienation.

It becomes apparent, then, that the Supreme Court in rendering RPM illegal *per se* was not concerned with the arguments of an economic nature relating to these intrabrand restraints. Indeed, inspite of repeated attacks on the principles enunciated *in Dr Miles* it still represents the current state of law in the US. Any attempt to impose minimum RPM by a manufacturer on its distributors amounts to a violation of the Sherman Act. In spite of this, however, large-scale business used various strategies in an attempt to circumvent these principles. As a result, various exceptions soon emerged. In 1919 the Supreme Court decision of *US v Colgate & Co*[19] created confusion and doubt as to the continuing vitality of *Dr Miles*. On the facts, the Colgate Corporation was engaged in the manufacture of soap and toiletry articles. As a result of certain business behaviour it was indicted for alleged Sherman Act violations. It was alleged that a vertical combination existed between Colgate and its wholesale and retail distributors. The object of the combination was simply to ensure the distributors compliance to the resale prices fixed by Colgate. However, the indictment was "... couched in rather vague and general language".[20] Technically, it failed to allege that any agreement which existed was unlawful. The Supreme Court stated that it

> "... must conclude that ... the indictment does not charge Colgate & Co with selling its products to dealers under agreements which obligated the latter not to resell except at prices fixed by the company".[21]

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[18] Ibid at 379.
[19] 250 U.S. 300 (1919).
[20] Ibid at 302.
[21] Ibid at 307.

In the absence of such agreements, a producer is entitled to stipulate resale prices and to refuse to deal with any distributor which refuses to adhere to those prices. Such unilateral action cannot fall foul of S1 Sherman Act which requires some form of concerted action. In the words of Mr Justice McReynolds

> "In the absence of any purpose to create or maintain a monopoly, the act does not restrict the long-recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to deal".[22]

In 1926 the concept of agency was also successfully utilised as a means of circumventing the *per se* illegality of RPM. The case of *US v General Electric*[23] has a rather long history. In brief, prior litigation had taken place between the US Government and General Electric and 32 other corporations. This litigation was terminated when a consent decree was entered into; the defendants agreeing to refrain from fixing resale prices. As a result, General Electric developed new methods of distribution for which it sought the approval of the Attorney General. He, however, refused to comment upon the legality of the new methods of distribution. In spite of this, General Electric implemented its new system. Its plan was to distribute its electric lamps, which were produced under patent, by dividing its trade into three classes. The first method of distribution involved General Electric's own sales representatives selling directly to its own customers. The second method of

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[22] Ibid.
[23] 272 U.S. 476 (1926).

distribution involved the use of so called "B" agents to sell to its large customers. Finally, "A" agents were also used to sell directly to customers.

The contract between General Electric and its agents provided *inter alia* that title to the property was to remain with General Electric until the product was sold to the customer; "risk" was to remain with the principal - General Electric; the agent was to be reimbursed by means of commission; sale proceeds were to be accounted for to the principal irrespective of receipt of the same by the agent. Agents were also obliged to sell at minimum prices set by the principal. The government argued that this system of distribution was simply a guise to enable the Electric Company to fix the resale prices of lamps in the hands of purchasers. The so- called agents were, in fact, independent wholesale and retail merchants. In contrast, General Electric, contended that its distributors were *bona fide* agents and that it had the legal right to market its lamps through such agent and at prices prescribed by it. The Supreme Court recognised that the plan was doubtless intended to prevent sales by middlemen to consumers at competing prices.[24] However, distinguishing *Dr Miles*, the Supreme Court found that the contracts between General Electric and its distributors were, in fact, contracts of Agency. As a result, therefore, property in the goods remained with the principal. Any sale, therefore, by the agent could not amount to a resale. In the words of Chief Justice Taft, the "... owner of an article ... is not violating the common law or the Anti-Trust Law by seeking to dispose of his articles directly to the consumer and fixing the price by which his agents transfer the title from him directly to such consumers".[25] Obviously, then, selling by

[24] Ibid at 479.
[25] Ibid at 488.

means of agency or consignment enabled the producer to retain control of the product and dictate resale price.

These major decisions by the Supreme Court appeared to provide a means to enable business to circumvent the principles *of Dr Miles*. At State level, lobbying campaigns conducted by retailers and manufacturers under the banner of the "Fair Trade Movement" exerted pressure on State legislatures to pass laws which enabled producers to practice RPM. This eventually came about in California in 1931 with the enactment of the California Fair Trade Act. However, this particular Act was severely limited in that producers could only enforce RPM against those distributors with whom there was a contextual nexus. As a result the Act was subsequently amended to overcome this particular problem by the inclusion of a "non-signer" clause. That is, once a producer established contractually agreed resale prices with a distributor, it became illegal for other distributors (even if not contractually bound to the producer) to undercut the contractually agreed resale price. Legislation of this nature proliferated. Yet, State law by its very definition, is not applicable to interstate commerce. In 1937, therefore, Congress passed the Miller-Tydings Act. RPM agreements on trade marked products, therefore, were exempted from violations of the Federal Antitrust laws provided the agreement was lawful under State "fair trading" laws and the product was in free and open competition with other products of the same class. It was also assumed that the Miler-Tydings Act also bound "non signers" in a similar fashion to certain States fair trade laws. However, in the 1951 case of *Schwegmann Bros v Calvert Distillers Corp*[26] six members of the Supreme Court refused to read a "non-signers" clause into the Act. In the view of the Court, such clauses were unconstitutional and, in any event, the Miller-Tydings Act

[26] 341 U.S. 384 (1951).

applied specifically to contracts or agreements only. In 1952, however, Congress responded by passing the McGuire Act which specifically over-ruled the *Schwegmann* decision and allowed producers to bind non-signers. In 1964 in the case *of Hudson Distributors Inc v Upjohn Co*[27] the Supreme Court confirmed that the purpose of the McGuire Act was to ensure that the State fair trade laws including the non-signers provision with regard to interstate transactions, did not constitute a violation of the Sherman Act or the Federal Trade Commission Act.

The Colgate doctrine, the concept of agency as stated in the *General Electric* case and the State's fair trade laws are indicative of the fluctuating nature of RPM. In some measure they circumvented the principles of *per se* illegality enunciated in *Dr Miles*. The reach of these exceptions, however, were restricted by the Supreme Court in a number of decisions.

The unilateral right of a producer to refuse to deal with those distributors which failed to adhere to stated resale prices was, as a result of a number of Supreme Court decisions, narrowly confined. In 1920 in *US v Schrader's Son Inc*[28] a producer of components was indicted for entering into price fixing agreements with retailers, jobbers and other manufacturers. The District Court, believing that the principles enunciated in *Dr Miles* and *Colgate* were merely a distinction without a difference, applied the principles of Colgate to the facts of the case and dismissed the action against the defendant. The Supreme Court reversed this decision stating

[27] 377 U.S. 386 (1964).
[28] 252 U.S. 85 (1920).

> "The Court below misapprehended the meaning and effect of the opinion and judgment in (Colgate). We had no intention to overrule or modify the doctrine in Dr Miles ... where the effort was to destroy the dealers' independent discretion through restrictive agreements".[29]

The Court acknowledged that a producer will not violate antitrust laws if it merely "... indicates his wishes concerning prices and declines further dealings with all who fail to observe them".[30] However, this is not the case when a producer enters into agreement which may be either express or implied from a course of dealings or other circumstances. As a result of *Schrader* the Court could readily imply the existence of an agreement. In terms of its commercial use, therefore, the Colgate doctrine was rather limited. The fatal agreement may be readily inferred simply if the producer discusses his price structure with the distributor or if the latter gives its unsolicited assurance to abide by the producers prices. The fact that an agreement may be readily implied was confirmed in 1921, in the case of *Frey & Son Inc v Cudahy Packing Co.*[31] Here the plaintiff instituted a treble damage action alleging that the defendant and its jobbers conspired to maintain resale prices in violation of the antitrust laws. The District Court held for the plaintiff. The Court of Appeals, however, reversed this decision concluding that there was no formal written or oral agreement for the maintenance of prices.

The Supreme Court, however, reversed the Court of Appeals and referred to the *Schrader* decision stating that

[29] Ibid at 99.
[30] Ibid.
[31] 256 U.S. 208 (1921).

> "The latter (case) distinctly stated that the essential agreement, combination, or conspiracy might be implied from a course of dealing or other circumstance. Having regard to the course of dealing and all the pertinent facts disclosed by the present record, we think whether there existed lawful combination or agreement between the manufacturer and jobbers was a question for the jury to decide, and that the Circuit Court of Appeals erred when it held otherwise."[32]

The gradual narrowing of the *Colgate* decision was also assisted by the decision in *the Federal Trade Commission v Beech-Nut Packing Co.*[33] Here Beech-Nut refused to sell its products to any of its distributors if it failed to observe its stipulated prices. Indeed, it refused to sell to wholesalers who sold to retailers who refused to observe or adhere to its price structures. To ensure compliance to its price structure Beech-Nut adopted various strategies. It used special agents adept in the use of coercive methods, product code numbers and a system of reporting to detect those in breach of its stated policy. Once detected a defaulting distributor would be excluded from the distribution network and only reinstated if assurances were given to the effect that it would adhere to the declared pricing policy. Beech-Nut alleged that its activities were perfectly legitimate under the *Colgate* doctrine. The Supreme Court, however, held otherwise. The Beech-Nut system of distribution went "... far beyond the simple refusal to sell goods to person who will not sell at stated prices which in the Colgate case was held to be within the legal rights of the producer".[34] Moreover, the fact that express contracts did not exist between the producer and its distributors was irrelevant in this case. The methods by which Beech-Nut secured

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[32] Ibid at 210.
[33] 257 U.S. 441 (1922).
[34] Ibid at 454.

adherence to its resale prices sufficiently suppressed freedom of competition among its distributors. These methods were quite as effective as agreements express or implied. By adopting such methods, Beech-Nut was enabled "... to prevent competition in all their subsequent dispositions by preventing all who (did) not sell at resale prices fixed by it from obtaining its goods".[35]

Accordingly, not only can agreements express or implied fall foul of antitrust laws, but also the methods by which a producer secures adherence to its resale prices (beyond a mere refusal to sell to a distributor who fails to adhere to its stated resale policy) may also constitute an antitrust infringement.[36] This point was forcefully stated by Justice Brennan in *US v Parke, Davis & Co*[37]

> "When the manufacturer's actions, as here, go beyond mere announcement of his policy and the simple refusal to deal, and he employs other means which effect adherence to his resale prices ... he has put together a combination in violation of the Sherman Act".[38]

Any affirmative action, therefore, designed to secure a distributors adherence to stated resale prices effectively means that the product "... comes packaged in a competition free wrapping - a valuable feature in itself - by virtue of concerted action induced by the manufacturer".[39]

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[35] Ibid at 455.
[36] See also, in this respect, *US v Bausch & Lomb Optical Co* 321 U.S. 707 (1944).
[37] 362 U.S. 29 (1960).
[38] Ibid at 44.
[39] Ibid at 47.

Having confined the scope of a producer's unilateral right to refuse to deal with distributors, the Supreme Court also attempted to confine the scope of agency or consignment. Congressional investigations were conducted into marketing methods utilised in various industries.[40] Certain industries, in particular the petroleum industry, used agency or consignment as a means to maintain prices. This had the effect, with regard to the petroleum industry, that service station operators effectively lost their independent business status. Their selling prices, for example, and therefore their gross margin of profits were within the control and determination of the major oil companies. The latter justified their particular methods of distribution by advancing those arguments traditionally proffered for RPM. That is, such arrangements are designed to protect dealers profit margins to ensure a competitive relationship between dealer's prices and those of competitors. However, serious doubts were cast on this particular form of commercial arrangement in 1964 by the Supreme Court decision of *Simpson v Union Oil Co.*[41] This was a private, treble damage, antitrust case brought by Richard Simpson. The complaint developed as a result of Simpson's consignment agreement under which he sold petrol on behalf of Union Oil. The agreement was for a specific period terminable by either party. In any event, the said agreement would cease upon termination of the lease to the Petrol Station owned by Union Oil and let to Simpson. The renewal of the lease was, in effect, dependant upon observance of the conditions contained in the consignment agreement. The latter agreement gave Union oil the right to set the price of petrol sold by Simpson. Moreover, the Oil Company retained ownership of the petrol. Simpson, for his part, was to insure for property damage incurred as a result of the consigned petrol. He was paid by means of commission. During a specific period, the Oil Company fixed

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[40] HR Rep No 1958, 85th Cong 2d Sess; S Rep No 1555, 85th Cong 2d Sess.
[41] 377 U.S. 13 (1964).

resale prices at 29.9 cents per gallon. As a result of competitive pressures Simpson felt the need to sell the petrol at 27.9 cents. In consequence, Union Oil refused to renew the lease and the consignment agreement was thereby terminated. The Supreme Court adopted a different approach to that of the District Court and Court of Appeals. It stated that it had made it clear in the previous case law that a producer or supplier may not use coercive methods to achieve resale price maintenance. Moreover, it did not matter what form of coercive device or method was used. Failing to renew Simpson's lease was simply a coercive means of ensuring RPM. The Court stated

> "By reason of the lease and 'consignment' agreement dealers are coercively laced into an arrangement under which their supplier is able to impose non-competitive prices on thousands of persons whose prices might otherwise be competitive. The evil of this resale price maintenance program, ... is its inexorable potentiality for and even certainty in destroying competition in retail sales of gasoline by these nominal 'consignees' who are in reality small struggling competitors seeking retail gas customers".[42]

While the Court recognised the important function agency or consignment played in trade or commerce, it emphasised that no matter how lawful these matter may be in terms of private contract law they must give way before federal antitrust laws. As such, agency or consignment could not be used as a "cloak" to avoid antitrust. If it were otherwise they would simply furnish "... a wooden formula for administering prices on a vast scale".[43] It

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[42] Ibid at 21.
[43] Ibid at 22.

would be possible to achieve by vertical means that which is unlawful *per se* when competitors combine to fix prices. To allow this eventuality would be to make legality for antitrust purposes turn on clever draughtsmanship. The Supreme Court refused to let a matter so vital to the competitive process rest on such easy manipulation. It stated that the case of *General Electric* with its "special factors" involving the distribution of patented products was not apposite to the facts of Union Oil. The Court, therefore, distinguished *General Electric* on the basis that its rationale rested on patent law.

Attempts to circumvent the *per se* illegality of RPM have been confined by the Court to very narrow margins. Even the fair trade laws were effectively repealed when Congress passed the Consumer Goods Pricing Act 1975. This effectively restored *per se* illegality to those products which had previously been fair traded. In fact, the Supreme Court in one of the most fundamental American cases in the area of non-price vertical restraints, *Continental TV Inc v GTE Sylvania Inc*,[44] emphasised that vertical price restraints were still to be treated as illegal *per se*. The Court stated that the *per se* "... illegality of price restrictions (had) been established firmly for many years (because it) involves significantly different questions of analysis".[45] In spite of this, those with differing ideological perspectives over the nature of RPM, continue to do battle over its illegality. For some, it represents the last fortress of traditional antitrust analysis. Periodic attempts are, therefore, made to challenge its current status. Indeed, in the case *of Monsanto Co v Spray-Rite Service Corp*[46] the Department of Justice, by way of *amicus* brief, requested the Supreme Court to reconsider the *per se* illegality of RPM. The Court, however, categorically refused to consider the request. Indeed, the request actually precipitated

[44] 433 U.S. 36 (1977).
[45] Ibid at 51 n 18.
[46] 465 U.S. 752 (1984).

much Congressional anger. Congress stated that it had demonstrated its intent, with regard to RPM, by abolishing the fair trade laws by enacting the Consumer Goods Pricing Act 1975. It therefore took steps to prevent the Department of Justice from using its appropriation funds to achieve this end.

B. Maximum Resale Price Maintenance

The imposition of maximum resale prices was condemned as *per se* violative of the Sherman Act in the 1968 case of *Albrecht v Herald Co.*[47] The case involved a treble damage action by a newspaper distributor or carrier against the publisher of the Globe Democrat, a morning newspaper. Each newspaper contained a retail price, printed on it. Albrecht, adhered initially to the publishers pricing policy. Eventually, however, the carrier charged more than the maximum advertised price. The Supreme Court, in holding the setting of maximum resale prices to be *per se* unlawful stated

> "... by substituting the perhaps erroneous judgment of a seller for the forces of the competitive market, may severely intrude upon the ability of (distributors) to compete and survive in (the) market".[48]

Furthermore,

> "Maximum prices may be fixed too low for the dealer to furnish services essential to the value which goods have for the consumer or

[47] 390 U.S. 145 (1968).
[48] Ibid at 152.

> to furnish services and conveniences which consumers desire and for which they are willing to pay.... Moreover if the actual price charged under a maximum price scheme is nearly the fixed maximum price... the scheme tends to acquire all the attributes of an arrangement fixing minimum prices".[49]

This remained the position, however, until November 1997 when the US Supreme Court in the case of *State Oil Co v Khan*[50] reversed the *Albrecht* decision. Here Barkat Khan leased from the State Oil Company a petrol station and retail shop. The agreement between the two parties provided that State Oil would supply Khan with petrol for sale at a recommended resale price. Built into the recommended price was a profit margin available to Khan of 3.25 cents per gallon sold. Two further points should be made. Firstly, Khan was permitted under the agreement to sell petrol at any price. However should the actual sale price exceed the recommended price Khan was obliged to repay the excess to State Oil in the form of rebate. Secondly, Khan was also permitted to sell petrol below the recommended price. Should this occur, however, Khan's profit margin of 3.25 cents per gallon sold was reduced proportionately. In effect, a maximum resale price was set.

As a result of Khan's non-payment of rent the State Oil Company took legal action to seek Khan's eviction and to terminate the lease. Khan defended his position by alleging that the mposition of maximum resale prices affected his profitability and was, in any event, *per se* illegal under S.1 Sherman Act. The District Court for the Northern District

[49] Ibid at 152-153.
[50] 522 U.S. 3 (1997).

of Illinois, however, held in favour of the State Oil Company. In its view the pricing provisions in the agreement did not amount to a *per se* violation of the Sherman Act as they did not have the requisite pernicious effect on competition. Khan appealed the decision to the 7th Circuit Court of Appeals[51] which felt compelled to follow the Supreme Court's decision in *Albrecht* and reversed the decision below. The matter then proceeded to the Supreme Court. Justice O'Connor, known for her pro-Chicagoan leanings, delivered the unanimous verdict of the Court.[52] She stated that *per se* illegality is reserved for those arrangements or restraints which have predictable, pernicious anticompetitive effects. In the unanimous view of the Court the imposition of vertical maximum price restraints, while they may cause dealers to change suppliers, did not harm consumers or competition to the extent necessary to justify *per se* illegality. The Supreme Court, therefore, reversed the *Albrecht* decision and held that vertical maximum price fixing should now be evaluated under the rule of reason. In this analysis the Court should consider such matters as the nature, effect and history of the restraint as well as the type of business concerned.

For some this is a particularly significant antitrust decision. In reality, however, the full implications of *State Oil* are not exactly clear. Three points can be made. Firstly, while the Department of Justice, Federal Trade Commission and the American Association of Manufacturers supported the change, many urged that *per se* illegality in this area should be maintained.[53] In fact, over thirty Federal States and associations of retailers and dealers argued that any change in the legal status of maximum price fixing would render

[51] 93 F. 3d 1358, 1996 US App LEXIS 22504.
[52] See, for example, Justice O'Connor's Opinion in the case of *Jefferson Parish Hospital District No 2 v Hyde* 466 U.S. 2 (1984) where she argued for the abandonment of the *per se* treatment of tie-ins in favour of an approach based on the rule of reason.
[53] See, for example, D.F. Broder & K.J. Perra, "State Oil Co v Khan", 1998 *ECLR* N 39.

dealers and retailers subject to the coercive powers of powerful suppliers. Secondly, it seems that the laws in relation to horizontal fixing of maximum prices remains unchanged. In 1951, for example, in the case of *Kiefer-Stewart Co v Seagram & Sons*[54] the US Supreme Court held that joint action taken by a group of affiliated distillers to ensure that their wholesalers did not exceed a specified price, with regard to the sale of alcohol, amounted to an illegal horizontal maximum price fixing conspiracy. The Supreme Court confirmed the position more recently in the 1982 case of *Arizona v Maricopa County Medical Soc*[55], where horizontal price fixing agreements did not escape *per se* condemnation. Finally, it also seems to be the case that *State Oil* does not effect the *per se* illegality of minimum price fixing. In which case, some may assert, State Oil is just another exercise in barren formalism. Whether this is the case only time will tell. What is, perhaps, more certain is that the scope of *per se* illegality in US antitrust has been contracted even further. Moreover, one can anticipate further efforts to reduce its scope in the area of minimum RPM.

III. THE LAW AND PRACTICE OF RPM IN THE EU

A. Resale Price Maintenance: An Overview

In the EU the Court and the Commission have examined systems of private and public RPM. The former can involve individual and collective systems. In the case of individual RPM a producer makes agreements with its distributors as to the consumer price of a specific product. Collective systems arise when members of an association, for example, agree to impose resale prices on their distributors. These systems are enforced

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[54] 340 U.S. 211 (1951).
[55] 457 U.S. 332 (1982).

by the producer itself or collectively by the maintenance machinery set up by the association. Public systems arise when a Member State itself imposes resale prices on a specific product.[56] In one of its earliest pronouncements on the subject the Commission stated that resale price maintenance was essentially a matter for Member States national competition policy. Provided national systems were confined to "... compelling retailers in a member state to respect certain prices for the resale within that State of products supplied by a manufacturer established on that market..." trade between Member States would not be affected.[57] The Commission, stressed, however, that this would only be the case provided national systems were not used to prevent or stem the flow of parallel imports. Consumers and traders should remain free to purchase goods anywhere in the Community at the most favourable prices. Shortly after this statement the Commission, in a series of cases, expanded upon its position.

In the 1973 case of *Deutsche Philips GmbH*[58] German law permitted a manufacturer of electric razors to impose resale prices on its dealers. The German undertaking, however, obliged its dealers to sell its products to consumers in other Member States at the prices lawfully fixed in Germany. Furthermore, German retailers were also obliged to charge the maintained price when reselling goods manufactured by Deutsche Philips and reimported from other Member States. This prevented German retailers from entering into price competition with other German retailers in respect of goods reimported into Germany. The Commission concluded that these arrangements infringed Article 81(1) (ex 85(1)) and were ineligible for exemption. In the view of the Commission, reimport

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[56] For a general overview of RPM in the EU see D.G. Goyder, *EC Competition Law* (3rd edn., Oxford, 1998) Ch. 12. See also the Opinion of Advocate General Verloren Van Themaat in Cases 43, 63 82 *VBVB and VBBB v Commission* [1984] ECR 19, [1985] 1 CMLR 27.
[57] EEC Commission, *First Report on Competition Policy: 1971* (Brussels, 1972) p.62.
[58] Comm. Dec. 73/322 JO 1973 L293/40, [1973] CMLR D241.

price fixing could not be justified by the fact that it protected legally permissible national price fixing by preventing the sale of imported goods below stipulated German prices. While this may be advantageous to retailers in that they can still acquire the contract goods at favourable prices, thereby increasing their own profit margins, they remained unable to pass this advantage on to the consumer in the form of price reductions. This amounted to market sharing which was incompatible with the objectives of the Common Market and the rules of competition.

The Commission made similar observations in the 1973 case of *Dupont de Nemours (Deutschland) GmbH.*[59] Here a contractual term in the standard form distribution agreement of a manufacturer of photographic and photochemical equipment, requiring its German dealers to respect prices fixed by that manufacturer as regard reimported goods into Germany infringed Article 81(1) (ex 85(1)). However, the removal of this and other offending provisions enabled the Commission to grant negative clearance to the standard form agreements of Du Pont, a German subsidiary of the American Du Pont de Nemours group.

In 1976 in *Gerofabriek NV*[60] the Commission examined the notified agreement of a Dutch manufacturer of silver-plated and stainless steel cutlery. Gero sold its highly successful product range in the Netherlands and Belgium. From 1925 its standard form agreements contained strict conditions in relation to a number of matters, in particular, resale prices. Dealers agreed not to sell Gero's products above or below its indicated prices or to offer discounts or rebates of any kind. The Commission concluded that these arrangements

[59] Comm. Dec. 73/196 JO 1973 L194.27, [1973] CMLR D226.
[60] Comm. Dec. 77/66 OJ 1977 L16 8, [1977] 1 CMLR D35.

violated the provisions of Article 81(1) (ex 85(1)) and were ineligible for exemption. Imposed resale prices made it impossible for dealers to fix their own prices according to their own costs and commercial policy. This reduced the ability of undertakings to pass cost savings to the final consumer. Interestingly, the Commission concluded that RPM could influence trade between Member Sates by deflecting trade flows away from the channels it would naturally have taken if prices were fixed freely. RPM can impact, therefore, upon import and export patterns. The number of dealers affected (more than 2000) and Gero's market share (50 per cent in the Netherlands and 15 per cent in Belgium) was sufficiently large for the adverse affect on trade between Member States to be appreciable. This contrasts with the more tolerant position previously adopted by the Commission. With regard to its Article 81(3) (ex 85(3)) analysis, the Commission succinctly concluded that the imposed price obligations did not assist product distribution. They simply hindered dealers ability to compete. Even if this was not the case, however, RPM did not allow consumers a fair share of any hypothetical benefit since resellers were prevented from passing on any cost benefits. Nor was it clear to the Commission why RPM would be indispensable to the attainment of any alleged benefits.

It is apparent, then, that action will be taken against agreements between supplier and dealer containing restrictions on resale prices, even if permissible under the legislation of a Member State, provided they affect trade between Member States and satisfy the other conditions of Article 81 (ex 85).[61] In *Hennessy-Henkell*[62] the French undertaking Hennessy & Co, entered into an exclusive distribution arrangement with the German

[61] In Case 123/83 *BNIC v Clair* [1985] ECR 391, [1985] 2 CMLR 430 the Court held that an agreement setting minimum prices for an intermediate product was capable of affecting intra-Community trade, even though the product was sold on the market of a single Member States, provided it constituted the raw material for another product sold elsewhere in the Community.
[62] Comm. Dec. 80/1333 OJ 1980 L383/11, [1981] 1 CMLR 601.

undertaking Henkell & Co., for the distribution of Cognac in Germany. The agreement, concluded for a term of 25 years, was notified to the Commission in April 1971. Hennessy agreed not to supply any other customer with cognac, other than those stipulated in the agreement. Henkell was permitted to fix its resale prices for the German market although Hennessy retained supervisory control over the upper and lower parameters of the dealer's pricing structure. Should Henkell, therefore, wish to set its prices above cost plus 17 per cent or below cost plus 12 per cent it was necessary to obtain Hennessy's consent. Hennessy also guaranteed a profit margin of 25 per cent (later reduced to 18 per cent) and that the German market would be protected from parallel imports. In return, Henkell was obliged to use its best endeavours to promote the sale of cognac in Germany and to represent no other brand of cognac or wine based spirits.

The Commission concluded that the exclusivity clauses relating to the sale and purchase of Hennessy's cognac and the non-compete clause prohibiting Henkell from directly or indirectly representing other brands infringed Article 81(1) (ex 85(1)). These restrictions were aggravated by the limitations imposed on Henkell's freedom to set its own prices and Hennessy's undertakings to provide a guaranteed profit margin and protection from parallel imports. The agreement affected trade between Member States: firstly, Henkell became the sole direct importer of Hennessy's cognac into Germany unable to obtain the product from other French undertakings and incapable of selling other brands; secondly, it restricted parallel importation and finally, Henkell's inability to fix its own prices deflected trade flow from the directions it would naturally have taken. As Hennessy was one of the major three producers of cognac and the Federal Republic of Germany was the world's third largest importer, the restriction on competition was appreciable.[63]

[63] Ibid 14-15.

The Commission stated that the agreement could not benefit from Regulation 67/67 nor individual exemption. The Block Exemption was rendered inapplicable because the agreement contained restrictions relating to parallel importation and price competition not permissible under the Regulation.[64]

With regard to individual exemption the Commission concluded that the requirements of Article 81(3) (ex 85(3)) were simply not satisfied. The Commission stated that in order for the benefits of exclusive distribution to accrue, dealers must remain free to set their own prices on the basis of the cost of the products and according to prevailing market conditions. This was essential if Hennessy's products were to penetrate the market and to combat competition from other brands. Indeed, under the present arrangement consumers did not stand to benefit because Henkell was not free to pass on any cost savings in the form of price reductions. The imposition of RPM was simply not indispensable to the attainment of the objectives of the agreement. Hennessy's arguments that RPM was necessary to preserve the character of the product by preventing cut price selling and protecting brand name and product image were rejected by the Commission. Hennessy's arguments were undermined by its own business strategy in that it had not imposed RPM on distributors of its other luxury brands.[65]

In 1978 the Commission considered the imposition of resale prices in exclusive purchasing agreements in the *Spices* case.[66] Here the three main supermarket chains in Belgium (GB-Inno-BM, Delhaize Frères and Sarma Penney Ltd) entered into modified exclusive purchasing agreements with Brooke Bond Liebig. The supermarkets agreed to

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[64] Ibid 15.
[65] Ibid 16-17.
[66] Comm. Dec. 78/172 OJ 1978 L53/20, [1978] 2 CMLR 116.

purchase from Brooke Bond all of their requirements for packaged spices intended for domestic consumption. They were, however, permitted to sell their own respective brands. In return for entering into these agreements, Brooke Bond imposed price restraints designed to guarantee each supermarket a minimum gross profit of 35 per cent on retail sales. The Commission took the view that these arrangements foreclosed access to the Belgian market and infringed Article 81(1) (ex 85(1)). This infraction was made all the more significant by the imposition of resale prices which prevented intrabrand price competition. These restrictions had an effect on the pattern of trade between Member States in that foreign spice producers, already established on the Belgian market, could not utilise the three main supermarket chains in order to expand their own network and producers seeking to gain market entry were hindered in their attempts. The system of price fixing rendered Regulation 1967/67 inapplicable and the agreements ineligible for exemption had they been notified. Product distribution was not improved because the restraints limited the availability of other brands and prevented price competition within the same brand. The Commission, emphasised, once again, that consumers failed to benefit because dealers were prevented from passing on, in the form of price reductions, any part of the substantial benefits which they received from sales.

In October 1977 in the *Metro I*[67] case, the Court of Justice considered the compatibility of systems of selective distribution with the rules on competition. One of the many issues considered was that of price competition. The facts are generally well known. Briefly, Metro, a German cash and carry outlet, complained to the Commission that it was excluded from the selective distribution network of SABA. The Commission required SABA to amend its standard distribution agreements. Not satisfied, Metro brought the

[67] Case 26/76 *Metro v Commission* [1977] ECR 1875, [1978] 2 CMLR 1.

matter before the Court of Justice. This provided the Court with the opportunity to enunciate its principles governing network admissions. Provided, firstly, that criteria for admission was objective and not applied in a discriminating manner and, secondly, admitted dealers were free to supply and provide post sale services anywhere in the Community, simple systems would not infringe Article 81 (ex 85).[68] However, the Court stressed that price competition in these systems was not to be regarded as an exclusive or principal factor. This was particularly true in the case of "complex" systems, where admitted dealers are obliged to undertake further obligations which may require additional capital investment from the dealer. At this point, the Court seems to be acknowledging that this additional capital investment may not be forthcoming if the investing dealer is subject to competition from outlets embracing low service provision and reduced prices - discounters. The Court emphasised, however, that while price competition could never be eliminated it was not the only effective form of competition. The desire of specialist dealers

> "... to maintain a certain price level, which corresponds to the desire to preserve, in the interest of consumers, the possibility of the continued existence of this channel of distribution in conjunction with new methods of distribution based on a different type of competition policy, forms one of the objectives which may be pursued without necessarily falling under the prohibition contained in Article (81(1)), and, if it does fall thereunder, either wholly or in part, coming within the framework of Article (81(3))".[69]

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68 Ibid 1904.
69 Ibid 1905.

The Court then attached two important provisos to this statement. It stressed that if systems of selective distribution were to proliferate the Commission must ensure that their increased numbers do not, firstly, result in structural price rigidity and secondly, the elimination of dealers pursuing a marketing strategy based on low service provision and low pricing.

In 1983 the Court of Justice, once again, considered the issue of pricing levels within systems of selective distribution. In November 1973 AEG, a German undertaking engaged in the production and sale of consumer electronic equipment, notified its selective distribution agreements to the Commission. These European Community Agreements indicated that network admission was based on objective qualitative criteria. In May 1976 the Commission, having required AEG to make certain modifications to its agreements, indicated by comfort letter that it had no objections to AEG's system of selective distribution. Over a period of time, however, the Commission received a number of complaints from dealers aggrieved by the way AEG was operating its system. The Commission initiated proceedings resulting in its Decision of January 1982.[70] It found that AEG was operating its system in such a manner as to exclude discount stores, self service supermarkets and cash and carry outlets from its network, irrespective of whether they had suitable business premises or qualified personnel. Furthermore, AEG directly and indirectly set resale prices. AEG's Belgian subsidiary (ATBG) set a market price with which contracted dealers had to align. In Germany, AEG's sales office explained its pricing policy in detail and often required dealers to undertake to abide by set prices. In France specific agreements were concluded to ensure dealers complied with pricing policy. The Commission found that AEG's system was being operated in such a

[70] Comm. Dec. 82/267 *AEG-Telefunken* OJ 1982 L117/15, [1982] 2 CMLR 386.

manner as to infringe Article 81(1) (ex 85(1)) and was ineligible for exemption. It issued a cease and desist order and imposed a fine of one million ECU.

AEG, in the case of *AEG v Commission*,[71] appealed to the Court of Justice. In rejecting its appeal the Court used the opportunity to clarify its position on maintaining pricing levels within these systems. It stated that certain legitimate requirements, such as the maintenance of a specialist trade, may justify a reduction of price competition in favour of competition relating to factors other than price. However, this limitation, which is inherent in such systems, is only compatible with the rules on competition if network admission is based on objective qualitative criteria applied in a non-discriminatory fashion. If different or stricter admission criteria is used to determine whether discounters, for example, should be admitted an infringement of the rules on competition will occur. Refusal to admit discounters which satisfy the network admission criteria is proof of an unlawful application of the system "... if their number is sufficient to preclude the possibility that they are isolated cases not forming part of systematic conduct".[72] With regard to price maintenance AEG argued that its conduct was designed to obtain a level of pricing which ensured the survival of the high service providing specialist trade. AEG argued that systems of selective distribution in so far as they are designed to guarantee to approved dealers the enjoyment of a minimum margin cannot be considered to be incompatible with Community law.[73] The Court observed, however, that a restriction of price competition must be regarded

[71] Case 107/82 [1983] ECR 3151, [1984] 3 CMLR 325.
[72] Ibid 3195-3196.
[73] Ibid 3196.

"... as being inherent in any selective distribution system in view of the fact that prices charged by specialist traders necessarily remain within a much narrower span than that which might be envisaged in the case of competition between specialist and non-specialist traders".[74]

The Court then emphasised that this inherent restriction is "... counterbalanced by competition as regards the quality of the services supplied to customers, which would not normally be possible in the absence of an appropriate profit margin making it possible to support the higher expenses connected with those services. The maintenance of a certain level of prices is therefore lawful, but only to the extent to which it is strictly justified by the requirements of a system within which competition must continue to perform the functions assigned to it by the Treaty."[75]

The Court rejected, therefore, AEG's claim that it was necessary to maintain prices at such levels in order to guarantee sufficient profit to provide high service levels as a *condition* of network entry. If dealers were not in a position to provide the requisite services AEG, in applying its objective qualitative criteria, could have legitimately refused to admit them.[76]

It will be recalled that in *Metro I* the Court of Justice attached two important provisos or conditions to its statement that, in the area of selective distribution, price maintenance is inherent and may be pursued without necessarily falling foul of Article 81 (ex 85). In

[74] Ibid 3196-3197.
[75] Ibid 3197.
[76] Ibid.

1986 in the *Metro II*[77] case, the Court of Justice expanded upon its earlier statements.[78] The undertaking from Leverkusen challenged the Commission's decision to renew the exemption granted to SABA in 1975. Apart from certain procedural changes relating to network admission, SABA's system remained relatively unchanged.

Metro put forward six substantive submissions in support of its application. In its first and second submissions, however, Metro contended that SABA's current system resulted in structural price rigidity and the elimination of undertakings following a different commercial strategy. In its first submission Metro contended that fundamental changes had taken place in the market for consumer electronic equipment since 1975. The use of selective distribution systems had increased significantly in Germany and throughout the Community. In Metro's view the Commission had failed to take this consideration into account, in particular, the large number of "simple" systems operating on the market which had not been notified. This resulted in structural price rigidity.[79] The Commission rejected these claims. In its view an increase in the number of "simple" systems was not relevant because they were compatible with Article 81 (ex 85). The Court agreed, however, with Metro that it was incumbent upon the Commission to determine whether the competitive situation on the market had changed to such an extent that the preconditions for exemption could no longer be fulfilled.[80] Thus, the combined effects of simple and notified systems had to be considered. The Court then stated, in a rather confusing manner, that after an exemption had already been granted and an application for renewal was being considered, any increase in the number of simple systems need only be

[77] Case 75/84 *Metro v Commission* [1986] ECR 3021, [1987] 1 CMLR 118.
[78] See R.J. Goebel, "Metro II's Confirmation Of The Selective Distribution Rules: Is This The End Of The Road?", (1987) 24 *CML Rev* 605.
[79] Case 75/84, note 77 above, 3083-3084.
[80] Ibid 3084.

considered "... in the special situation in which the relevant market was already so rigid and structured that the element of competition inherent in 'simple' systems (was) not sufficient to maintain workable competition".[81] On the facts, Metro had failed to establish this. SABA and the Commission provided evidence to indicate that structural price rigidity did not exist. The Court rejected, therefore, Metro's submission.

In its second submission Metro contended that self service wholesalers were unable to obtain supplies from leading manufacturers of electronic equipment, ostensibly on the ground that they failed to satisfy network admission criteria. They were, therefore, eliminated from the competitive process. The Court accepted the Commission's arguments. Metro had only been excluded from three simple systems and four systems entailing other obligations. It was still possible for Metro and others to obtain supplies elsewhere.[82] The Court dismissed Metro's application.

The Court of Justice, in the case of selective distribution, is prepared to accept that maintaining certain pricing levels is inherent in the system. It is equally apparent that the Court accepted free rider arguments as justification. However, the free rider justifications for the imposition of RPM has its limitations. It pertains, in the main, to pre-sale services and applies to a limited number of products. Indeed, manufacturers can induce service provision by other means. Dealers can be contractually obliged to provide services and reimbursed accordingly. Above all, the use of RPM to induce service provision may simply serve the sectional interests of unknowledgeable consumers whilst leaving knowledgeable consumers to pay for services they do not require. If the latter

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[81] Ibid 3085.
[82] Ibid 3089.

exceed the former numerically, the interests of the majority of consumers are not furthered.

In January 1986 the Court of Justice considered franchise agreements in the case of *Pronuptia de Paris v Schillgalis.*[83] Here Pronuptia, a French franchisor, operated a network in Germany for the retail sale of wedding dresses and other related apparel. Its German franchisee, Irmgard Schillgalis, failed to make certain royalty payments and Pronuptia took legal action to recover the amount due. Schillgalis claimed that the franchise agreement was void under Article 81(2) (ex 85(2)) and her argument succeeded before the Frankfurt Court of Appeals (Oberlandesgericht). She appealed to the German Supreme Court (Bundesgerichtshof) and it referred certain questions to the Court of Justice by way of the preliminary reference procedure.

With reference to the issue of RPM Advocate General Verloren Van Themaat took a rather relaxed view. He noted, firstly, that royalty provisions included in these agreements resulted in a strong upward influence on prices. RPM, therefore, should not fall within the parameters of Article 81(1) (ex 85(1)) unless a party is in a position of economic strength on the local market or competitors of the franchisor impose RPM or the franchisor is in a position of price leader on the market concerned.[84]

Although the Court's ruling is favourable to franchising generally, it took a more severe view of RPM. It stated that clauses which prevented price competition would implicate Article 81 (ex 85). The Court, however, emphasised that price recommendation was

[83] Case 161/84 [1986] ECR 353, [1986] 1 CMLR 414.
[84] Ibid 369-70.

permissible provided attempts were not made to directly or indirectly enforce the recommendation. This amounted to unilateral action not within the reach of the requisite Article.[85] The Commission has also required the removal of clauses imposing RPM on franchisees emphasising that such restraints are unacceptable.[86]

B. Sectoral Resale Price Maintenance

The Community authorities have also considered whether certain sectors, because of their specific nature, necessitate the imposition of RPM. In this context publishing has been subjected to scrutiny.[87] In 1985 in the case *of Binon v Agence Et Messageries de la Presse (AMP)*[88], Binon, a Belgian seller of books, stationery and office equipment, sought to expand its operations by selling newspapers and periodicals. AMP and various other publishers refused it admission into its selective distribution network. It, therefore, applied to the Belgian Tribunal de Commerce for an order to the effect that AMP acted in breach of domestic rules on fair competition and the European rules on competition. The Belgian Tribunal referred several questions to the Court of Justice, in particular, whether the imposition of fixed prices by AMP was lawful. AMP and the Federal Republic of Germany, as intervener, emphasised the importance of a free and autonomous press. In this context, they noted that the special characteristics of newspapers and periodicals meant that their shelf life was short and they required, therefore, rapid distribution. Substantial copies had to be made available to cater for an uncertain demand. Inevitably

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[85] Ibid 384.

[86] Comm. Dec. 87/17 *Pronuptia* OJ 1987 L13/39, [1989] 4 CMLR 355 para 12; Comm. Dec. 87/14 *Yves Rocher* OJ 1987 L8/49, [1988] 4 CMLR 592 para 63; Comm. Dec. 87/407 *Computerland* OJ 1987 L222/12, [1989] 4 CMLR 259 para 33; Comm. Dec. 88/604 *ServiceMaster* OJ 1988 L332/38, [1989] 4 CMLR 581 para 20; Comm. Dec. 89/94 *Charles Jourdan* OJ 1989 L35/31, [1989] 4 CMLR 591 para 29.

[87] S.B. Hornsby, "Public and Private Resale Price Maintenance Systems in the Publishing Sector: The Need For Equal Treatment In European Law", (1985) *10 EL Rev* 381.

[88] Case 243/83 [1985] ECR 2015, [1985] 3 CMLR 800.

copies remained unsold and had to be returned to the publisher incurring dual transportation costs and retailer rebates. Publishers should remain free, they argued, to fix prices in order to cater for these special circumstances.[89] The Commission accepted most of these arguments but refused to accept the necessity for RPM. The Court of Justice agreed with this. It stressed, however, that the Commission should take into account these special characteristics in deciding whether to grant an exemption under Article 81(3) (ex 85(3)). The Court observed that RPM may be acceptable in this sector if two conditions were satisfied: firstly, the imposition of resale prices was the only way by which publishers could bear the cost of taking back unsold copies and secondly, the taking back of unsold copies was the only means of ensuring that consumers received a wide range of newspapers and periodicals.[90]

The Community authorities have also considered the issue of book publication and RPM. In the *Dutch Books* case[91] the Court of Justice examined a transnational agreement concluded in 1949 between Dutch and Flemish associations in the publishing sector. The agreement introduced a system of collective RPM. Members of each association were obliged to fix a price for each format in which each of its titles appeared. Once fixed the books could not be sold in the Netherlands or Belgium at a lower price. To enforce the agreement a system of collective exclusive dealing was introduced. Only official dealers, recognised as such by the respective Associations, could be appointed as distributors. The latter could not sell, stock or promote books supplied by non-recognised publishers or resellers. Both Associations notified their respective agreements and the Commission concluded they were ineligible for exemption. The system prevented intrabrand price

[89] Ibid 2045.
[90] Ibid 2046.
[91] Cases 43, 63/82 *VBVB and VBBB v Commission* [1984] ECR 19, [1985] 1 CMLR 27.

competition which hindered market integration. Booksellers were unable to increase their market shares through the creation of efficiencies or reduction in prices. The lack of price competition also diminished the incentive to rationalise or improve the distributive process. Furthermore, the system of cross-subsidisation meant that the majority of consumers were contributing to the cost of maintaining less popular works aimed at a more specialist market. Its abolition would not result in the diversion of sales away from traditional outlets to those pursuing cash and carry marketing strategies. The Commission also rejected the notion that the system was designed to preserve cultural identity.[92]

In February 1982 the two associations appealed to the Court of Justice seeking annulment of the Commission's decision. They contended, firstly, that the abolition of RPM would result in indirect censorship by reducing the diversity of available books. This jeopardised freedom of expression and was contrary to the Convention for the Protection of Human Rights. The Court rejected this because the applicants failed to establish any link between the decision of the Commission and the Convention.[93] Secondly, the Court also rejected the argument relating to loss leading. The fact RPM may have incidentally prevented unfair competition was not sufficient reason for not applying Article 81(1) (ex 85 (1)) to a whole sector.[94] Thirdly, the two associations argued that price competition was not the essential element in competition in the book trade. Factors such as stock diversity, efficiency in processing orders and customer advice and service were of importance. The Court rejected this approach. The system set up by the two associations simply deprived distributors of their freedom to set prices.[95] Fourthly, the applicants' contended that their system of price maintenance had no prejudicial effect on intra-

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[92] Ibid 67.
[93] Ibid 62.
[94] Ibid 63.
[95] Ibid 64-66.

Community trade. The region to be taken into account was the Dutch language territory common to Belgium and the Netherlands and not the political territories of the two Member States. In rejecting this argument the Court stated that the agreement indisputably affected trade between two Member States notwithstanding the linguistic links between them.[96] Finally, the two associations contended that RPM in relation to books was permitted either by national legislation or the judicial practice of all Member States and the Commission was bound to accept this when formulating policy. The Commission rejected this and stated that it intended to ensure that intermediate sellers and consumers retained the opportunity to buy at the most favourable prices. Where national systems prevented this, it had the right to intervene.[97] Advocate General Verloren Van Themaat accepted that it was not entirely clear whether purely national systems of RPM reinforced compartmentalisation on a national basis. Where, however, these systems impeded parallel imports he accepted that the possibility of Community action should not be ruled out, even if the maintenance of national systems became difficult or impossible.[98] The Court rejected the arguments of the applicants. However, it passed no judgment on national systems of RPM. Adopting a guarded attitude it side-stepped the issue by stressing that it was concerned with the compatibility of the associations transnational agreements with the rules on competition. In dismissing the appeal it stated that the Commission had not exceeded the limits of its discretion in refusing to grant an exemption. The Commission had simply rejected arguments in relation to the advantages of cross-subsidisation. The Court, however, passed no comment on these alleged advantages as they could be "... conclusively appraised only in terms of the national arguments".[99]

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[96] Ibid 67.
[97] Ibid 46.
[98] Ibid 76-79.
[99] Ibid 66-70

In *Leclerc v Au Ble Vert*[100] the Court of Justice examined the French system of *public* RPM relating to the sale of books as introduced by the Book Price Act 1981, commonly known as the "Loi Lang". The legislation required all publishers to set a resale price for books they published or imported. Retailers were obliged to observe these prices although they were permitted to grant discounts up to 5 per cent. Greater discounts were available to institutional purchasers. The Act applied to all publications including domestic publications sold abroad and reimported into France. Centres Leclerc, a member of the Edouard Leclerc network, offered books for sale at discounted prices in excess of the maximum permissible allowance. Legal action ensued and Leclerc was enjoined from selling books at discounts greater than the stipulated limits. It appealed to the Cour d'Appel, Poitiers and questions were asked of the Court of Justice by way of preliminary reference.

Disagreement existed as to the appropriate legal rules to be applied. Leclerc contended that the Loi Lang did not introduce State price controls. It merely introduced rules restricting price competition because publishers and importers were free to set their own prices. The rules relating to competition and the free movement of goods (Article 28 [ex 30) EC) were applicable.[101] The French Government disagreed. The rules on competition applied only to private undertakings. The only potentially relevant Treaty provision was that of Article 28 (ex 30) EC which prohibits quantitative restrictions on imports and all measures having equivalent effect.[102] In the view of the French Government this provision had not been infringed. It made a number of observations. Firstly, each Member State retained the freedom to enact rules governing its own internal trade. It had

[100] Case 229/83 [1985] ECR 1, [1985] 2 CMLR 286.
[101] Ibid 30.
[102] Ibid 31.

enacted this legislation to protect books as a cultural media from the adverse effects of untrammelled competition in retail prices. The legislation ensured the survival of the specialist bookseller, in the face of competition from others pursuing a policy of reduced margins and limited title ranges. This ensured the continued availability of poetic, scientific and creative works. Secondly, the legislation applied equally to domestic and imported books. The fact that the main importer was obliged to set the book prices did not amount to a barrier to trade. It was simply performing the same commercial function as French publishers. Without this protection retailers, especially in border areas, could obtain foreign supplies of books and sell them in France at less than the prevailing price. The provision relating to the reimportation of books was necessary to preserve the structural integrity of the system. Without it "illusory" intra-Community trade could take place designed merely to defeat the Act.[103] Finally, the French Government argued that the two provisions at issue could be justified under the mandatory requirements *of Cassis de Dijon*.[104]

In the view of the Commission the rules relating to the free movement of goods were apposite. It stated that the provisions in the French legislation which set prices for imported and reimported books constituted measures equivalent in effect to quantitative restrictions on import. They rendered it impossible for importers to charge lower prices and hindered them from using price competition as a means of penetrating the French market. Article 28 (ex 30) was infringed and justification could not be found under the finite list of Article 34 (ex 36).[105]

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[103] Ibid 34.
[104] Case 120/78 *Rewe-Zentrale v Bundesmonopolverwaltung fur Branntwein* [1979] ECR 649, [1979] 3 CMLR 494.
[105] Case 229/83, note 100 above, 33-34.

Advocate General Darmon took the view that the French legislation did not constitute a barrier to intra-Community trade. Article 28 (ex 30) was not applicable. As far as foreign imported books were concerned, he accepted that theoretically the Loi Lang, by debarring retailers from granting discounts in excess of 5 per cent, might impact upon trade. This risk, in his view, had to be seen in context. Foreign publishers still retained power to negotiate prices with the main importer. Advantage could still be taken of favourable exchange rates and the lower costs of foreign banks. In fact, trade figures indicated that foreign imports had actually increased since the introduction of the 1981 Act. With regard, however, to the reimportation of books published in France the Advocate General made a distinction between "normal" commercial transactions which should qualify for Community protection and "artificial" trade flows designed to evade the requirement of French legislation. In his view the French legislation did not prevent French retailers from procuring French books more cheaply abroad. In fact, they had every incentive to do so. They could increase their own margins and use their increased profits to purchase products other than books or second-hand books not covered by the legislation. The Advocate General's main concern was that the obligation placed on the main importer could place it in a dominant position which if abused could be capable of affecting intra-Community trade.[106]

The Court stated that the Commission had publicly announced its intention to investigate national and private RPM but that it had failed to bring its investigations to a conclusion or to adopt a common policy. It stated that no exact precedents existed in the Court's previous judgments. It concluded, however, that the relevant Treaty provision was that of Article 28 (ex 30). It recognised the right of the French Government to enact legislation

[106] Ibid 13-14.

imposing RPM on books published and sold in France. However, the provisions in the Act relating to the importation of foreign books and the reimportation of French books fell foul of Article 28 (ex 30) EC. With regard to imported books the Court found that by transferring the responsibility to fix resale prices to the main importer, operating at a different level in comparison with domestic publishers, the French law created separate rules for domestic and imported products liable to restrict intra-Community trade. With reference to reimported French books the Court concluded that the legislation discouraged the marketing of these books because it prevented the importer from passing on any cost savings to the final consumer. These indistinctly applicable rules also infringed Article 28(3). However, this would not be the case if it was established that the books were simply exported and reimported in order to defeat the provisions of the national legislation. The Court then rejected the French Government's invocation of the mandatory requirement of consumer protection as justifications for these provisions. The latter could only be justified under Article 34 (ex 36) and as consumer protection is not contained thereunder the French Government's justification could not be accepted.[107]

Three brief points should be made with regard to the *Leclerc* judgment. Firstly, it highlights the distinction between the rules on competition and those relating to the free movement of goods. Under the former the Court seems to have accepted a wide definition as to what constitutes imports to include reimportation.[108] In *Leclerc*, imports were defined to exclude reimportation designed specifically to defeat national legislation imposing RPM. Secondly, the Court's analysis seems to have blurred the distinction between distinctly and indistinctly applicable rules. It stated that both types of measures

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[107] Ibid 32-36.

[108] See, for example, Comm. Dec. 73/322 *Deutsche Philips GmbH* JO 1973 L293/40, 1973 CMLR D241.

could only be justified under Article 34 (ex 36) EC. Finally, as a result of the Court's ruling the French Government amended the 1981 Act. A sixth paragraph was introduced which provided that the Act would not apply to books imported from other Member States unless they were reimported French books which had not been marketed in another Member State.[109]

In 1995 the Court of Justice had the opportunity to examine the Net Book Agreements (NBA) of the UK. In 1973, after the UK's accession to the Community, the Publishers Association notified its agreements to the Commission. Under the NBA publishers remained free to select which of their publications were to be classified as "net books". Once classified publishers set a net price and resellers were obliged not to sell the title at less than the published net price. These arrangements applied to sales in Ireland and the UK and were monitored and enforced by the association.

It seems the Commission paid little attention to the notification until 1985 when it requested further information. In 1986 it initiated proceedings and adopted a final decision in 1988.[110] The Commission refused exemption because the system imposed collective price fixing. The imposition of RPM was not indispensable to the attainment of the associations stated objectives of preventing a decrease in the number of stockholding booksellers, a fall in sales, small print runs and rise in the price of books. The Commission ordered the association to bring the infringement to an end.

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[109] In Case 355/85 *Draincourt v Cognet* [1986] ECR 3231, [1987] 2 CMLR 51 - the Leclerc group unsuccessfully challenged this amendment on the basis of reverse discrimination

[110] Comm. Dec. 89/44 *Publishers Association – Net Book Agreements* OJ 1989 L22/12, [1989] 4 CMLR 825.

An appeal was made to the Court of First Instance.[111] The applicants` argued that the Commission was bound by the "principle of sound administration" to have regard to the judgments of the Restrictive Practices Court even if it was not bound by its ruling.[112] The British Court found, as a matter of fact, that the restrictions in the agreement were indispensable to the international and domestic book trade. The applicant argued that it had supplied the Commission with evidence to show that this situation had not changed.[113] The Court of First Instance rejected this. The national Court gave its ruling prior to the admission of the UK into the Community and did not express any view as regards the indispensability of the restrictions, within the Common Market. The Commission's decision could not be vitiated on the basis of inadequate reasoning. Placing reliance on the *Dutch Books* case the Court of First Instance stated that "... national judicial practices, even on the supposition that they are common to all Member States, cannot prevail in the application of the competition rules...".[114] Indeed, a system of RPM could not qualify for exemption simply because it produced beneficial effects inside a national market.

The Publishers Association in the case of *Publishers Association v Commission*[115] appealed to the Court of Justice submitting eight detailed pleas. The Court, however, felt able to identify the appellant's third, fourth and sixth pleas as central to its case. In essence, the Court of First Instance failed to take into account "... consequences of the existence of a single language area forming a single market for books in Ireland and the United Kingdom".[116] This prevented the Court below from conducting a sufficiently

[111] Case T-66/89 *Publishers Association v Commission* [1992] ECR II-1995, [1992] 5 CMLR 120.
[112] Ibid 2024.
[113] Ibid 2025-26.
[114] Ibid 2026.
[115] Case C-360/92P [1995] ECR I-23, [1995] 5 CMLR 33.
[116] Ibid 67.

detailed analysis of the Commission's assessment of indispensability. It simply held that because the Publishers Association was established in the UK market it could not rely on the advantages brought about by the NBA on the Irish market in order to justify the indispensability of the restrictions imposed.[117] The Court of Justice ruled that the finding of the Court of First Instance, in this respect, was vitiated by an error of law. There was nothing in the wording or spirit of Article 81(3) (ex 85(3) that required the benefit of an agreement to be felt only on the same territory as that in which the parties to the agreement were established. This interpretation was incompatible with the fundamental objectives of the Treaty and the very concepts of Common Market. The Court of Justice stated that the lower Court had also failed to indicate that it had considered whether the Association's arguments relating to the Restrictive Practices Court were correct. On there simple grounds the Court annulled the judgment of the Court of First Instance.

IV. CONCLUSION

The imposition of resale prices is condemned on both sides of the Atlantic. In the US its condemnation is of long standing. RPM simply restricts a dealer's ability to trade on the basis of price and its effects are similar to that of horizontal price fixing. For some this condemnation amounted to a great landmark; for other a travesty of justice. Mr Justice Holmes in the *Dr Miles* case[118], adopting a *laissez-faire* attitude in his dissenting judgment, could find no reason for interfering with the contractual freedom of manufacturers and dealers to set prices. Others argued for the Legitimacy of RPM on different grounds. Mr Justice Brandeis, although not sitting on the Supreme Court at the

[117] Ibid 68.
[118] 220 U.S. 373 (1911).

time of *Dr Miles*, took the view that RPM enabled small retailers to compete with larger multinationals. This, of course, provided the intellectual underpinnings of the Free Trade Movement comprised mainly, although not exclusively, of lobbying retailers. The repeal of the Fair Trade law, however, amounted to a rejection of the Brandeis view of RPM. In any event these laws suffered from two main disadvantages. Firstly, an unwillingness on the part of the manufacturer to engage in costly litigation to enforce their resale prices particularly against powerful purchasers. Secondly, the system of fair trade lacked structural integrity as a result of the refusal of a number of states to enact Fair Trade laws. Entrepreneurs used these "hold-out" states (eg Texas, Vermont, Washington DC) as business havens to set up mail order houses to allow consumers in Fair Trade States to "import" branded products at greatly reduced prices.[119] The *laissez-faire* attitude of Mr Justice Holmes has proved more enduring and is reflected in the many and repeated attacks on the current illegal status of RPM. So far, the Government and the judiciary have refused to accept economic justifications for the imposition of RPM. Not so, however, with regard to *maximum* vertical price fixing. The latter may advance consumer interest by preventing agreement to keep product prices high and prevent dealer price gorging.

RPM in the EU is also condemned. Private systems of RPM, whether individually or collectively enforced, fall within the parameters of Article 81(1) (ex 85(1)) and ineligible for exemption. They make it impossible for dealers to set their own retail prices by reference to their costs and commercial strategy. Prohibiting intrabrand price competition acts as a disincentive to innovate, rationalise and create efficiencies. Guaranteeing profit

[119] The legality of this practice was confirmed in *Bissell Carpet Sweeper v Masters Mail Order Co of Washington*, 240 F. 2d 684 (4th Cir. 1957) and *General Electric Co v Masters Mail Order Co of Washington*, 244 F. 2d 681 (2nd Cir. 1957).

margins may simply make horizontal collusion between manufacturers or distributors easier. Consumers also fail to benefit because of the inability of dealers to pass on cost savings or increased profitability in the form of price reductions. Justifications for the imposition of RPM relating to *inter alia* the need for cross-subsidisation, brand image protection and the preservation of cultural identity have all been rejected. Unlike the US the imposition of resale prices may also impact upon market unification by deflecting trade flows away from channels it would naturally have taken if prices were fixed freely. The imposition of resale prices, therefore, renders the block exemptions in relation to exclusive distribution, exclusive purchasing and franchising inapplicable.[120] Interestingly, Article 4 of Regulation 2790/1999[121] now seems to permit a supplier to impose maximum sale prices provided it does not amount to a fixed or minimum sale price as a result of pressure from, or incentives offered by, any of the parties. Finally, in both the US and the EU the recommendation of prices by a manufacturer does not fall foul of the antitrust laws. This unilateral action lacks the necessary bilateral quality necessary to implicate the laws of both systems. Manufacturers must, however, refrain from imposing indirect pressure to enforce their recommendation.

[120] See Recital 8 to Regulations Nos 1983/83 and 1984/83 and Recital 13 and Article 5(e) of Regulation 4087/88.
[121] OJ 1999 L336/21, [2000] 4 CMLR 398.

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TERRITORIAL ALLOCATION

I. INTRODUCTION

Manufacturers are generally engaged in profit maximisation. It is in their interests to keep the cost of distribution as low as possible. If their dealers charge excessive prices consumers may purchase another lower priced comparable product made by another manufacturer. The imposition of territorial restrictions, designed to protect dealers from intrabrand competition, seems contrary to the interests of manufacturers. Territorial allocation, however, serves a number of purposes. The following are merely suggestive and not exhaustive.

Prospective market entrants may use the lure of territorial allocation to attract dealers to market its product. If the latter are obliged to invest heavily in terms of time and finance, territorial allocation assist dealers to recoup their investment. On the other hand, established manufacturers may simply offer such protection as a means of attracting the most efficient and effective dealers. Alternatively, a manufacturer may feel the need to limit the number of its dealers because it is unable to efficiently supply or give appropriate support to a large network. In this regard territorial allocation may facilitate product planning, decrease sales costs, reduce credit risks and lead to the establishment of an appropriate number of dealers consonant with efficient distribution. Indeed, product quality may be preserved because product malfunction is more readily traceable to specific points of distribution. Finally, interorganisational problems, particularly those relating to the already familiar problem of intrabrand free riding, can be addressed.

In contrast, limiting intrabrand competition through territorial allocation may have detrimental effects. Intrabrand competitive activity provides dealers with the necessary stimulus to review the distributive process, innovate to improve performance and introduce new methods of distribution in an attempt to gain a competitive edge. Restricting intrabrand competition reduces these incentives. Where interbrand competition is weak, intrabrand competition may be the only real source of competitive rivalry on the market. Reducing this, may result in price stabilisation usually at uniformly high levels. Territorial allocation also makes side by side product price comparisons more difficult for consumers, particularly if the allotted territories are large. Indeed, consumers purchasing from exclusive distributors, for example, are compelled to accept resale prices which inevitably include costs relating to service provision, advertising and other marketing activities. Consumers with product awareness are paying for services they do not require. Territories, once allocated, tend to be viewed by dealers as property rights. When a manufacturer attempts to alter allocated areas, perhaps to improve distribution, it may be faced with unresponsive dealers. Finally, territorial allocation also gives rise to concerns over supplier and dealer cartels.

In the US territorial allocation was outlawed for many years. The Department of Justice (DOJ), without ever submitting its views to legal scrutiny, considered territorial allocation to be *per se* violative of S.1 Sherman Act 1890.[1] The DOJ

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[1] See Hearing on Automobile Marketing Legislation before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 84th Cong. 1st Sess 89 (1933).

reinforced its belief with the threat of criminal prosecutions. In consequence numerous US corporations entered consent decrees with the US Government agreeing to refrain from the use of territorial allocation. Over time, however, US authorities have come to accept the use of territorial allocation and the economic justifications underpinning its use. *Per se* illegality has now been supplanted by an approach based on the rule of reason.

Territorial allocation in the EU is viewed with greater suspicion. Unlike the fully integrated market of the US, the EU, which currently consists of 15 Member States, is striving to achieve unification. In pursuit of this goal EU authorities are hostile to any agreements which may undermine the process. Greater importance is attached to intrabrand competitive rivalry particularly cross border parallel trade. The latter is seen as a vehicle to promote the interpenetration of markets. It is important to stress, however, that territorial allocation is permitted within the context of Europe provided it is qualified and not absolute. These concerns are reflected in the Commission's annual Reports on Competition, the block exemptions and principles governing exclusive distribution, franchising and selective distribution as well as the decisions of the Commission and Community Courts.[2]

Part II of the following explores the development of the law of the US and the underlying reasons for its change of approach to territorial allocation. Part III examines the approach adopted to territorial allocation in the EU.

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[2] Regulation 1983/83 on exclusive distribution agreements (OJ 1983 L173/1); Regulation 1984/83 on exclusive purchasing agreements (OJ 1983 L173/1); Regulation 4087/88 on franchising agreements (OJ 1988 L359/46).

II. TERRITORIAL ALLOCATION IN THE US

A. From White Motor To Schwinn

Whilst vertical restrictions of this nature were by no means a new phenomenon in the world of business, it was not until 1963 that the Supreme Court first considered limitations of this nature. In the case of *White Motor Co v US*[3] the Supreme Court subjected the views of the Department of Justice to legal enquiry. The White Motor Company (White) was engaged in the manufacture of trucks, parts and accessories. Its products reached the market via a two-tier system of distribution involving both wholesalers and retailers. The principal practices charged as section 1 Sherman Act violations were White's use of territorial limitation and customer allocation clauses. The territorial limitation clauses ensured that distributors could only sell vehicles to individuals, firms or corporations having a place of business and/or purchasing headquarters within their own allotted territories. The customer clause prevented distributors from selling trucks or parts to specified customers including the Federal or State Government. White reserved the right to sell directly to these important customers.

Before the District Court, White asserted that these restraints were imposed for procompetitive reasons. Essentially, they were implemented to promote and increase the sales of White's vehicles in the face of powerful competition. The object of the territorial limitation clause, White asserted, was to enable dealers to cultivate their own allotted area. In order to do so, they needed protection from other dealers selling

[3] 372 U.S. 253 (1963).

the same product. Such protection ultimately prevented cut throat price competition and allowed efforts to be concentrated on taking sales away from competing manufacturers. Intrabrand competition was thereby reduced and interbrand competition stimulated. With regard to the customer clauses, White asserted, they were justifiable for a number of reasons. Until its distributors received sufficient technical training, White contended, they were not qualified to cope with the reserved accounts. Additionally, White argued that it reserved these accounts to ensure that its important customers received the appropriate discounts. Thus preventing them from becoming disgruntled or dissatisfied. In any event, White believed that it had legitimate reasons to ensure that its distributors did not tarnish its business reputation by faulty promotional work or faulty servicing. The District Court, however, accepted the Government's contentions. It found that these restrictions resembled two traditionally outlawed forms of restraint namely horizontal market division and resale price maintenance. Judicial aversion to these types of restraint had been long standing.[4] The territorial and customer allocation clauses should therefore be governed by the same absolute test of *per se* illegality. The District Court entered summary judgment in favour of the Government and enjoined White from enforcing its territorial and customer clauses. White, refusing to be beaten, appealed to the Supreme Court.

The judgment of the Supreme Court was delivered by Mr Justice Douglas and it concluded that summary judgment was improperly employed. The Supreme Court, however, was not prepared to equate these challenged vertical restraints with horizontal agreements to divide and allocate territories and customers. The latter were

[4] See, *Timken Roller Bearing Co v US*, 341 U.S. 593 (1951); *Dr Miles Medical Co v John D Park and Sons*, 220 U.S. 373 (1911).

simply "... naked restraints of trade with no purpose except (the) stifling of competition".[5] Nor was the Supreme Court prepared to say whether such restraints were to be considered as illegal *per se* or tested under the rule of reason. The exact holding of the Court was that the legality of such restraints could only be determined after a proper trial. It adopted an agnostic approach and stated

> "This is the first case involving a territorial restriction in a *vertical* arrangement; and we know too little of the actual impact of both that restriction and the one respecting customers to reach a conclusion on the bare bones of the documentary evidence before us".[6]

As if to reinforce the point, Mr Justice Douglas, stated further

> "We do 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'. We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a 'pernicious effect on competition and lack any redeeming virtue' (Northern Pac. R v US 356 U.S. 1) and therefore should be classified as *per se* violations of the Sherman Act".[7]

[5] 372 U.S. at 263.
[6] Ibid at 261.
[7] Ibid at 263.

As a result, the summary judgment of the lower Court was reversed and the matter remanded to the District Court for trial.

The diverse ideological perspectives of the Justices with regard to these restraints was revealed in the differing approaches enunciated in White's concurring and dissenting judgments. Mr Justice Brennan in his separate concurring opinion commented on those factors which he considered the District Court should consider on remand. In terms of economics, he suggested that vertically imposed territorial restraints may be justifiable because they foster interbrand competition by limiting intrabrand competition. Furthermore, if a manufacturer is not vertically integrated into distribution, these restraints may be necessary to enable it to acquire and retain outlets for its products. This is, particularly the case, if the manufacturer is just starting out in business or manufacturing a new and risky product. Additionally, this type of restraint may, in Mr Justice Brennan's view, be necessary to ensure that the product is properly advertised, promoted and serviced. However, economic justification, according to Mr Justice Brennan, was not of itself sufficient. He would take the analysis a stage further. Enquiry should be made to determine whether the restraint is more restrictive than necessary or excessively anticompetitive. As such, the operational and practical effects of the restraint must be considered. Specifically one must consider the sanctions imposed on distributors who act in breach of their agreements. If, for example, a distributor acts in breach of its territorial agreements, is its franchise terminated? If so, intrabrand competition across territorial boundaries involves serious hazards which might deter competitive activity. If, however, the raiding distributor is obliged only to "pass over" any profit to its neighbour, the territorial limitation is relatively benign. In addition to considerations of the operational and practical effects of the restraint the Court should also consider whether less restrictive alternatives are available. [8] This may include *inter alia* assigning areas of primary responsibility or granting exclusive franchises. Having considered all these ramifications if the restraint is more likely to promote rather than subvert competition it is, in Mr Justice Brennan's view, justifiable.

With regard to the customer restrictions, Mr Justice Brennan took the view that they were inherently more dangerous than vertical territorial restrictions. They were, therefore, more difficult to justify. He stated

> "(t)he crucial question for 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 justifications ... their invalidity would seem apparent".[9]

In Mr Justice Brennan's view this form of restraint seems to suppress all competition between manufacturers and distributors for the most prestigious accounts. Moreover, they lack "... any of the countervailing tendencies to foster competition between brands which may accompany the territorial limitations".[10] Manufacturers may, therefore, use such restraints to protect a non-competitive pricing policy. Mr Justice Brennan suspected the Government might prevail on this issue unless it could be shown that the distributor could not have competed in any event.

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[8] Ibid at 269-271.
[9] Ibid at 272-273.
[10] Ibid.

The majority's agnostic approach was roundly condemned by the dissenting judgment of Chief Justice Warren, Justice Clark and Justice Black. The dissenting judgment was delivered by Justice Clark and embraced a different philosophical and ideological perspective. In his own words vertically imposed restrictions amounted "... to one of the most brazen violations of the Sherman Act that (he had) experienced in a quarter of a century".[11] The dissenters failed to see any material difference between horizontal and vertical restrictions which eliminate competition. White seems to place "... some halo around its agreement because they are vertical. But the intended and actual effect is the same as if not even more destructive than, a price-fixing agreement or any of its *per se* counterparts".[12] In the view of the dissenters, the use of such restraints may have been beneficial for White but if used generally they would have disastrous effects on free enterprise and ultimately undermine the effectiveness of the Sherman Act. Indeed, White's economic justifications, in the dissenters view, had no bearing on the legal issues. The promotion of interbrand competition was no justification for an explicit agreement to eliminate intrabrand competition. Any such agreement, no matter how beneficial, fell foul of the Sherman Act. On the basis of *Dr Miles*[13] the dissenters argued that White having sold its products at a price satisfactory to itself, could not deprive the consumer of any subsequent competition in the traffic of the product. Such restraints were illegal *per se*.

One of the perplexing contradictions of the *White Motor* case is the fact that there was a substantial body of US lower federal and state court precedents which upheld on a rule of reason basis, vertical restraints of this nature. It would seem the District Court in

[11] Ibid at 276.
[12] Ibid at 279.
[13] *Dr Miles Medical Co v John D Park and Sons Co*, 220 U.S. 373 (1911).

White Motor preferred to accept the Government's contentions as to *per se* illegality and the Supreme Court simply refused to apply the precedents of the lower courts. As early as 1903 the Eighth Circuit Court of Appeals in *Philips v Iola Portland Cement Co*[14] considered a case in which a cement manufacturer sold to Philips (a partner in Williams Parr & Co) 50,000 barrels of Portland cement. Philips agreed that the cement would not be shipped outside the state of Texas.[15] Under the contract 24,580 barrels of cement were accepted and paid for. William Parr & Co, however, refused to accept and pay for the remainder. The cement manufacturer sued Philips for breach of contract. Philips argued that the contract was illegal under the Sherman Act as it confined the geographical area in which the cement could be sold. Judge Sanborn stated that provided such arrangements did not restrict competition substantially, it was not the purpose of the Sherman Act to "... render illegal the ordinary contracts ... of manufacturers, merchants and traders, or the usual devices to which they resort to promote the success of their business, to enhance their trade and to make their occupation gainful".[16] In 1915 in *Cole Motor Car Co v Hurst*[17] the Fifth Circuit Court of Appeals found that an agreement between Cole Motor's and Hurst, its distributor, was a contract of agency and not one of sale. However, it stated generally that contracts containing territorial limitations were designed to "... foster the trade of the ... company and enhance its business to make secure its returns. This sort of arrangement is not obnoxious to the law".[18] In 1917 the Fifth Circuit Court of Appeals in *Tillar v Cole Motor Car Co*[19] stated that territorial limitations "... appear to be a reasonable

[14] 125 Fed. 593 (8th Cir. 1903).
[15] Ibid at 594.
[16] Ibid at 594-5.
[17] 228 Fed. 280 (5th Cir. 1915).
[18] Ibid at 283 - 284.
[19] 246 Fed. 831 (5th Cir. 1917). This case arose out of *Cole Motor Co v Hurst* 228 F. 280. Benjamin Tillar acted as guarantor for Hurst to the sum of £50,000 and appealed against the District Court's decision.

provision, almost essential to efficient marketing of the company's products".[20] In 1922 in *Lorillard Co v Weingarden*[21] the plaintiff corporation sought to enjoin Weingarden from selling a large quantity of inferior grade "Helmar" cigarettes to customers within the US in violation of an agreement between itself and the Volga Engineering Trading Company. Weingarden denied purchasing the cigarettes from Volga subject to any territorial or customer restrictions. However, the District Court was prepared, subject to conditions, to issue an injunction to enforce both restrictions. In the following year the Ninth Circuit Court of Appeals in *Fosbury v California & Hawaiin Sugar Refining Co*[22] stated that it was settled law that a "... trader or manufacturer engaged in private business ... may sell to whom he pleases, may charge different prices for the same article to different individuals and make such discrimination in his business as he chooses".[23]

The aforementioned cases are merely representative of a large body of US case law upholding such restraints.[24] Yet the Supreme Court's preferred route in *White Motor* was one of agnosticism. Within months of the *White Motor* decision, however, the Court of Appeals adopted a less diffident position. The Seventh Circuit Court of Appeals proffered a more definitive statement. In *Snap-On Tools Corp v FTC*[25] the Court of Appeals considered a tool manufacturer's nation-wide system of distribution. In 1950-51 Snap-On, a large manufacturer of mechanics hand tools and related equipment used primarily in the automotive and aircraft industries, ceased to use its

[20] Ibid at 832.
[21] 28 Fed. 238 (5th Cir. 1922).
[22] 291 Fed. 29 (9th Cir. 1923).
[23] Ibid at 36.
[24] See also, for example, *Boro Hall Corp. v General Motor's Corp*, 124 F. 2d 822, 823 (2nd Cir. 1942); *Reliable Volkswagen Sales & Service Co v World Wide Auto Corp.*, 182 F. Supp 412, 425-27 (D.N.J. 1960); *US v Newbury Mfg. Co.*, 125 F. 2d 453 (1st Cir. 1941).
[25] 321 F. 2d 825 (7th Cir. 1963).

own representatives to sell its equipment. It initiated a system of distribution through independent franchised dealers. These dealers purchased Snap-On's tools and resold the products out of mobile walk in trucks within defined geographical areas. Snap-On contended that the imposition of geographical limitations was necessary for various reasons. It contended, firstly, that the nature and complexity of the products was such that each distributor needed to establish and maintain a continuing relationship with its purchasers. Secondly, Snap-On asserted that unless it imposed such territorial limitation it could not attract and maintain dealers to service its purchasers to the standard and degree expected of them. Territorial restrictions were necessary, therefore, to protect its own interests as well as the interests of its dealers and customers.

The Hearing Examiner took the view that there was merit in the manufacturer's arguments and that the "... maintenance of exclusive territories (was) indispensable to the successful operation of its business".[26] If it were forced to abandon such a policy, confusion and chaos would ensue. After extensive hearings the Federal Trade Commission (FTC) took a different view. It suggested that there was nothing to prevent Snap-On from "... assigning areas of primary responsibility to its dealers and insisting that they provide adequate sales coverage and service within these territories".[27] The FTC seemed to take the position that vertically imposed territorial restraints were *per se* violative of S5 Federal Trade Commission Act 1914, simply because of its existence as a term in a contract between manufacturer and independent dealer. In any event the FTC ordered Snap-On to remove the restriction on its dealers. The matter was then appealed to the Seventh Circuit Court of Appeals. Here a

[26] Ibid at 832.
[27] Ibid at 832-833.

contrasting approach was taken. In its view certain benefits may accrue to a manufacturer imposing such a restraint. In the absence of horizontal dealer collusion such a restraint promotes "... in a broad, meaningful way competition between (Snap-On) and other manufacturers of similar products and which therefore justify a minimal curtailment of intrabrand competition among its dealers".[28] As Snap-On was not in a monopolistic position in relation to its competitors and as the restraint could not be used for abusive purposes, the legality of the restraint was to be determined by a rule of reason analysis. Evidently, agnosticism was not the preferred route of the Seventh Circuit Court of Appeals.

Shortly after this decision the Sixth Circuit Court of Appeals arrived at a similar conclusion in the 1964 case of *Sandura Co v FTC*.[29] This case involved a relatively small manufacturer of vinyl floor covering. Sandura Co, was competing with and rapidly losing ground to the "giants" of the floor covering industry. The Commission found that the corporation was involved in unfair methods of competition in violation of S5 Federal Trade Commission Act 1914, in that it engaged in price fixing and vertically imposed territorial restraints. Sandura immediately appealed the Commission's finding with regard to territorial restraints. It asserted that as a result of product failure it had experienced operating losses and its system of distribution had become demoralised.[30] In consequence it faced bankruptcy, suffered bad product reputation and even after it had corrected the defects in its products, it could not attract dealers to stock it. Faced with these difficulties Sandura resorted to "special inducements" to attract distributors. It offered exclusive territories to those distributors

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[28] Ibid at 833.
[29] 339 F. 2d 847 (6th Cir. 1964).
[30] Ibid at 851.

which would stock and sell the product. This inducement was all the more necessary because Sandura, as a result of a lack of money, required its distributors to pay for an expensive advertising campaign.

The FTC acknowledged that the imposition of "closed territories" may have been necessary initially to attract distributors. However, since product quality had been improved territorial restrictions were no longer necessary.[31] In fact, the Commission believed that the high cost of shipping floor covering actually prevented territorial invasion and limited intrabrand competition among Sandura's distributors. The FTC held that the territorial limitation was more restrictive than necessary particularly as less restrictive alternatives existed. It, therefore, issued a cease and desist order. In reviewing this decision the Sixth Circuit Court of Appeals rejected the notion that territorial limitation was illegal *per se*. These restrictions, in its view, were to be tested under a rule of reason analysis. The Court of Appeals recognised that in this instance, this was not a case of a powerful manufacturer employing methods to increase its share of the market. The imposition of these restraints were in the best interest of the consumer and distributor in that it ensured the continued economic health and competitive existence of Sandura. Without the restraint distributors would not have engaged either to distribute Sandran products or undertake expensive advertising if it were "... possible for one distributor to make the sales and take the profits promoted by another's advertising".[32] The only conclusion to be drawn was that the elimination of these closed territorial arrangements would impair rather than foster competition.

[31] Ibid at 855.
[32] Ibid at 850-852.

The situation with regard to customer and territorial restraints, to say the least, was contradictory and confusing. The Supreme Court refused to make any pronouncement as to the method of treatment or legality of such restraints; the Courts of Appeals, at least as far as territorial restraints were concerned, advocating a rule of reason analysis and the US government pushing for *per se* illegality. The government's push was further evidenced in the 1967 case of *US v Sealy Inc.*[33] Here the appellee, Sealy Inc, had been engaged in the business of licensing bedding manufacturers to make and sell these products under the Sealy name and trademarks in mutually exclusive territories. The District Court found Sealy's price fixing activities violative of the Sherman Act. However, the Court concluded that it was neither Sealy's nor its distributors intention to divide the US into territories where competitors could not compete. The District Court held that the government had not proved its case. It, therefore appealed directly to the Supreme Court.

Before the Supreme Court both the appellant and appellee focused their arguments upon the vertical nature of the arrangement. In contrast, the Supreme Court considered whether this particular arrangement was to be "... treated as the creature of the licensor, Sealy, or as the product of a horizontal arrangement among the licensees".[34] Looking to substance rather than form, the Supreme Court concluded that the day to day running of Sealy Inc was conducted by its 30 licensees. Sealy was merely a "front" created and used by the licensees to conceal their own horizontally collusive conduct.[35] Oddly, the Court did not condemn this horizontal agreement as a *per se* violation of the Sherman Act. It coupled the territorial limitation with that of price fixing and condemned them

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[33] 388 U.S. 350 (1967).
[34] Ibid at 352.
[35] Ibid at 353.

both as part of an "aggregation of trade restraints". By concluding that the restraint was not purely vertical the Court side-stepped consideration of vertically imposed territorial restraints. Justice Harlan, in his dissenting judgment was not nearly as evasive. In his view vertical restraints could have legitimate procompetitive justifications. A manufacturer may enhance its position in relation to its competitors by the use of these restraints. Territorial restraints should not be automatically unlawful. A rule of reason analysis should be applied.

The issues *Sealy* neatly side-stepped were met head on in its companion case of *US v Arnold, Schwinn & Co.*[36] Arnold, Schwinn & Co, was a family owned business engaged in the manufacture and sale of bicycles and accessories. In 1951 it was the largest manufacturer of bicycles in the US with a market share of 22.5 per cent. By 1961 Schwinn's market share had dramatically fallen to 12.8 per cent although its profits had risen substantially. Studies of its system of distribution revealed it to be haphazard and inefficient. At one point, for example, it used as many as 15,000 retail outlets. Some of them proved to be inactive or ineffective in that sales methods and service provision failed to comport with Schwinn's policy of manufacturing and selling quality products. Expensive promotional and advertising campaigns were being unnecessarily wasted. Schwinn looked to revamp its distribution system. A franchising policy was adapted designed to assure quality and efficiency in distribution. Accordingly, Schwinn franchised about 5500 retailers chosen on the basis of credit risk, sales and service abilities.

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[36] 388 U.S. 365 (1967).

Schwinn adopted three principal marketing techniques. Firstly, it would sell its product directly to wholesalers. Secondly, products reached retailers via wholesalers or jobbers acting for Schwinn on an agency or consignment basis. Thirdly, Schwinn would deliver the product directly to approved retailers, invoice the wholesaler which took the order and pay it by way of commission - the so-called "Schwinn Plan". Schwinn's twenty-two wholesale distributors were each assigned specific territories and instructed to sell only within their own designated area and only to franchised Schwinn accounts. Schwinn was both "*firm and resolute*" in insisting upon observance of these restrictions. Failure to observe resulted in termination.[37]

The government brought a civil action in the District Court of Illinois alleging *per se* violations of the Sherman Act in relation to price fixing, territorial allocation and customer restrictions. In its view the distributors had actually agreed amongst themselves to impose these restrictions even though Schwinn had instigated the idea. This horizontal collusion was *per se* unlawful. The District Court refused to condemn the customer restrictions or the territorial limitations in the Schwinn plan and those sales made on an agency or consignment basis. The government appealed to the Supreme Court and abandoned its 20 year long insistence on *per se* violation in favour of analysis under the rule of reason.[38] In a twist of delicious irony, Mr Justice Fortas writing for a five-member majority opted for a *per se* approach. He stated quite emphatically that

> "Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with

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[37] Ibid at 372.
[38] Ibid at 368.

> whom an article may be traded after the manufacturer has parted with dominion over it. ... Such restraints are so obviously destructive of competition that there mere existence is enough".[39]

Territorial and customer restrictions were branded illegal *per se* under the Sherman Act, if made incidental to an outright sale of the product. This conclusion was reached only four years after the cautious agnostic approach advocated by *White Motor*. In their part concurring and part dissenting judgment Justices Stewart and Harlan felt that the majority of the Court were unable to give any reason why the position adopted by the Supreme Court in *White Motor* should now be repudiated. Mr Justice Stewart stated

> "(s)urely, we have not in this short interim accumulated sufficient new experience or insight to justify embracing a rule automatically invalidating any vertical restraints in a distribution system based on sales to wholesalers and retailers. ... Indeed, the Court does not cite or discuss any new data that might support such a radical change in the law."[40]

The majority, however, felt its *per se* approach to be justified because the facts of the present case did not fall within the

> "... specific illustrations which the Court in *White Motor* articulated as possible factors relevant to a showing that the challenged vertical

[39] Ibid at 379.
[40] Ibid at 389.

restraint is sheltered by the rule of reason because it is not anticompetitive. Schwinn was not a newcomer, seeking to break into or stay in the bicycle business. It was not a 'failing company'. On the contrary ... it was the leading bicycle producer in the Nation".[41]

At this point it should be emphasised, however, that where a manufacturer retained title, dominion and risk in the product (a non-sale agency or consignment basis), the Court in *Schwinn* concluded that the restraint was to be analysed under the more flexible rule of reason. Mr Justice Fortas stated

> "... we are not prepared to introduce the inflexibility which a *per se* rule might bring if it were applied to prohibit all vertical restrictions of territory and all franchising, in the sense of designating specified distributors and retailers as the chosen instrument through which the manufacturer retaining ownership of the goods will distribute them to the public. Such a rule might severely hamper smaller enterprises resorting to reasonable methods of meeting the competition of giants and of merchandising through independent dealers, and it might accelerate the trend to vertical integration of the distribution process".[42]

[41] Ibid at 374.
[42] Ibid at 379-380.

The Supreme Court predicated this new distinction on the ancient rule against restraints on alienation.[43] That is, post sale restrictions cannot be imposed by a manufacturer on its distributors once it has parted with title, dominion and risk over the goods. In his dissenting judgment, Mr Justice Stewart referred to this rule as a "wooden and irrelevant formula".[44] It is also notable that this ancient rule was only fleetingly referred to in the *White Motor*[45] decision and only then by Justice Brennan to suggest that restraints on alienation did not mean that vertical restrictions should be illegal *per se* in every case.[46] In *Schwinn*, however, Mr Justice Stewart in his dissenting judgment roundly condemned the approach adopted by the Supreme Court. In his view, such a rule should not be adopted simply on the basis of antiquity. In any event, judicial views appropriate to a few centuries ago need not necessarily be appropriate to contemporary commercial policies. He stated quite emphatically that

> "Centuries ago, it could perhaps be assumed that a manufacturer had no legitimate interest in what happened to his product once he had sold them to a middleman and they had started their way down the channel of distribution. But this assumption no longer holds true in a day of sophisticated marketing policies, mass advertising and vertically integrated manufacturer - distributors".[47]

The decision in *Schwinn* represents a particular brand of antitrust. It represents a view of antitrust based on traditionalism or populism. According to this view, the interests of society are best served when the competitive process is atomistic in nature and not

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[43] Ibid at 380.
[44] Ibid at 394.
[45] 372 U.S. 253 (1963).
[46] Ibid at 265.
[47] 388 U.S. at 392.

comprised of a few fully integrated industrial giants. The *Schwinn* Court was concerned with keeping the channels of distribution open. Its object was to enable small independent entrepreneurs to make their own competitive decisions free from coercion and from the imposition of restraints by powerful manufacturers. According to this view antitrust serves social and political functions as well as those of economics.

The *Schwinn* decision was widely castigated by much scholarly and judicial criticism. In fact it spawned a veritable industry. Bork, for example, criticised the Court's underlying notion of competition. In *Schwinn*, Bork asserts, competition is defined as complete freedom of the outlet. In his view this notion is not keyed to consumer welfare; it is more akin to the destruction of contractual relations. In fact, Schwinn's distillation of modern antitrust policy into an ancient rule on alienation was not only wrong but verged on mere wittiness.[48] Martin Louis criticised the *Schwinn* judgment for reneging on the promise to eschew the use of *per se* rules until all the ramifications of these restraints could be investigated and fully understood.[49] A recurring criticism has been the Supreme Court's erroneous assumption that such an ancient rule on alienation ever existed. Indeed, Handler asserts that antitrust law as well as the common law analysed the legality of these restraints on a rule of reason basis. To simply apply this basis in a non-sale situation is to give "... priority to form over substance at the expense of justice".[50] For Baker, *Schwinn* was simply an exercise in "barren formulism". It had a "strange red-haired, bearded, one-eyed man-with-a-

[48] R.H. Bork, *The Antitrust Paradox* (Reprint, New York, 1993) pp. 282-285.
[49] M.B. Louis, "Vertical Distributional Restraints Under *Schwinn* and *Sylvania*: An Argument For the Continuing Use of A Partial Per Se Approach", (1976) 75 *Mich L Rev* 275, 276.
[50] M. Handler, "Twenty-Five Years of Antitrust (Twenty-Fifth Annual Antitrust Review)", (1973) 73 *Col L Rev* 415, 458-59.

limp" quality. It was both "artificial and unresponsive to the competitive needs of the real world".[51]

In spite of the wide ranging scholastic criticism of *Schwinn* some lower Federal and District Courts took the view that *Schwinn* had illuminated the way and they were bound to follow.[52] Others, however, refused to be bound. Judicial ingenuity was focused, therefore, on ways and means to limit or circumvent the logical rigors of *Schwinn*. In 1970 the Third Circuit Court of appeals turned *Schwinn* on its head in the case of *Tripoli Co Inc v Wella Corporation.*[53] Until the summer of 1967 Tripoli had acted as a wholesale distributor for the Wella Corporation. The latter manufactured a range of hair care products designed solely for use by the trade. Wella discovered that Tripoli sold these "professional use only products" (via its own retail outlets) directly to the public. As a result Wella stopped supplying Tripoli and the latter brought an antitrust action.

Before the District Court of Pennsylvania, Tripoli sought an injunction to require Wella to resume its supplies and damages under the Clayton and Robinson-Patman Acts. Wella, however, made application for summary judgment asserting that the termination of Tripoli was based on its failure to comply with credit terms and its violation of resale restrictions imposed on its products. Tripoli countered by alleging that under *Schwinn* such post sale restrictions were *per se* violative of the Sherman Act. The District Court, however, granted summary judgment in favour of Wella.

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[51] D.I. Baker, "Vertical Restraints In Times Of Change: From White to Schwinn To Where?", (1975) 44 *Antitrust LJ* 537.
[52] See, for example, *Eastex Aviation Inc v Sperry & Hutchinson Co.*, 367 F. Supp. 868 (E.D. Tex 1973); *Cook v Ralston Purina Co.*, 366 F. Supp. 999 (M.D. Ga. 1973); *Dobbins v Kawasaki Motor Corp.*, 362 F. Supp 54 (D. Ore 1973).
[53] 425 F. 2d 932 (3rd Cir. 1970).

On Appeal the Third Circuit Court of Appeals stated, on the basis of *Schwinn*, that it was unreasonable *without more* to impose post sale restrictions. However, on the facts of this case there *was more*. Here the restraints were imposed to protect the public against harm from products designed for professional use and to protect Wella from product liability claims. Restraints imposed for reasons of health and safety should, therefore, be tested under a rule of reason analysis. The Court of Appeals affirmed the decision of the lower Court and found the restraint reasonable.

Judicial dissatisfaction and antipathy towards *Schwinn* also surfaced in the 1973 case of *Williams v Independent News Inc.*[54] The facts of this case are rather tortuous. Very briefly, Magazine Management published a comic known as "Atlas" and used Independent News as its exclusive distributor. The latter used regional wholesalers to distribute the comic to retailers. Upon receipt of new issues, the old editions were returned by Independent News to Magazine Management. The latter either sold these copies abroad or sold them to Israel Waldheim on the understanding that his distribution would be confined to a premium basis. That is, they could be used in prizebags or as promotional gifts but not for the purpose of retail. In breach of this agreement Waldheim sold the comics to Williams who sold to retailers at discounted prices. As a result discounted old editions competed with full price current issues. Independent News requested that the publisher take action. Eventually it terminated Waldheim and Williams supply ceased. Williams brought an action for antitrust violations, alleging that as Independent News was without title, dominion and risk of loss it was a *per se* violation under *Schwinn* for it to control the destiny or impose conditions of resale on these old issues.

[54] 485 F. 2d 1099 (3rd Cir. 1973).

The District Court disagreed and the Court of Appeals affirmed. It stated that even though title, dominion and risk had passed from Independent News, it was still permissible for the latter to direct the publisher to ensure that those dealing in old editions restrict and confine their distribution channels to a premium basis rather than the retail market.

Further judicial confinement of *Schwinn* was evidenced in the case of *Scooper Dooper Inc v Kraftco Corp.*[55] Here the Third Circuit Court of Appeals expressly stated that where a legitimate business purpose existed (eg the preservation of work standards) the imposition of restraints by a manufacturer on its distributors may be lawful.

Perhaps one of the more spurious reasons for distinguishing *Schwinn* was provided by the Court of Appeals for the Second Circuit. In 1968 in the case of *Janel Sales Corp v Lanvin Parfums Inc*[56] the Court of Appeals held that a customer limitation clause, was not necessarily *per se* violative of the Sherman Act. The Court stated that the Supreme Court premised its finding of *per se* violation on the fact that Schwinn had been "firm and resolute" in enforcing its vertical restraints. This firmness and resolution was evidenced by the communicated danger of termination for those failing to observe the vertically imposed restrictions. In this particular case the Court of Appeals refused to condemn such clauses because of conflicting evidence in relation to the willingness of the manufacturer to enforce its restraint.

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[55] 494 F. 2d 840 (3rd Cir. 1974).
[56] 396 F. 2d 398 (2nd Cir. 1968).

This rather dubious distinction was also used by the Tenth Circuit Court of Appeals in the 1973 case of *Colorado Pump & Supply Co v Febco Inc.*[57] Here Febco Inc manufactured lawn and turf equipment which Thompson Pipe & Steel and Colorado Pump & Supply Co distributed. In January 1967 Febco and Thompson entered into an exclusive distribution agreement whereby Thompson agreed to distribute the product within a defined geographical area. Having concluded this agreement Febco refused to directly supply Colorado Pump. The latter, however, could still receive the product from Thompson, albeit at reduced rates of discount. Colorado's profits fell and it discontinued selling Febco's products. It then instituted proceedings against Febco alleging, on the basis of *Schwinn*, *per se* violations of the Sherman Act. The District Court held for Febco and Colorado appealed to the Tenth Circuit Court of Appeals.

Before the Court of Appeals Colorado Pump alleged once again that contractually agreed vertical limitation on products, title to which had passed from manufacturer to distributor, amounted to *per se* violation of the Sherman Act. In delivering the Court's decision, Judge Breitenstein stated that in *Schwinn* the Supreme Court commented on the need for firmness and resolution in the enforcement of the vertical restraint predicated upon the danger of termination.[58] The present case could, therefore, be distinguished in that Febco lacked the required firmness and resolution to enforce the restraint. Senior personnel from both Febco and Thompson gave oral evidence to the effect that Thompson was not prevented from selling Febco's products outside its allotted geographical area. The Court of Appeals concluded that these contractual provisions were no more than a "... description of a primary marketing

[57] 472 F. 2d 637 (10th Cir. 1973).
[58] Ibid at 639.

area and as such ... not a *per se* violation".[59] However, Judge Murrah in his part dissenting judgment stated emphatically that if the legality of these restraints depended on the firmness and resolution of enforcement *Schwinn* was a shambles.[60]

This sentiment, however, did not prevent the Sixth Circuit Court of Appeals from relying on the same justification to hold similar restraints lawful. In *Good Investment Promotions v Corning Glass Works*[61] Good Investment a trading stamp company, unilaterally expanded a promotional programme involving Corning's products into non-designated supermarkets. As a result Corning terminated its contact with Good Investment. The latter alleged antitrust violations stating that once Corning had sold the products it could not impose conditions restricting subsequent alienation. The District Court found *per se* violations of the antitrust laws and granted summary judgment in favour of Good Investments. The Court of Appeals reversed and remanded this judgement. It stated that the record was devoid of any information from which it may be determined that "... firm and resolute (insistence) upon observance of ... customer limitations was required by Corning, such as was the situation in *Schwinn*".[62]

B. Sylvania And Its Aftermath

It is apparent that *Schwinn* was the butt of much scholarly and judicial criticism. It is not surprising, therefore, that its reign lasted only ten years. Its demise was brought about by the 1977 Supreme Court decision of *Continental TV Inc v GTE Sylvania*

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59 Ibid.
60 Ibid at 642.
61 493 F. 2d 891 (6th Cir. 1974).
62 Ibid at 983.

Inc.[63] Sylvania, a corporate subsidiary of Telephone Electric, manufactured and sold radios and television sets via its Home Entertainment Products Division. During the so-called black and white television era, Sylvania together with other manufactuers engaged in a relatively unselective method of saturation distribution. It sold its product in volume to wholesalers without any constraints upon resale. Using this method of distribution Sylvania's market share fell to 1 or 2 per cent. In 1962, however, Sylvania in an attempt to phase out the wholesale aspect of its distribution process, implemented a programme of franchising dealers selectively by location. This, it was believed, would encourage the franchisees to actively promote Sylvania's product. To prevent territorial invasion Sylvania concluded *oral* agreements with its franchisees to the effect that its products could only be sold from specifically approved locations. Thus, should a franchisee relocate it needed Sylvania's specific approval to sell its products from the new location. Strictly speaking this location requirement is not the same as a vertically imposed territorial restraint. All franchisees were permitted, for example, to sell competing brands and to customers irrespective of their location. In terms of effect, however, the location clause had similar results. By 1965 Sylvania's market share increased to 5 per cent and it emerged as the United States eighth largest manufacturer and seller of colour television sets.

In May 1964 Continental TV Inc, became an authorised Sylvania dealer and was granted franchisees for several locations. As a result of its expansionist programme Continental soon became one of Sylvania's largest dealers operating from eight locations in California. A series of disputes arose after Sylvania authorised the

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[63] 433 U.S. 36 (1977).

opening of a new dealership near one of Continental's most profitable outlets. Continental responded by opening a new outlet in Sacremento and sold Sylvania's products from its new unauthorised location. Handy Andy was Sylvania's existing franchisee in Sacramento and it voiced its dissent. Accordingly, Sylvania terminated Continental's dealership. The latter brought suit charging that Sylvania's enforcement of the location clause was, on the basis of *Schwinn, a per se* violation of the Sherman Act.

The issue was tried in the District Court for Northern California before retired Supreme Court Justice Tom C. Clark.[64] He rejected Sylvania's contention that location and territorial clauses could be distinguished and that their legality should be determined by a rule of reason analysis.[65] He instructed the jury that should it find an agreement between the parties to confine location, such an arrangement is a *per se* violation of the Sherman Act. On this basis the jury found in favour of Continental and fixed damages in the sum of 591,505 dollars. The Court automatically tripled these damages and awarded costs in the sum of 275,000 dollars.

Sylvania appealed to the Ninth Circuit Court of Appeals. Sitting as a *Panel* it voted by a majority of 2 to 1 to affirm Justice Clark's *per se* instructions.[66] Sylvania petitioned for an *en banc* hearing. The petition was granted and the matter reargued. By a majority of 7 to 4, however, the *en banc* Court reversed and remanded to the

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[64] Mr Justice Clark, although on the Court, did not participate in the *Schwinn* decision. However, he formed part of the vociferous dissent in *White Motor*. He stated in that case that territorial confinement amounted to one of the most brazen violations of the Sherman Act.

[65] Traditionally, the legality of location clauses was determined under the rule of reason analysis. See, for example, *Boro Hall Corp v General Motors Corp.*, 124 F. 2d 822 (2nd Cir. 1942); *Salco Corp. v General Motors Corp.*, 517 F. 2d 567 (10th Cir. 1975); *Kaiser v General Motors Corp.*, 530 F. 2d 964 (3rd Cir. 1976).

[66] Judges Kilkenny and Skopil voted to affirm with Judge Ely dissenting. *GTE Sylvania v Continental TV Inc* 1974-1 Trade Cas (CCH) 65,072.

District Court with the instruction that the legality of the location clause was to be determined under a rule of reason analysis. It was the view of the Court of Appeals that a "... contrary holding would constitute an unwarranted body blow to legitimate business enterprise and would place our free capitalistic system under stifling restraints, never contemplated or intended by the Congress".[67]

The differing ideological perspectives of US antitrust is evidenced most graphically in the manner in which the Court of Appeals arrived at its decision. Judge Ely delivered the Court's decision. He rather disingenuously stated that the lower Court's *per se* instruction was erroneous in that it was based on a misinterpretation of *Schwinn*. This misinterpretation conflicted with existing law in relation to exclusive distribution and would ultimately "seriously undermine" the purpose of the Sherman Act.[68]

As the Court of Appeals was bound by the Supreme Court's ruling in *Schwinn* the only course of action opened to the majority was to distinguish the location clause before it from *Schwinn's* territorial confinement. In the words of Judge Ely, Sylvania "... imposed neither of the restrictions that *Schwinn* appropriately condemned".[69] For the majority the critical and obvious distinction was that "... Schwinn involved a restriction on the locations and types of permissible *vendors* while Sylvania only imposed restrictions on the permissible *locations of vendors*.[70] A mere statement of the obvious. More fundamentally Judge Ely stated that the *per se* holding of the trial judge was irreconcilable with the "veritable avalanche" of precedent holding exclusive dealerships lawful. An exclusive distribution agreement is worthless to both

[67] *GTE Sylvania Inc v Continental TV Inc.*, 537 F. 2d. 980, 988 (9th Cir. 1976).
[68] Ibid at 998.
[69] Ibid at 986.
[70] Ibid at 990.

manufacturer and distributor if it does not contain a location clause. Under the approach advocated by the District Court

> "... a manufacturer legally prevented from imposing or enforcing a location restriction could not lawfully prevent its franchisee from creating new outlets at any unauthorised location the franchisee might choose and distributing the franchiser's merchandise therefrom. In other words under the rule of *per se* illegality, *if a dealer is franchised anywhere he is franchised everywhere*".[71]

Judge Ely then proceeded to turn on its head the traditionalist or populist approach to antitrust and use it to his own advantage. He argued that a *per se* approach to location clauses may result in the growth of "giant franchisees" which may ultimately replace networks of small, local businesses; smaller manufacturers may suffer as a result of an inability to attract and maintain dealers and larger manufacturers may eliminate franchising by integrating vertically into distribution.[72] Ultimately free enterprise would suffer, monopoly would be promoted and consumers disadvantaged. The Court then gave recognition to the fact that there were differences of opinion as to the alleged procompetitive benefits of such restraints. Nevertheless, it recognised that procompetitive benefits could be derived from location clauses. They could be used to prevent free riding[73] and to create the orderly marketing of products. Judge Ely stated

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[71] Ibid at 998.
[72] Ibid at 999-1000.
[73] Ibid at 1002.

> "... the legislative intent underlying the Sherman Act had as its goal the promotion of consumer welfare, we decline briefly to condemn a business practice as illegal *per se* because it imposes a partial ... limitation on intrabrand competition, when there is a significant possibility that its overall effect is to promote competition between brands".[74]

Evidently, the consumer welfare perspective had impinged on judicial thinking.

Judge Kilkenny delivered the principal dissent. In a separate opinion, however, Judge Browning delivered a remarkably powerful, bold and forthright defence of the traditionalist approach to antitrust. He wasted no time and disagreed with the majority's contention that the *sole* goal of the Sherman Act was simply the promotion of consumer welfare. For him one of the objectives of the Sherman Act was to protect independent business entities. He stated

> "Congressional debates reflect a concern not only with the consumers interest in price, quality and quantity of goods and service, but also with society's interest in the protection of the independent business for reason of social and political as well as economic policy".[75]

Antitrust policy is to be viewed as an amalgam of social, political and economic elements. In support of this contention he quoted widely from academic works and

[74] Ibid at 1003.
[75] Ibid at 1019.

Supreme Court decisions.[76] His conclusion was that independent traders needed protection from the imposition of unnecessary restrictions. Having established an academic, legal and historic basis for his suppositions he moved on to consider the imposition of vertically imposed restraints. In Judge Browning's view the "naked transfer of title" in *Schwinn* was not a determinant fact. In his view, *Schwinn* was primarily concerned with drawing a line between those restraints imposed by a principal upon its agent and those imposed by one independent business entity upon another. In distinguishing between these two categories the Court had actually "located the boundary for the application of the *per se* rule in a way that (served) the Sherman Act's purpose of preserving the competitive freedom of independent businessman".[77] In any event, it was not an appropriate judicial function to weigh the loss of intrabrand competition against gains in interbrand competition to determine whether such restraints violate the Sherman Act. In Judge Browning's view, the Courts were ill-equipped to resolve these complex economic issues. To utilise a rule of reason analysis in such circumstances simply enabled the Court to ramble freely through the wilds of economic theory. A fruitless exercise which simply ended in guesswork. Issues of this nature should be determined by Congress as they are beyond the ordinary limits of judicial competence. Finally, Judge Browning simply dismissed as pure speculation the majority's contention that the nation's competitiveness would be disastrously effected if location clauses were held to be illegal *per se*. The minority considered *Schwinn* to be correctly decided and on this basis Sylvania's location clause should be held illegal.

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[76] Ibid at 1019-1022.
[77] Ibid at 1022.

The decision of the Court of Appeals is particularly illustrative of the diversity of ideological approach to antitrust. Not surprisingly, Continental TV, took the matter to the Supreme Court. Here the Supreme Court, for the first time in antitrust jurisprudence, overruled a prior Supreme Court decision. The Supreme Court's decision which Bork has referred to as "... one of the best in the modern career of antitrust"[78], is notable in many respects.

While Mr Justice White in his concurring judgment agreed with Judge Browning's populist interpretation of the Sherman Act, the majority of the Supreme Court failed to do so. In the view of the majority "(c)ompetitive economies have social and political as well as economic advantages ... but an antitrust policy divorced from market considerations would lack any objective benchmarks".[79] In this short sentence the Supreme Court made an ideological break with the past. American antitrust was to be refocused. No longer was its focus to include social and political concerns. These benchmarks lacked the necessary objectivity. The policy reformation was to focus on economics. Oddly, however, the Supreme Court failed to give any explanation as to why it was dispatching the traditionalist or populist approach to antitrust. What is more certain, however, is that Chicagoan influence had successfully infiltrated the Supreme Court.

In considering *Schwinn* Mr Justice Powell simply concluded that it was an abrupt and largely unexplained departure from the agnostic approach to vertical restraints evidenced in *White Motor*. Unlike the Court of Appeals the Supreme Court stated that it could not find a principled basis for distinguishing *Schwinn* from the present case.

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[78] R.H. Bork, note 48 above, 287.
[79] *Continental TV Inc v GTE Sylvania Inc* 433 U.S. 36, 53 (1977).

An emphatic rejection of the Court of Appeals approach. The Supreme Court also recognised that *Schwinn's* reliance on an ancient rule of alienation provoked scholarly criticism "... as both a misreading of legal history and a perversion of antitrust analysis"[80] as well as judicial ingenuity to limit and confine its extent. It concluded, therefore, that *Schwinn's* distinction between sale and non-sale transactions was not sufficient in itself to justify a *per se* approach. Thus, the question before the Court was whether the *per se* rule should be expanded to include non-sale transaction or abandoned for a rule of reason analysis. Justice Powell reviewed the distinction between the two approaches. He stated that *per se* rules are only appropriate in those circumstances were the practice or agreement has a pernicious effect on competition and lacks any redeeming virtues. While acknowledging that the market impact of vertical restrictions was complex, he recognised that they possessed the potential to stimulate interbrand competition. Such restraints, therefore, possessed redeeming virtues. Firstly, they may be used by manufacturers to attract and maintain distributors, especially if dealer investment is required. Secondly, manufacturers may impose these restraints to induce retailers to engage in promotional activities or to provide post sale service and repair functions. Here the Court specifically gave judicial recognition to the existence of market imperfection and the necessity for such restraints to be used to overcome the possibility of free riding. Finally, in addition to market efficiency justifications, these restraints may also be necessary for health and safety considerations.[81] The Supreme Court, therefore, overturned *Schwinn* and held that non-price vertical restraints should be subject to a rule of reason analysis. Furthermore, any departure from this standard must be based on economic effect rather than formalistic line drawing typified by *Schwinn*.

[80] Ibid at 53-54.
[81] Ibid at 55.

Since the Supreme Court's decision in *Sylvania* most Courts in the US have upheld the legality of territorial allocation under a rule of reason analysis. It should be stressed, however, that the *Sylvania* decision merely provided general direction as to the analytical approach to be adopted in the assessment of this type of restraint. Lower courts were left to refine its application and provide a detailed operational method. In order to prevent lengthy and costly litigation a truncated or "quick look" rule of reason, based on a market power filter, has been developed.

The antitrust plaintiff must show that the party imposing the restraint has market power. If this proves to be the case the burden of proof shifts to the Defendant to justify its imposition.[82] Where the plaintiff fails to show market power the situation is rather ambiguous. Some judgments indicate that the rule of reason involves a two step analysis. Firstly, a determination of market power and, secondly, an assessment of the procompetitive justifications for the implementation of the restraint.[83] Other Courts have simply taken the view that a failure to show market power invariably means that the defendant can show that the restraint has no anticompetitive effect. A failure to show market power, therefore, ends the analysis.[84] The use of such a threshold necessitates product and geographic market definitions. Most Courts have accepted market share as a proxy for market power and have acknowledged that these definitional issues are not a precise science. Where the party imposing the restraint has a market share of less than 20 per cent the restraint is usually upheld as legal.[85]

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[82] See *Illinois Corporate Travel v American Airlines*, 866 F. 2d 722, 729 (7th Cir. 1986); *Valley Liquors Inc v Reafield Importers Ltd* 822 F. 2d 656 (7th Cir. 1987).
[83] *Graphic Prods. Distribs. v Itek Corp.*, 717 F. 2d 1560 (11th Cir. 1983); *Davis-Watkins Co v Service Merchandise*, 686 F. 2d 1190, 1202 (6th Cir. 1982).
[84] *Assam Drug Co v Miller Brewing Co.* 798 F. 2d 311, 316 (8th Cir. 1986); *Murrow Furniture Galleries v Thomasville Furniture Indust.*, 889 F. 2d 524, 529 (4th Cir. 1989); O.S.C. Corp v Apple Computer, 792 F. 2d 1464, 1469 (9th Cir. 1986); *Jack Walters & Sons Corp v Morton Bldg Inc.*, 737 F. 2d 698, 702 (7th Cir. 1984).
[85] *Ryko Mfg. v Eden Servs*, 823 F. 2d 1215, (8th Cir. 1987).

Market share in excess of 50 per cent leads the Court to question the validity of the territorial restraint.[86]

III. TERRITORIAL ALLOCATION IN THE EU

A. Exclusive Distribution

Exclusive distribution arises when a manufacturer agrees to provide its dealer with a specific contract territory in which to concentrate its sales efforts. In such circumstances resellers invariably agree to enter exclusive purchasing obligations. Prior to the creation of a block exemption in this area, exclusive distribution agreements in Europe were exempted on an individual basis by the European Commission following notification. In the latter half of 1965 the Commission examined the notified agreements of three undertakings. In *Blondel's Agreement*[87] a Dutch manufacturer of cast iron household articles, DRU, appointed Blondel of Paris as its exclusive distributor for France. In *Edmond Isbeque*[88] a German manufacturer of agricultural machinery, Hummel appointed Edmond Isbeque as its exclusive distributor for Belgium. In *Maison Jallatte*[89] Hans Voss and Vandeputte acted as exclusive distributors for Germany and Belgium of Maison Jallatte, a French producer of safety shoes.

In each of these cases the Commission found that the notified agreements infringed Article 81(1) (ex 85(1)). The contractual arrangement, in all three cases, restricted the

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[86] *Graphic Prods Distrib v Itek Corp.*, 717 F. 2d 1560 (11th Cir. 1983)
[87] Comm. Dec. 65/366 JO 1965 2194/65, [1965] CMLR 180.
[88] Comm. Dec. 65/426 JO 1965 2581/65, [1965] CMLR 242.
[89] Comm. Dec. 66/5 JO 1966 37/66, [1966] CMLR DI.

freedom of the parties and the position of third parties was noticeably altered. Undertakings established on the respective markets, other than the exclusive distributor, could not acquire the contract goods.

The Commission, however, was prepared to grant exemptions in all three cases. It recognised that exclusive distribution could lead to improvements in product distribution. Manufacturers no longer needed to maintain a multiplicity of contracts with a large number of dealers. Concentrating distribution in the hands of a single dealer within a defined contact territory increased market awareness. Levels of production could, therefore, be adjusted to meet changing patterns of demand. Linguistic, legal and other differences which arise between country of production and that of distribution could more readily be overcome. Moreover, these arrangements also facilitated information exchange and technical help between the parties. Consumers also benefited because foreign products, adapted to meet their needs, were more readily available. The Commission also emphasised that exclusive distribution could increase product demand and lead to a better spreading of manufacturer's overheads. Consumers benefited from this as a result of better product pricing. In all three cases, however, the Commission emphasised that the dealer did not acquire absolute territorial protection. Parallel imports remained possible.

In the following year the Court of Justice considered three cases in this area, each of which raised interpretative issues relating to Article 81(1) (ex 85(1)) and exclusive distribution. In *Italy v Council and Commission*[90] the Italian Government brought an action for annulment of Council Regulation 19/65 which empowers the Commission

[90] Case 32/65 [1966] ECR 389, [1969] CMLR 39.

to draft block exemptions. In contended *inter alia* that Article 81(1) (ex 85(1)) applied only to horizontal agreements and Article 82 (ex 86) governed relation of a vertical nature. In rejecting these arguments the Court of Justice concluded that the Italian Government had made a distinction which the Treaty itself did not make. Both horizontal and vertical arrangements were susceptible to Article 81(1) (ex 85(1)). Exclusive Distribution, in particular, could implicate Article 81 (ex 85) because of the possibility that it might be used to restore national partitioning in trade between Member States.

In *Société Technique Minière v Maschinenbau Ulm GmbH*[91] the Court of Justice examined the distribution arrangements between Maschinenbau Ulm (MBU), a German manufacturer of heavy plant and machinery, and its distributor, Société Techinque Minière (STM). The latter agreed to purchase a specific quantity of earth moving equipment over a period of two years and to provide post sale repair and maintenance services. In return MBU appointed STM as its exclusive distributor for France. The agreement did not prevent parallel importation or exportation. STM was unable to sell the German equipment on the French market and its bills of exchange, payable to MBU, were not honoured. The latter, therefore, took successful action before the Tribunal de Commerce for contractual recession and damages. STM appealed to the Cour D'Appel, Paris which referred the matter to the Court of Justice. STM argued that exclusive distribution eliminated competition and simply guaranteed monopoly profits for dealers within their allotted territories. Furthermore, while these arrangements may not expressly restrict parallel imports its prohibition is a prerequisite of exclusive dealerships.[92] In contrast MBU contended that provided

[91] Case 56/65 [1966] ECR 235, [1966] 1 CMLR 357.
[92] Ibid 243-244.

interbrand competition existed exclusive distribution arrangements should not fall within the confines of Article 81(1) (ex 85(1)). On the facts, its agreement with STM related to a sector where interbrand competition was particularly intense. MBU also stressed that its arrangements did not curtail parallel exports or imports. In its view exclusive distribution assisted in opening new markets, helped SMEs to gain market footholds and enabled dealers to appropriate the benefits of their investments.[93]

The Commission adopted the stance that Article 81(1) (ex 85(1)) applied virtually automatically to these arrangements with the possibility of exemption under Article 81(3) (ex 85(3)).[94] The freedom of action of the respective parties was restricted and provided trade between Member States was affected appreciably Article 81(1) (ex 85(1)) applied. On the facts, the Commission felt this determination had to be made by the national Court. Advocate General Roemer also accepted that exclusive distribution could, in principle, fall within the parameters of Article 81(1) (ex 85(1)).[95]

In concluding that exclusive distribution did not by its nature infringe Article 81(1) (ex 85(1)) the Court of Justice enunciated a "two-step" analysis. Firstly, the object of the agreement had to be considered in the economic context in which it is intended to operate. Any interference with competition must stem from all or some of the clauses of the agreement itself.[96] Secondly, if a sufficiently deleterious effect on competition is not revealed by this examination, the consequences or effect of the agreement must then be considered. In this context special attention should be given to

[93] Ibid 241.
[94] Ibid 240.
[95] Ibid 260.
[96] Ibid 249.

> "... the nature and quantity ... of the products covered by the agreement, the position and importance of the grantor and concessionaire on the market for the products concerned, the isolated nature of the disputed agreement or ... its position in a series of arrangements, the severity of the clauses intended to protect the exclusive dealerships or alternatively the opportunities allowed for other commercial competitors in the same products by way of parallel re-exportation and importation".[97]

In this case the Court observed that there was an attempt by MBU to penetrate the market of another Member State. It doubted whether there was any interference with competition if the agreement was "really necessary" to achieve market penetration.

Shortly after the *STM* case the Court of Justice in the case of *Consten and Grundig v Commission*[98] reviewed the exclusive distribution arrangements of a German manufacturer of consumer electronic products. The facts are generally well known. In April 1957 Grundig appointed Consten as its sole distributor for France, the Saar and Corsica. Consten agreed not to handle competing goods or represent other undertakings. It also agreed to invest heavily in post sale services. In return Grundig agreed not to supply others in Consten's contract territory. This constituted one aspect of a system of territorial protection which also required other dealers to refrain from exporting or re-exporting the contract goods into Consten's contract territory. To provide further protection from parallel imports Consten was permitted to register

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[97] Ibid 250

[98] Cases 56, 58/64 [1966] ECR 299, [1966] CMLR 418.

the "GINT" trademark enabling it to sue for infringement in the event of parallel importation.

In 1960-61 French Quota restrictions on certain products (tape recorders, television sets and radios) were lifted. Realising that Grundig's products were considerably cheaper in Germany, UNEF of Paris and Leissner of Strasbourg, imported them into France. These imports were sold at prices which undercut those of Consten. The latter took legal action on the basis of trademark infringement and unfair competition. The Cour d'Appel, however, adjourned its proceedings once the Commission instigated its own investigations.

In September 1964 the Commission concluded that the Grundig - Consten agreement infringed Article 81(1) (ex 85(1)) and was ineligible for exemption.[99] The agreement infringed Article 81(1) (ex 85(1)) because it restricted the freedom of the respective parties. The Commission also attached importance to intrabrand competition because it provided consumers with real power of choice. Price differentials between official and parallel networks were immediately apparent. Parallel imports could be used, therefore, as a mechanism to bring about price convergence and market unification. In contrast, interbrand price comparisons did not allow the consumer to ascertain whether price differentials resulted from differences in production costs, production quality or the costs of distribution. The agreement, in effect, hindered or prevented market integration.

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[99] Ibid 304; see also Comm. Dec. 64/566 *Re The Agreement of Grundig Verkaufs GmbH* JO 1964 L2545/64, [1964] CMLR 489.

The Commission also refused exemption under Article 81(3) (ex 85(3)). Firstly, whilst the price of Grundig's products in France were falling, consumers still did not receive an equitable share in the resulting profits. Secondly, Consten did not need absolute territorial protection to exploit the French market. By ensuring that its profit margins equated roughly with those in other Member States the incentive to import on a parallel basis would diminish. Finally, the granting of absolute territorial protection was noxious to the realisation of market unification.

Consten and Grundig sought annulment of the Commission's Decision before the Court of Justice. For the most part the Court upheld the Commission's position. It rejected the applicant's contention and that of the Italian Government, intervening on their behalf, that Article 81(1) (ex 85(1)) applied only to horizontal agreements. Any agreement between producer and distributor "... which might tend to restore the national divisions between Member States might be such as to frustrate the most fundamental (objects) of the Community".[100] Article 81 (ex 85) applied, therefore, to vertical as well as horizontal arrangements. The Court upheld the importance attached by the Commission to intrabrand competition. It stated "(a)lthough competition between producers is generally more noticeable than that between distributors of products of the same make, it does not thereby follow that an agreement tending to restrict the latter kind of competition should escape the prohibition of Article 81(1) merely because it might increase the former".[101]

The Court then found the necessary restriction of competition in the agreement between Consten and Grundig to use French law to grant absolute territorial

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[100] Ibid 340.
[101] Ibid 342.

protection. No amount of economic data or arguments showing the favourable effects of exclusive distribution could lead to a different conclusion. The Court also rejected the applicants' submissions under Article 81(3) (ex 85(3)). Arguments that parallel imports added to commercial risk by making advance planning difficult did not justify special consideration. Risk is inherent in all commercial activity. The Court also rejected the submission that damage to Grundig's reputation might occur as a result of parallel trading. It was still open to the applicants to publicise the nature of their services and the benefits to be derived from using the official network for Grundig's products. In fact, UNEF actually provided a free guarantee and after sale service which did nothing to harm Grundig's reputation.[102]

At this point it is interesting to note the submissions of Advocate General Roemer. He was critical of the Commission's Decision and argued that it should be annulled and the matter referred back for fresh examination. He made reference to the American case of *White Motor* and concluded that American law required a wide examination of the economic repercussions of such restraints. It was not possible, in his view, to dispense with observing the market *in concreto*. An examination of this kind might lead to the conclusion that exclusive distribution is procompetitive and not necessarily within the parameters of Article 81(1) (ex 85(1)).[103]

In the *STM* case the Court of Justice concluded that exclusive distribution need not necessarily fall foul of the competition rules. In effect, a balance needed to be struck between the legal control of these agreements and product distribution. In *Consten and Grundig* the Court used the notion of absolute territorial to distinguish between

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[102] Ibid 349.
[103] Ibid 358.

the legal and illegal. Indeed, a similar approach was adopted in the case of *Maize Seeds*[104] where the Court made a distinction between open and closed licensing systems.

Shortly after these judgments the Court of Justice refined its analysis in the case of *Volk v Vervaecke.*[105] Here a German undertaking, Josef Erd and Co owned by Mr Volk, manufactured washing machines under the trade name Konstant. In September 1963 it appointed Vervaecke as its exclusive distributor for Belgium and Luxembourg. In return for purchasing a specific quantity of machines each month, Vervaecke was granted protection from intrabrand competition. In November 1964 Volk alleged that its exclusive distributor acted in breach of contract. Volk successfully took legal action before the landgericht. Vervaecke appealed to the Oberlandgericht arguing that the disputed provisions were void under Article 81 (ex 85) because they provided absolute territorial protection. The German Court referred the matter to the Court of Justice.

In submitting its observations the Commission noted that Josef Erd and Co had a market share of 0.08 per cent in the Common market and 0.2 per cent in the Federal Republic of Germany. Its total share of the Belgian and Luxemborg markets amounted to 0.6 per cent. In view of these small market shares the Commission concluded that even though absolute territorial protection was conferred upon the distributor it did not restrict competition appreciably.[106]

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[104] Case 258/78 *Nungesser v Commission* [1982] ECR 2015, [1983] 1 CMLR 278.
[105] Case 5/69 [1969] ECR 295, [1969] CMLR 273.
[106] Ibid 301.

The Advocate General adopted similar reasoning. In a very brief judgment the Court stressed that agreements which have an insignificant effect on the market, taking into account the weak position of the parties, fall outside the parameters of Article 81 (ex 85). This remained the case even if absolute territorial protection was afforded to the dealer.[107]

The Commission reacted quickly to the Court's judgment. In 1970 it introduced its Notice relating to Decisions and concerted practices of Minor Importance. Agreements between undertakings whose effects on competition and trade between Member States is not significant do not fall within Article 81(1) (ex 85(1)).[108]

In July 1983, Regulation 1983/83 came into force replacing Regulation 1967/67. This Regulation exempts exclusive distribution agreements, exhibiting certain characteristics, from the provisions of Article 81(1) (ex 85(1)).[109] The principles enunciated by the Commission and approved by the Court of Justice in *Consten and Grundig* formed the basis of the Regulation. Article 3 (c) and (d) provides that the benefits of the block exemption do not apply to agreements which confer absolute territorial protection. According to the Recitals to the Regulation competition at the level of distribution is ensured only if parallel imports remain possible.[110] The Regulation identifies two situations in which absolute territorial protection is conferred. Firstly, where users can only obtain the contract goods from the exclusive distributor with no alternative sources of supply outside the contract territory.[111] To

[107] Ibid 301-302.
[108] This Notice has been revised on a periodic basis. Its most recent revision is to be found at OJ 1997 C372/3, [1998] 4 CMLR 192.
[109] See Annex I.
[110] Recital 12.
[111] Article 3(c).

prevent this the parties must ensure that the contract goods are available from parallel importers or can be acquired outside the contract territory.[112] The supplier can represent an alternative source of supply provided it has not agreed not to supply others in the dealer's contract territory. Secondly, territorial protection is absolute if either party, jointly or unilaterally, impede parallel importation.

Relative or qualified territorial protection is conferred upon an exclusive distributor provided only those restrictions of competition envisaged in Article 1 and Article 2(1) are imposed upon the supplier. The distributor must remain free to respond to passive sales in accordance with Article 2(2)(c). Article 1 of the Regulation enables the supplier to supply goods to a distributor within a defined contract territory. According to Guideline 27, however, a supplier is not prevented from providing the contract goods to other resellers who then resell in the exclusive distributors contract territory. This is the case provided the "other resellers" request supply of the contract goods, the latter are handed over outside the exclusive dealers territory and the resellers bear the cost of transportation into the contract territory. These requirements are designed to ensure that the exclusive dealer is subject to competitive intrabrand pressures. Article 2(1) of the Regulation also enables the supplier to agree not to supply the contract goods to other users in the contract territory. This restriction is optional and, in any event, cannot be absolute. The supplier must remain free to supply the contract goods outside the contract territory to final users in the territory.[113]

An active sales restraint may be imposed on an exclusive distributor (Article 2(2)(c)). This may oblige a dealer to refrain from "seeking customers", establishing a branch

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[112] Guideline 31.
[113] Guideline 30.

office or maintaining a depot outside its contractual territory in relation to the contract goods. However, the distributor must remain free to respond to unsolicited requests for sales from other users or intermediaries outside its exclusive territory (passive sales).[114]

B. Territorial Allocation In Other Systems Of Distribution

Territorial allocation has so far been considered in the context of exclusive distribution. Economic analysis indicates that different types of vertical restraints serve the same purpose and may be used as substitutes for each other. Limiting the number of dealers in a selective distribution network, for example, has the same effect as granting territorial protection. This section focuses primarily on selective distribution and franchise agreements. It should be noted, however, in the case of exclusive purchasing agreements that any form of territorial allocation will render Regulation 1984/83 inapplicable. The exclusive purchaser is free of restrictions, therefore, as to the area over which it makes its sales efforts.

In systems of selective distribution provided network admission is based on objective, qualitative criteria applied uniformly and without discrimination, the agreement is not regarded as violating Article 81(1) ex 85(1)). Numerical or quantitative restrictions on dealer admission, which in effect controls spatial density and performs the same function as territorial allocation, is acceptable only in exceptional cases.

[114] Guideline 28.

In 1980 the Court of Justice in the *Guerlain*,[115] *Estee Lauder*[116] and *Lancome*[117] cases, collectively known as the "perfume cases", examined the selective distribution systems of certain perfume manufacturers. In *Guerlain* and *Estee Lauder* the French Courts were faced with criminal proceedings and claims for damages against manufacturers for their refusal to supply certain retail outlets contrary to French law. In both cases the manufacturer argued that their respective systems of selective distribution, which employed qualitative and quantitative network admission criteria, were in conformity with the European rules on competition. Both manufacturers had notified their agreements and received comfort letters from the Commission. The French Court referred the matter to the Court of Justice. In the *Lancome* case, Lancome of Paris and its Dutch subsidiary took action before the Dutch Courts to prohibit the sale of its perfumes at discounted prices by unauthorised stockists. The discount stores claimed, however, that the manufacturer's sales arrangements infringed the competition rules and the comfort letter received by the plaintiff did not preclude this adjudication. This matter was also referred to the Court of Justice.

The manufacturers' reliance upon the receipt of comfort letters proved fruitless. They simply amounted to administrative communications designed to inform the recipient that no further action was envisioned. With regard to network admission criteria the Court affirmed the principle that quantitative restriction would render such systems susceptible to the European rules on competition. In this regard the manufacturers' contentions that quantitative limitation was necessary to guarantee the earning power of authorised stockists to enable them to absorb the costs of advertising and the

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[115] Cases 253/78 1-3/79 *Procureur de la République v Giry and Guerlain* [1980] ECR 2327, [1981] 2 CMLR 99.
[116] Case 37/79 *Anne Marty SA v Estée Lauder SA* [1980] ECR 2481, [1981] 2 CMLR 143.
[117] Case 99/79 *SA Lancome v Etos BV and Albert Heyn Supermart BV* [1980] ECR 2511, [1981] 2 CMLR 164.

provision of customer services as well as preservation of brand image were rejected. Quantitative selection criteria is acceptable only by way of exception and only then, if close collaboration between supplier and dealer is necessary because of the nature of the product.[118]

In 1992 in the case of *Vichy v Commission*[119] the Court of First Instance reviewed the selective distribution system of another French perfume manufacturer. In July 1985 Vichy notified its distribution arrangements relating to the sale of cosmetic products through retail pharmacies. This notification lapsed as a result of a decision of the French Conseil de la Concurrence which required the manufacturer to modify its French system to ensure conformity with the European rules on competition.[120]

In August 1989 Vichy notified its modified French agreements and its unmodified European agreements. In January 1991 the Commission concluded that the latter violated Article 81(1) (ex 85(1)) and was ineligible for exemption.[121] Network admission was dependent upon the reseller being a retail chemist. This quantitative criteria restricted the number of potential resellers. Firstly, dispensing chemists needed to possess a diplomacy in pharmacy. Secondly, in a number of Member States the right of establishment was controlled on a quantitative basis by national rules linked to a certain number of inhabitants per point of sale and/or to a certain geographical distance between the retail outlets. The Commission went further and

[118] See Cases 253/78 1-3/79, note 115 above, 2387.
[119] Case T-19/91 [1992] ECR II-415.
[120] The French court arrived at this decision on 9 June 1987 (Decision No 87-D15) and was later upheld by the Paris Cour D'Appel (28 June 1988) and the Cour de Cassation (25 April 1989). Vichy was required to modify its agreements by (1) removing a clause under which resellers were prohibited from selling products to other approved resellers and (2) to discontinue the requirement that its distributors should have the status of dispensing chemist.
[121] Comm. Dec. 91/153 *Vichy* OJ 1991 L75/57.

concluded that even if sales through retail chemists could be deemed qualitative, the admission criteria was not proportional. It went beyond what was necessary to ensure quality control and proper product use. National and Community rules ensured that cosmetic products did not pose a risk to consumer's health.

The Commission simply rejected Vichy's arguments that sales through retail chemists contributed to product availability through large stock holdings or rapid establishment; assisted in the launch of new and innovative products; provided information feedback to manufacturers and provided an educative and advisory function to consumers. These alleged benefits could equally be achieved through sales outlets, other than pharmacies, by means of contractual obligations. In fact, the professional standards and ethics of chemists, in any event, curbed intrabrand competition. Finally, the Commission stressed that Vichy was unable to provide any justification for its dual system of distribution which resulted in market compartmentalisation.

In March 1991 Vichy appealed to the Court of First Instance seeking annulment of the Commission's Decision. In its view its network admission criteria was of a qualitative nature and any quantitative ceilings were attributable solely to the national provisions of the various Member States.[122] The Commission rejected this view. Vichy had deliberately opted for a system designed to limit the number of outlets. A producer who "... decided to distribute (its) products only at airports could not claim that (it) had no control over the number of sales outlets on the ground and that it was the competent authority that limited the number of airports."[123]

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[122] Case T-19/91, note 119 above, 434.
[123] Ibid 437.

The Court of First Instance agreed with the position of the Commission, provided a manufacturer is in some way associated with outlet limitations, it matters not that some degree of limitation can be attributed to legislation. Furthermore, the status of dispensing chemists was not necessary for the purpose of product distribution. The Court held that the Commission was correct to conclude that Vichy's admission criteria was quantitative and despite the existence of a clause designed to permit cross-supplies, was capable of reducing parallel trade. Because of the dual nature of the system an authorised reseller who might wish to acquire the contract goods from a reseller other than a dispensing chemist, was confined to imports from France. The Court also agreed with the Commission that the professional ethics of chemists reduced intrabrand competition and rejected arguments in relation to improved product distribution. In dismissing the appeal, the Court stressed that Vichy's own actions actually contradicted its own arguments. Vichy actually sold the same products, albeit under different brand names, through non-pharmaceutical channels.[124]

More recently the Court of First Instance in the cases of *Leclerc v Commission (Yves Saint Laurent)*[125] and *Leclerc v Commission (Givenchy)*[126] examined the lawfulness of the distribution networks of Yves Saint Laurent Parfums SA (YSL) and Parfums Givenchy SA (Givenchy). In July 1989 and March 1990 YSL and Givenchy notified their respective distribution agreements. The Commission raised several objections to both systems, especially in relation to the use of quantitative network admission. Oddly, both manufacturers employed remarkably similar admission procedures. In

[124] Ibid 442-454
[125] Case T-19/92 [1996] ECR II-1851.
[126] Case T-88/92 [1996] ECR II-1961.

France both competitors placed applications for admission to their respective networks on regional waiting lists. Admission depended upon the economic potential of the region in question, in particular, whether it was capable of sustaining another outlet. In other Member States the waiting list procedure was not followed. However, in both cases, admission was still subject to considerations of "economic opportuneness".

Following adverse comments from the Commission YSL and Givenchy amended their agreements to dispense with the use of quantitative limitations. In December 1990 and October 1991, the Commission stated that it intended to adopt a favourable position with regard to the modified systems of both undertakings. It invited comments from interested third parties. Edouard Leclerc (Galec), a French co-operative society and frequent litigator in matters of competition, submitted observations in January 1991 opposing the Commission's proposed decisions. The Commission required further contractual amendments and in December 1991 and August 1992 granted exemption to both systems.[127]

The Commission's Decisions set in motion a number of legal actions. Firstly, in March and October 1992 Galec applied to the Court of First Instance to have the Commission's Decision in Yves Saint Laurent (Case T-19/92) and Givenchy (Case T-88/92) annulled. Secondly, in October 1992 BVBA Kruidvat, the Belgian subsidiary of a Dutch chain of outlets selling health and beauty products, brought a similar action to have the Givenchy decision annulled.

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[127] Comm. Dec. 92/33 *Yves Saint Laurent Parfums* OJ 1992 L 12/24; Comm. Dec. 92/428 *Parfums Givenchy* OJ 1992 L 236/1.

With regard to Galec's action in relation to YSL and Givenchy, the Court of First Instance concluded it had *locus standi* under Article 230 (ex 173). Galec had approached both manufacturers to gain network admission and many of its members had brought legal action seeking admission. Galec had also participated in the administrative procedure by submitting observations. In many respects the situation was similar to that in *Metro I*[128] where the Court of Justice held that an operator which submitted observations during the administrative process was directly and individually concerned by a Commission Decision which upheld admission criteria which it had criticised.

The Court of First Instance reviewed the arguments of the respective parties. Galec contended that the degree of selectivity accepted by the Commission, in both cases, excluded some of its hypermarkets *a priori* from the respective networks. In exempting this criteria the Commission offended against the principle that quantitative restrictions are *prima facie* unlawful.[129]

Both YSL and Givenchy intervened in the respective actions. They rejected the argument that their admission criteria set numerical limits to their systems in order to control spatial density. Provided traders satisfied their objective qualitative criteria they were admitted. Both manufacturers pointed to the diverse compositions of their respective networks. They both agreed with the Commission that consumers attached importance to brand names and prestige and without the concept of selective distribution the concept of luxury products would disappear. In this respect they

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[128] Case 26/76 *Metro v Commission* [1977] ECR 1875, (1978) 2 CMLR 1.

[129] Case T-19/92, note 125 above, 1887; Case T-88/92, note 126 above, 1995.

referred to the market exit of Coty perfumes as a result of an inappropriate match between product quality and product distribution.[130]

The Commission also rejected the notion that the approved admission criteria excluded any form of modern trading *a priori*. It was patently objective and necessary to preserve product quality and proper product use. The Commission stressed that since the 1980s it had continually objected to the use of quantitative selection criteria in the perfume industry.[131] Its decisions, therefore, neither fixed the number of distributors nor endorsed a system based on numerical restriction. Interestingly, while the Commission received support from several organisations representing manufacturers and retailers, four French consumer associations did not unreservedly support its position. In their view, the Commission's approach could lead to the maintenance of excessively high consumer prices. Thus, preventing a significant population from gaining access to the products.[132]

The Court of First Instance, in both actions, reviewed the general legal principles applicable to selective distribution. With regard to cosmetics it noted that such systems were used to protect brand image and exclusivity and to ensure appropriate marketing settings. These systems, however, had to be justified in the interests of the consumer and must not limit inordinately network admission.[133]

The Court then considered, in both actions, the lawfulness of the selection criteria used by both manufacturers. It concluded that criteria relating to the professional

[130] Case T-19/92, note 125 above, 1891-1892; Case T-88/92, note 126 above, 2000.
[131] Case T-88/92, note 126 above, 1996.
[132] Case T-19/92, note 125 above, 1961; Case T-88/92, note 126 above, 2025.
[133] Case T-19/92, note 125 above, 1899-1901; Case T-88/92, note 126 above, 2009-2011.

qualification of resellers, outlet location, external outlet appearance, bans on selling products which detract from brand image and shop name requirements do not, in principle, offend Article 81 (ex 85).[134] In both cases, however, a clause which required sales of perfume in YSL and Givenchy outlets to constitute 60 and 50 per cent respectively of all sales activity infringed Article 81(1) (ex 85(1)). Sales turnover had no connection with the preservation of luxury image.[135] The Court also stressed that Galec had failed to show that it had been excluded *a priori* from the respective networks. Network admission was based on qualitative criteria. However, it emphasised that in any application for renewal the Commission must consider whether the market had become so rigid and structured as to exclude new forms of distribution.[136] The Court, therefore, annulled the Commission's Decisions only to the extent that the agreements of the respective parties allowed them to discriminate against retailers where sales of perfume represented a minority of its sales activities. In all other respects it dismissed Galec action.

It will be recalled that in October 1992 Krudidvat BV brought annulment proceedings with regard to Givenchy's system of selective distribution in the case of *Krudidvat v Commission*.[137] The Court of First Instance dismissed this action as inadmissible as Krudidvat was unable to establish locus standi under Article 230 (ex 173) EC. A subsequent appeal to the Court of Justice proved equally unsuccessful.[138] Krudidvat had simply failed to avail itself of the invitation extended by the Commission to participate in the administrative proceedings.

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[134] Case T-19/92, note 125 above, 1904-1911; Case T-88/92, note 126 above, 2014-2020.
[135] Case T-19/92, note 125 above, 1910; Case T-88-92, note 126 above, 2019.
[136] Case T-19/92, note 125 above, 1917-1922; Case T-88/92, note 126 above, 2026-2031.
[137] Case T-87/92 [1996] ECR II-1931, [1994] 4 CMLR 1046.
[138] Case C-70/97P *Krudidvat v Commission* [1998] ECR I - 7183, [1999] 4 CMLR 68.

It is apparent then that EU authorities have been cautious in approving quantitative restrictions. This caution applies not only to selective distribution networks in the perfume industry but to such systems in other sectors.[139] However, the Commission has stated that in certain circumstances it would grant exception to numerical limitations if close co-operation between manufacturer and dealer is needed. In some respects the relevant issues are similar to those of exclusive distribution. That is, the need to furnish dealers with protection from intrabrand competition to justify their investments, to provide them with the necessary incentive to expand sales, or to ensure the appropriate number of dealers consonant with efficient and effective distribution. In other circumstances, the restriction in the number of dealers may be necessary because of the manufacturers inability to supply an expanded network.

In *Omega*[140] a Swiss manufacturer of quality watches distributed its products via a combination of exclusive and selective distribution. The manufacturer appointed, in each Member State, an exclusive dealer responsible for importing, promoting and setting up a retail system of selective distribution. Network admission was based on qualitative and quantitative criteria. The number of admitted dealers was limited to an optimum figure dependant on the size of the local population and its presumed wealth.

The Commission concluded that Article 81(1) (ex 85(1)) was infringed but that the arrangement was eligible for exemption. The use of an exclusive distributor allowed for intense market exploitation and the choice of selected dealers enabled the manufacturer to adapt itself to local preferences. Ultimately consumers benefited

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[139] See, for example, Case 26/76 *Metro v Commission* [1977] ECR 1875, [1978] 2 CMLR 1; Case 86/82 *Hasselblad v Commission* [1984] ECR 883, [1984] 1 CMLR 559; Case 107/82 *AEG Telefunken v Commission* [1983] ECR 3151, [1984] 3 CMLR 325.

[140] Comm. Dec. 70/488 JO 1970 L242/22, [1970] CMLR D49.

because they obtained a range of watches adapted to local tastes supported by an international guarantee. The use of quantitative selection criteria was necessary, firstly, because Omega was only "physically capable" of producing a limited number of watches. Secondly, demand for the Omega product was also limited. Thirdly, to admit all dealers capable of satisfying objective qualitative criteria would have resulted in too many dealers seeking a limited number of watches to meet a limited demand. Ultimately, dealers interest in promoting the product would diminish. Numerical limitation was, therefore, indispensable to the successful marketing of Omega's product. In granting exemption the Commission stressed that interbrand competition remained strong and that Omega had lifted export restrictions.[141]

In *BMW*[142] a German manufacturer of motor vehicles used quantitative admission criteria to exclude dealers from its network system. However, the Commission found that the reasons given by BMW in support of its restrictions were justified. Numerical limitations were necessary to persuade dealers to make substantial investment in terms of finance and staff. Furthermore, the limited number of dealers selected were all capable of receiving and storing BMW vehicles in technically perfect conditions. Vehicle maintenance and repair work was readily available and to a high standard. BMW was also in a position to inform its limited number of dealers of any technical problems, knowing that modifications would be rapidly carried out. Quantitative limitation also enabled BMW to co-operate with its dealers to improve road safety and reduce environmental pollution. The Commission, however, was only prepared to grant exemption once BMW had lifted its export restrictions.

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[141] Ibid D.51-60.
[142] Comm. Dec. 75/73 OJ 1975 L29/1, [1975] 1 CMLR D44.

Similar justifications for the use of quantitative restrictions were also approved by the Commission in the *Ivoclar*[143] case. Firstly, numerical limitation enabled this dental supplier, based in Lichtenstein, to focus its efforts and expensive training programmes on a manageable number of distribution outlets. Secondly, concentrating distribution in the hands of a limited number of professionally qualified outlets ensured proper product use and proper patient care. Finally, numerical limitation provided the necessary incentive for dealers to make the substantial financial commitments necessary to employ suitably qualified staff, provide intensive product promotion and carry a full product range. Once again the Commission emphasised that interbrand competition was strong and that intra-network supplies remained possible.

Franchise distribution was first introduced into the Community in the 1970s. Since that time the use of franchise arrangements have proliferated. Franchising involves the transference of industrial or intellectual property rights, the use or application of uniform commercial methods and the payment of an entrance fee or monthly royalty. Franchisors, unlike suppliers in selective distribution networks, do not post selection criteria. Contracts are concluded *intuito personae* - on the basis of the candidates personal and professional qualities. In consequence a franchise agreement may not be assigned or transferred without the franchisor's consent.

It was not until 1986 in the case of *Pronuptia v Schillgalis*[144] that the Court of Justice considered franchising. Here, the German Supreme Court referred certain questions to the Court of Justice in an attempt to resolve a dispute between a French franchisor, Pronuptia, and its German franchisee, Schillgalis, over the latter's non payment of

[143] Comm. Dec. 85/559 OJ 1985 L369/1, [1988] 4 CMLR 781.
[144] Case 161/84 [1986] ECR 353, [1986] 1 CMLR 414.

royalty fees. The German Court asked whether franchise agreements fell within the parameters of Article 81 (ex 85) and whether such agreements could benefit from Regulation 1967/67 the predecessor of Regulation 1983/83 and 1984/83.

Pronuptia contended that its franchise arrangements enabled it to present a uniform face to the public, even though its network was comprised of independent outlets each of which bore their own risks of sale. Franchising, enabled it to create a "supra regional" network without risking its own capital. These arrangements, therefore, did not fall within the parameters of Article 81(1) (ex 85(1)) unless the contractual restrictions went beyond those demanded by the system. Should, however, the Court consider Article 81 (ex 85) to be applicable it should benefit from the provisions of Regulation 1967/67.[145] In contrast Mrs Schillgalis contended that these arrangements involved territorial restrictions and, therefore, fell within the parameters of Article 81(1) (ex 85(1)). Regulation 1967/67 was inapplicable because it was not drafted with this type of arrangement in mind.[146]

The French Government adopted the position that franchising may fall foul of the competition rules depending on the factual circumstances and that Regulation 1967/67 did not appear relevant. The Commission stated succinctly that Article 81 (ex 85) was not limited to specific agreements. When its conditions are met, Article 81(1) (ex 85(1)) applies. Regulation 1967/67 was not applicable because it was not intended to exempt restrictions of competition licensing trademarks, trade names or symbols.[147]

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145 Ibid 380-386.
146 Ibid 386.
147 Ibid 386-387.

Advocate General Verloren Van Themaat delivered his Opinion in June 1985. In his view the question of whether a franchise agreement resulted in a fair division of costs and benefits between franchisor and franchisee was irrelevant to the applicability of Article 81. In the Advocate General's view, Article 81 should apply only if the vertical obligation caused injury to third parties, including competitors, suppliers or purchasers. This would seldom be the case where alternative chains of distribution for similar products existed. However, he stressed that particular attention should be paid to whether market access was foreclosed and whether the arrangement resulted in higher retail prices.[148] Finally, Regulation 1967/67 did not, in his view, apply to franchise agreements.

In July 1986 the Court of Justice gave its ruling. It classified franchises into three categories: production franchises where the franchisee manufactures and sells the contract goods bearing the franchisor's trademarks; service franchises where the franchisee offers a service under the franchisor's name or symbol and distribution franchises where the franchisor licenses independent dealers, in return for royalty payments, to use its name and proven business formula. The Court concluded that the arrangement before it was a distribution franchise and limited its judgment accordingly.[149]

With regard to the compatibility of these arrangements with Article 81(1) (ex 85(1)) the Court held that any assessment could not be made in the abstract. Much depended on the clauses in the agreement. Clauses which resulted in market division, either between the franchisor or franchisee or between the franchisees *inter se*, fell within

[148] Ibid 368-371.
[149] Ibid 380-381.

Article 81 (ex 85).[150] The Court concluded that the use of territorial or location clauses would render the agreement susceptible to the rules on competition. Surprisingly, the Court failed to make any distinction between absolute and qualified territorial protection. It did, however, stress that these clauses may be exempted by the Commission if deemed necessary to protect the franchisee from intrabrand competition to protect its investments or to attract other franchisees.[151] The Court also stressed that other clauses may not offend the competition rules. These included, firstly, clauses designed to enable the franchisor to communicate its know-how and commercial practice without benefiting its competitors. Such clauses included non-compete obligations and prohibitions on changing outlet location without the franchisor's consent. Secondly, clauses designed to enable the franchisor to take appropriate measures to preserve its identity and reputation would not offend Article 81 (ex 85). These included clauses relating to the use of business method and know-how, specification for business set-up, advertising approval and site location clauses.[152]

In *Pronuptia v Schillgalis* the Commission made it abundantly clear that it lacked experience in the area of franchise distribution. Over the course of a two year period (December 1986 - December 1988) the Commission received a number of notifications with which to rectify this situation. With one exception these notifications related to distribution franchises. The *ServiceMaster Agreement*[153] related to the provision of services but this displayed such strong similarities with distribution franchises that the Commission felt it could be treated in a similar fashion.

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[150] Ibid 383-384.
[151] Ibid 384.
[152] Ibid 381-383.
[153] Comm. Dec. 88/604 OJ 1988 L332/38, [1989] 4 CMLR 581.

The other notified agreements included *Pronuptia's*[154] standard form franchise contracts relating to the sale of its bridal wear; *Yves Rocher's*[155] agreements relating to the sale of its cosmetic products; the franchise agreements of *Computerland Europe*[156] developed for the sale of its computer products and the agreements of *Charles Jourdan*[157] governing the sale of its shoes. In each of these cases the franchisee was allotted a defined territorial area or required to operate from an approved site location.

The Commission concluded, in each of these cases, that Article 81(1) (ex 85(1)) was infringed. The use of territorial and site location clauses amounted to market sharing. Location clauses prevented franchisees from setting up in other locations including the markets of other Member States. In *Computerland*, for example, the Commission noted that expansion into other Member States was a logical and desirable development, particularly as Computerland's franchisees were not "one man operations" but SMEs employing between 10 and 20 employees and sometimes substantially more. The fact that Computerland's franchisees were empowered to open "satellite shops" was only a relative freedom since approval had to be acquired and this was dependent on the payment of another entrance fee.[158] In all five cases the Commission had no difficulty in concluding that trade between Member States would be affected appreciably. In *ServiceMaster* the Commission found this on the basis of "sufficient probability" concluding that the franchisor's market share would exceed 5 per cent in the near future and it was sufficiently probable that its network would affect intra-Community trade.[159]

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[154] Comm. Dec. 87/17 OJ 1987 L13/39, [1989] 355.
[155] Comm. Dec. 87/14 OJ 1987 L8/49, [1988] 4 CMLR 592.
[156] Comm. Dec 87/407 OJ 1987 L222/12, [1989] 4 CMLR 259.
[157] Comm. Dec 89/94 OJ 1989 L35/31, [1989] 4 CMLR 591.
[158] Comm. Dec 87/407, note 156 above, para 25.
[159] Comm. Dec 88/604 OJ 1988 L332/38, [1989] 4 CMLR 581, para 23.

The Commission's approach also reflected the approach adopted by the Court of Justice, in that certain clauses were not relevant to competition (entrance fee payments, monthly royalties, business medium) and others fell outside the parameters of Article 81(1) (ex 85(1)). The latter related to the transference of know-how and assistance and provisions designed to safeguard the common identity of the network. In all of these notifications the Commission concluded that exemption was available. Prospective franchisees would be unwilling to undertake the necessary financial investment if they were not going to receive a degree of protection from other resellers. However, in all of these cases the Commission stressed the importance of cross-supplies and the need to preserve franchisee's freedom to respond to unsolicited enquiries. The Commission also noted that franchising improved production and distribution through rationalisation, encouraging market feedback and allowing franchisors to meet fluctuations in demand. In all of this consumers benefited from an efficient and attentive service provided by independent undertakings.

The knowledge and experience gained from dealing with these notifications underpin the drafting of Regulation 4087/88 (See Annex III). This block exemption, which currently governs franchising, permits territorial allocation in limited circumstances. Firstly, the franchisor may be obliged to refrain from allowing third parties to exploit the franchise in a territory already allocated to its franchisee. Secondly, the franchisor may agree not to exploit the franchise within the territory of another franchisee or otherwise sell or market the contract goods (Article 2(a)).

The franchisee, by virtue of Article 2(c), may be obliged to exploit the franchise from an approved location and to refrain from actively seeking customers outside its contract territory (Article 2(d)). This active sales restraint however, still permits the franchisee to respond to passive requests for sale. Importantly, Article 4(a) insists that franchisees are entitled to obtain the contract goods from other franchisees. Cross-supplies must remain possible if the agreement is to be block exempt. Article 4(b) prevents guarantees being used as instruments of market compartmentalisation. Article 5(c) black lists any clause which prevents the franchisee from supplying end users with the contract goods because of their place of residence. Finally, Article 8(c) empowers the Commission to withdraw the benefit of the block exemption if either party uses differences in product specification to compartmentalise the market.

IV. CONCLUSION

In the fully integrated market of the US an efficiency based, market power approach is adopted to territorial allocation. It is now generally accepted that where markets are not concentrated and interbrand competition is strong, manufacturers will not insulate their dealers from intrabrand competitive pressures simply to enable them to enrich themselves. Other justifications must, therefore, exist. In the case of territorial allocation it is usually to attract aggressive dealers to engage in product distribution. Providing dealers with intrabrand protection encourages optimal dealer investment by overcoming free riding problems.

Unlike the EU the US has no equivalent to the regulatory enactments of the block exemption governing territorial allocation. The matter is mainly dealt with by the Courts. Since 1977 and the Supreme Court's *Sylvania*[160] decision a rule of reason approach has been applied to non-price vertical restraints. Over the years the US

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160 433 U.S. 36 (1977).

judiciary has developed a truncated rule of reason approach based on market power filters. Market power is traditionally defined in terms of market share. This structural approach, generally precludes the application of S1 Sherman Act to territorial allocation, unless the party imposing the restraint has market power. Whilst there is ambiguity over what market share percentage gives rise to market power, shares over 50 per cent give rise to concerns over the legality of the restraint. Although, it is still possible for the supplier to justify its use.

This approach contrasts significantly with the approach adopted in the EU. The latter consists of a collection of States striving to achieve the goal of unification, constantly vigilant over private efforts designed to perpetuate market fragmentation. Concerns of efficiency, whilst of importance, have not occupied centre stage. In the EU greater importance is attached to intrabrand competition. Often distribution arrangements are organised along national lines and allocated territories coincide with national markets. Cross border parallel trading is viewed, therefore, as a means to achieve market unification. The parallel trader, which often free rides on the promotional efforts of official distributors within Member States, is seen as saint and not sinner.

The goal of market integration, therefore, ensures that territorial allocation cannot be absolute and must be qualified. These concerns are reflected in the block exemptions governing exclusive distribution, franchising and the principles governing selective distribution. Moreover, attempts to directly or indirectly fragment the market are treated with short shrift. These include, dual pricing schemes[161], the use of

[161] Case 30/78 *Distillers v Commission* [1980] ECR 229, [1980] 3 CMLR 121; Comm. Dec. 72/403 *Pittsburg Corning Europe* OJ 1972 L272/35, [1973] CMLR D2; see also V. Korah "'Goodbye' Red Label: Condemnation of Dual Pricing by Distillers", 1978 3 *EL Rev* 62; T. Sharpe, "The Distillers Decision", (1978) 15 *CMLR Rev* 447; C.W.F. Baden Fuller, "Private Variations - The Distillers Case and Article 85 EEC", (1979) 28 *ICLQ* 128.

intellectual property rights[162], the limitation of guarantee rights[163], controlling price mechanisms to impede parallel imports[164] and, of course, export bans.[165]

[162] See L.J. DeKeyser, "Territorial Restrictions and Export Prohibitions Under The United States And The Common Market Antitrust Laws", (1964-5) 2 *CML Rev* 271; A. Deringer, "Exclusive Agency Agreements With Territorial Protection Under The EEC Antitrust Laws", (1965) 10 *Antitrust B* 599; C.H. Fulda, "The First Antitrust Decisions Of The Commission Of The European Community", (1965) 65 *Col L Rev* 625.

[163] EEC Commission, *Seventh Report on Competition Policy: 1977* (Brussels, 1978) p 24; Comm. Dec. 78/922 *Zanussi* OJ 1978 L322/26, [1979] 1 CMLR 81; Case 31/85 *ETA Fabriques d'Ebauches v DK Investment* [1985] ECR 3933, [1986] 2 CMLR 674; Case 86/82 *Hasselblad v Commission* [1984] ECR 883, [1984] 1 CMLR 559; see also F.L. Fine, "EEC Consumer Warranties: A New Antitrust Hurdle Facing Exporters", (1989) 10 *ECLR* 233.

[164] Comm. Dec. 80/1333 *Hennessey - Henkell* OJ 1980 L383/11, [1981] 1 CMLR 601.

[165] See, *inter alia*, Case 19/77 *Miller International v Commission* [1978] ECR 131, [1978] 2 CMLR 334; Case T-77/92 *Parker Pen Ltd v Commission*, [1994] ECR II-549, [1995] 5 CMLR 435; Case T-41/96R *Bayer v Commission* [1996] ECR II-381, [1996] 5 CMLR 417.

5

EXCLUSIVE DEALING OR PURCHASING

I. INTRODUCTION

An agreement between supplier and dealer where the latter promises to purchase the contract goods exclusively from the supplier and not to deal in competing goods is known in the US as an exclusive dealing arrangement and in the EU as an exclusive purchasing agreement. These arrangements cover both input and output contracts. The former are generally known as industrial supply or requirement contracts where the purchaser consumes the contract goods in the production process or the provision of services. The latter relate to the acquisition of products for the purpose of resale. These types of arrangements are restraints on interbrand competition and are usually employed in conjunction with other restraints. In a pure exclusive dealing or purchasing agreement the purchaser remains in competition with other parties entering into similar arrangements. Protection from intrabrand competition, for example, is only available if the supplier imposes restraints specifically designed to provide such protection.

There are a variety of explanations for the use of these type of arrangements. Perhaps the most conventional explanation is that it is a means of stimulating dealers to sell its suppliers product with maximum energy and efficiency. Dissipation of effort or dilution of energy caused by the sale of multiple products is overcome if a dealer's success is inextricably tied to the success of a single product line.[1] In 1982 Marvel provided an efficiency rationale for the use of such arrangements based upon a property right explanation.[2] While acknowledging that intrabrand restraints had attracted most academic attention, Marvel concluded that this interbrand restraint prevented the erosion of supplier's property rights with the corresponding diminution in the incentive to invest. By preventing interbrand free riding these arrangements encouraged optimal investment and the strengthening of dealer networks through the provision of finance, management, accounting and technical advice. Exclusive dealing or purchasing has other procompetitive benefits. It can be used to protect product innovation and design as well as protecting confidential technical information which a supplier has to pass on to its dealers.[3] It can also be used to ensure product quality is maintained by preventing dealers from substituting inferior unbranded products for more expensive branded products. Finally, although not exhaustively, these arrangements can encourage long term planning with corresponding savings in costs.

Others suggest, however, that exclusive dealing or purchasing can be used for strategic anticompetitive purposes. In particular, this restraint may precipitate market foreclosure. The latter may be calculated in a number of ways. A volume weighted calculation consists of determining the total volume or value of sales of the particular product on the relevant market and expressing the volume or value sold through tied outlets as a

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1 F.M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance* (3rd edn, Boston 1990) pp 563-565.

2 H.P. Marvel, "Exclusive Dealing", (1982) 25 *JL Ec* 1; see also S.I. Ornstein, "Exclusive Dealing And Antitrust", (1989) 34 *Antitrust B* 65; R.M. Steuer, "Exclusive Dealing in Distribution", (1983) 69 *Corn L Rev* 101.

3 In the US, for example, until the judgment *in Standard Fashion v Magrane Houston Co* (258 U.S. 346 1922) it was common practice in the dress-pattern design industry (in the absence of patent or copyright) to use exclusive dealing to protect supplier's proprietary interests in original dress pattern designs.

percentage of total sales. A numeric calculation involves expressing the amount of tied outlets as a percentage of the total number of outlets on the relevant market. Comanor and Frech[4] assert that these arrangements may be used to exclude prospective market entrants. Incumbent suppliers, by setting entry prices, may deter entry altogether or permit it on unfavorable terms. Aghion and Bolton[5] and Krattenmaker and Salop[6] echo these sentiments. More recently, Lin[7] has examined the possibility that exclusive dealing or purchasing can be used to "dampen" interbrand competition generated by rivals using common outlets to market their respective products.

In the US the Courts have generally upheld the legality of these arrangements at common law.[8] However, exclusive dealing is now governed by three distinct statutory enactments. These statutes were enacted to serve different legislative purposes. It is perhaps not surprising that this has resulted in inconsistent treatment. These arrangements may be interdicted as illegal restraints of trade contrary to the Sherman Act and as unfair methods of competition contrary to S.5 Federal Trade Commission Act 1914. The major antitrust weapon, however, is that of S.3 Clayton Act 1914 which provides that it is unlawful to leave or sell commodities on condition, agreement or understanding that the purchaser will not deal in the commodities of the suppliers' competitors where the effect of the arrangement "... may be to substantially lessen competition or tend to create a monopoly in any line of commerce". The US Courts have encountered difficulty in construing this

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[4] W.S. Comanor and H.E. Frech, "The Competitive Effects of Vertical Agreements?" (1985) 75 *Am Ec Rev* 539, 545.
[5] P. Aghion and P. Bolton, "Contracts as a Barrier to Entry", (1987) 77 *Am Ec Rev* 388.
[6] T.G Krattenmaker and S.C. Salop, "Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price", (1986) 96 *Yale LJ* 209.
[7] J. Lin, "The Dampening-of-Competition Effect of Exclusive Dealing", (1990-91) *39 J Ind Ec* 209.
[8] See, for example, *Peerless Pattern Co v Guantlett Dry Goods Co.*, 171 Mich. 158, 42 L.R.A. (N.S.) 843, 136 N.W. 1113; *Ripy v Artwall Paper Mills*, 41 Okla 20, 51 L.R.A. (N.S.) 33, 136 Pac. 1080.

competitive impact clause and case law has lacked consistency and has fluctuated considerably over the years.

In the EU Articles 81 (ex 85) and 82 (ex 86) EC are relevant to exclusive purchasing agreements. Regulation 1984/83,[9] due to expire shortly, governs these agreements provided they exhibit specific characteristics. Market foreclosure is also of real concern in that these agreements, if concluded on a national basis, can result in market compartmentalisation. Where this is not an issue the Court of Justice, since 1967 has taken the view that exclusive purchasing may not necessarily violate the provisions of Article 81 (ex 85).[10] Part II of this chapter examines the way in which the US authorities treat exclusive dealing arrangements and Part III examines the approach adopted in the EU.

II. EXCLUSIVE DEALING IN THE US

A. In Search Of A Standard: From Market Dominance To Quantitative Substantiality

The first exclusive dealing arrangement to come before the US Supreme Court, after the enactment of the Clayton Act, was the 1922 case of *Standard Fashion Co v Magrane – Houston.*[11] This case provided the Supreme Court with its first opportunity to direct lower Courts in their assessment and treatment of these restraints. Standard Fashion, a

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[9] OJ 1983 L173/5.
[10] Case 56/65 *Societe Technique Miniere v Maschinenbau Ulm* [1966] ECR 235, [1966] 1 CMLR 357.
[11] 258 U.S. 346 (1922).

New York corporation, was engaged in the marketing and distribution of paper patterns for women's and children's clothing. Magrane - Houston ran a retail outlet in Boston. In November 1914 both corporations entered into contractual relations. Standard Fashion agreed to sell its patterns to Magrane - Houston at discounted prices and to repurchase discarded patterns. For its part, Magrane - Houston agreed not to sell or permit to be sold on its premises any other makes of patterns. In July 1917, during the currency of the agreement, Magrane - Houston discontinued the sale of Standard Fashion's patterns and commenced selling the patterns of the McCall Company - a rival competitor.

In an attempt to restrain Magrane - Houston from continuing to violate the terms of the contract, Standard Fashion instituted proceedings in the District Court of Massachusetts.[12] The matter came before Judge Johnson and Magrane - Houston simply asserted that the contract was illegal as it violated the provisions of the Clayton Act. In contrast, Standard Fashion asserted that before such a conclusion could be reached a broad enquiry into the competitive nature of these arrangements should be conducted. Judge Johnson, reluctantly agreed to hear evidence which indicated that competition had actually increased since the introduction of the exclusive arrangement; that such agreements were customary in the pattern-trade industry and may be of benefit to supplier, dealer and customer alike. In fact, suppliers used exclusive dealing, in the absence of patent and copyright, to protect their proprietary interests in their original dress designs. While Judge Johnson permitted this evidence to be heard, he chose to ignore it. Instead, he preferred to focus on the defendant's assertion that the plaintiff had similar exclusive dealing arrangements with at least 20,000 out of a possible 52,000 outlets nationwide. In

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[12] 254 Fed. 493.

his view, this was sufficient, in itself, to violate Section 3 and he accordingly dismissed the action.

An appeal was made to the Circuit Court of Appeals[13] and affirming the decision below, it also chose to focus on the relative market position of the appellant. It also placed great emphasis on the fact that the appellant had similar arrangements with approximately 40 per cent of all retail outlets.

Standard Fashion appealed to the Supreme Court. Charles Hughes, appellant's counsel, argued that the Court of Appeals should have reached a conclusion on the basis of all the evidence before it. It should, he asserted, have considered whether the arrangement actually lessened competition. In effect, a Sherman Act rule of reason approach should have been adopted.

As the case involved matters of public policy the Supreme Court invited the US Department of Justice to file an *amicus* brief.[14] The Solicitor - General, James Beck, asserted that the sole reason for the use of such arrangements was to enable small manufacturers to enter a field already occupied by an entrenched monopolist or powerful economic unit.

Mr Justice Day delivered the unanimous judgment of the Supreme Court. He stated that the main issue before the Court was the construction of the competitive impact clause of Section 3. He concluded that the Sherman Act rule of reason approach was of no

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[13] 259 Fed. 793 (1st Cir. 1920).
[14] Brief for US - as *Amicus Curiae* 258 U.S. at 351.

relevance. The Clayton Act "... sought to reach the agreements embraced within its sphere in their incipiency, and in the section under consideration to determine their legality by specific tests of its own".[15]

He stated further

> "... Section 3 condemns sales or agreements where the effect of such sale or contract of sale 'may' be to substantially lessen competition or tend to create monopoly.... But we do not think that the purpose in writing the word 'may' was to prohibit the mere possibility of the consequences described. It was intended to prevent such agreements as would under the circumstances disclosed probably lessen competition or create an actual tendency to monopoly."[16]

Mr Justice Day then added that the fact that Section 3 was "... not intended to reach every remote lessening of competition is shown in the requirement that such lessening must be substantial".[17] Unfortunately, however, Mr Justice Day did not pause to indicate how to distinguish between a remote and substantial lessening of competition. The Supreme Court simply accepted the lower Court's judgment that the arrangement did substantially lessen competition and tended to create monopoly. Not only did the arrangement foreclose 40 per cent of nationwide outlets to Standard Fashion's competitors, but the Supreme Court also *assumed* that in large cities competitors would be denied access to the

[15] Ibid at 356.
[16] Ibid at 356-357.
[17] Ibid at 357.

most desirable outlets and, in smaller communities, it would exclude them altogether. Eventually, it was assumed that this would lead Standard Fashion to obtain most of the pattern business. The Supreme Court regarded the relative standing of the supplier in the market to be of prime importance. If it occupied a position of market dominance, this was sufficient in itself, to support the inference that competition had been or probably would be lessened by the restraint. Accordingly, Section 3 had been violated. A demonstration of the procompetitive effects of such arrangements embracing a Sherman Act rule of reason approach was not of prime importance. On this basis, the Supreme Court affirmed the decision below and held in favour of Magrane - Houston.

Almost 20 years later the Supreme Court once again embraced the importance of market dominance in holding an exclusive dealing arrangement violative of the antitrust laws. The 1941 case of *Fashion Originators' Guild v FTC*[18] involved both horizontal and vertical elimination of competition. The Fashion Originators' Guild was formed by a combination of textile and women's garment manufacturers. Both types of manufacturer claimed that their original textile and dress designs were being copied and sold by unscrupulous manufacturers and retailers. The Guild was formed, therefore, to combat and destroy all competition from the sale of garments which were copies of Guild-members original creations.[19] In addition to boycotting those involved in "style piracy", exclusive dealing arrangements were utilised to protect the respective manufacturer's investments. That is, textile manufacturers sold their products to garment manufacturers on condition they would refrain from using textiles copied from Guild members. In turn,

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[18] 312 U.S. 457 (1941).
[19] Ibid at 346.

garment manufacturers sold only to retailers on condition that the latter would not use or deal in copied dress design.

Upon investigation the Federal Trade Commission concluded these vertical restraints were an unfair method of competition and accordingly issued a cease and desist order. The Circuit Court of Appeals,[20] with certain modifications, affirmed this order. The Guild appealed to the Supreme Court. Mr Justice Black delivered the unanimous judgment of the Court. He concluded that the Commission was not in error when it refused to hear business justification proffered by the Guild for the implementation of the restraint. The Guild's assertion that these restraints were necessary and reasonable "... to protect the manufacturer, labourer, retailer and consumer against the ... pirating of original designs"[21] was held to be irrelevant. In affirming the decisions of the Commission and the Court of Appeals, the Supreme Court emphasised the presence and consequence of market dominance. It noted, for example, that in 1936 Guild members sold more than 60 per cent of all women's garments wholesaling in the US at more than 10.75 dollars and 38 per cent of all women's garments wholesaling at 6.75 dollars or more. Accordingly, the Guild's

> "... potential power, its tendency to monopoly, the coercion it could and did practice upon rival methods of competition, all brought it within the policy of the prohibition declared (illegal) by the ... Clayton Act".[22]

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[20] 114 F. 2d 80 (2nd Cir. 1940).
[21] 312 U.S. at 467.
[22] Ibid at 467-468

The Supreme Court concluded, therefore, that these arrangements violated both the Federal Trade Commission Act and the Clayton Act. It also condemned the horizontal combination of Guild Members as being violative of Section 1 and 2 Sherman Act.

During this period then, it became apparent, that if a business utilised exclusive dealing arrangements and also occupied a dominant market position the restraint would be considered to be in violation of the antitrust laws. In 1949, however, in the landmark decision of *Standard Oil of California v US*[23] the Supreme Court adopted a more stringent position. It extended the rule of *Standard Fashion* to include those business organisations which enjoyed a powerful though clearly not a dominant position in their industry. The Standard Oil Company owned petroleum producing resources and refining plants in California. It was, in fact, the largest seller of gasoline in what was referred to as the "Western Area".[24] In 1946 its retail gasoline sales amounted to 23 per cent of the total taxable gallonage sold in this area. Of this, 6.8 per cent was sold through company owned service stations and 6.7 per cent (approximately 58 million dollars worth of annual business) was sold through independent service stations bound to Standard Oil by exclusive dealing arrangements. These requirement contracts obligated the independents to purchase all of their gasoline and other petroleum related products from the company.[25] Standard Oil first entered into these arrangements in 1934. Until that time, however, retail sales by independent outlets were made pursuant to agency agreements. By 1947, Standard Oil had concluded exclusive dealing arrangements with 5937 independent outlets which amounted to 16 per cent of the available retail outlets in the Western area.

[23] 337 U.S. 293 (1949).
[24] This area comprised Arizona, California, Idaho, Nevada, Oregon, Utah and Washington.
[25] 337 U.S. at 295.

Standard's six leading competitors also employed similar arrangements and by 1946 these competitors absorbed 42.5 per cent of retail sales.[26] About 70 other small refiners absorbed the remaining trade.

The Government contended that these exclusive dealing arrangements were violative of both the Sherman Act and Clayton Act. On 2 January 1947, therefore, it instituted proceedings in the District Court of California for a Declaratory judgment to that effect and for an injunction to prevent Standard Oil from enforcing these contractual provisions. The District Court upheld the governments position. It held that the Section 3 requirement would be satisfied if the contract covered "... a substantial number of outlets and a substantial amount of products whether considered comparatively or not".[27] Having adopted this standard of proof Judge Yankwhich excluded as immaterial testimony from Standard as to the possible business justifications for the implementation of the restraints. In fact, the District Court took the view that it was also irrelevant that Standard Oil's position in the petroleum market had actually deteriorated since the introduction of exclusive dealing.

Not surprisingly, Standard Oil appealed to the Supreme Court. John Hall, lead counsel for the appellants, argued that the District Court had erroneously concluded that a violation of the antitrust laws was conclusively established simply on the basis of the number of dealers under contract to Standard and on the dollar volume of the products handled thereunder. It was asserted that the District Court should have considered other competitive factors in reaching its decision. An analytical approach based on the rule of

[26] Ibid.
[27] *US v Standard Oil* 78 F. Supp. 850.

reason should have been adopted.[28] Had these additional factors been considered, Standard argued, they would have indicated that it did not exert a monopoly nor had it perpetrated a calculated scheme to restrain or suppress competition.

Mr Justice Frankfurter delivered the opinion of the Supreme Court. He stated succinctly that the main issue before the Court was the construction of the competitive impact clause of Section 3 Clayton Act. In particular,

> "... whether the requirement of showing that the effect of the agreement 'may be to substantially lessen competition' may be met simply by proof that a substantial portion of commerce is affected or whether it must also be demonstrated that competitive activity has diminished or probably will diminish".[29]

Mr Justice Frankfurter commenced his analysis by reviewing prior Supreme Court case law. He noted that the Supreme Court had passed on the applicability of Section 3 on eight prior occasions. He acknowledged, however, that this case law included both tying arrangements and exclusive dealing arrangements. On two of these occasions, namely *FTC v Sinclair*,[30] and *Pick Mfg Co v General Motors*,[31] the Supreme Court considered the actual or probable economic consequence of the agreements and in so doing held Section 3 to be inapplicable and the restraints valid. These decisions, then, lent support to Standard's contentions that economic considerations ought to be taken into account in

[28] See A.D. Neale and D.G. Goyder, *The Antitrust Laws of the USA*, (3rd edn, Cambridge, 1980) p269.
[29] 337 U.S. at 299.
[30] 261 U.S. 463 (1923).
[31] 299 U.S. 3 (1936).

determining the legality of exclusive dealing arrangements. A third case, *FTC v Curtis Pub., Co.*,[32] involved contractual agency and was, therefore, of no precedential value. The remaining five cases, however, held Section 3 to be applicable and in each case the Court held the restraint between supplier and dealer to be in violation of the Clayton Act. With one exception, the Court had done so on the basis that the supplier had occupied a dominant position in its industry.[33] Market dominance, in itself, was sufficient to support the inference that competition had been or probably would be lessened. However, Standard Oil did not occupy a position of market dominance. Mr Justice Frankfurter, therefore, concluded that these cases could not be regarded as controlling the disposition of the present appeal.

There was, however, one exception. This was the 1947 case of *International Salt v US*.[34] Very briefly, this case involved a tying contract whereby International Salt leased patented salt dispensers on condition that the lessee would only dispense salt purchased from International Salt. The Supreme Court condemned the arrangement as violative of Section 3 even though International Salt did not occupy a position of market dominance. The Court rejected the necessity of considering economic consequences once it had established that the volume of business was "... not insignificant or insubstantial", and that the effect of such contracts was to "... foreclose competitors from a substantial market".[35] As Standard Oil did not occupy a dominant market position one might have expected that this case would be controlling. Mr Justice Frankfurter, however did not treat it so.

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[32] 260 U.S. 568 (1923).
[33] *Standard Fashion v Magrane – Houston Co.*, 258 U.S. 346 (1922); *Fashion Originators' Guild v FTC*, 312 U.S. 457 (1941); *United Shoe Mach. Corp v US*, 258 U.S. 451 (1922); *IBM Corp v US* 56, 298 U.S. 131 (1936).
[34] 332 U.S. 392 (1947).
[35] Ibid at 396.

Firstly, International Salt enjoyed the benefits of a patent on the machinery it leased to its dealers. Secondly, the Court took the view that important economic differences existed between tying agreements and exclusive dealing arrangements. As a result differing standards of proof were required to fulfil the conditions of Section 3. In support of this contention he said, quite emphatically, that "... tying agreements serve hardly any purpose beyond the suppression of competition".[36] In contrast exclusive dealing arrangements.

> "... may well be of economic advantage to buyers (dealers) as well as to sellers (suppliers), and thus indirectly of advantage to the consuming public. In the case of the buyer, they may assure supply, afford protection against rises in price, enable long term planning on the basis of known costs, and obviate the expense and risk of storage in the quantity necessary for a commodity having a fluctuating demand. From the seller's point of view, (exclusive dealing) may make possible the substantial reduction of selling expenses, give protection against price fluctuation and - of particular advantage to a newcomer to the field to whom it is important to know what capital expenditures are justified - offer the possibility of a predictable market".[37]

In these circumstances, Mr Justice Frankfurter, acknowledged that a rule of reason analysis could theoretically be used to determine the economic utility or usefulness of exclusive dealing. Factors that would be relevant to such an enquiry would include:

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[36] 337 U.S. at 305-306.
[37] Ibid.

evidence that competition had flourished despite the use of exclusive dealing arrangements (under this category much of the evidence tendered by Standard Oil would be relevant); whether the contractual arrangement was reasonable in terms of duration; the status of the supplier, that is, whether it is a struggling newcomer or an established competitor; the degree of market control the supplier possesses - the greater this is, the greater the inference that exclusive dealing has been used to attain and maintain the suppliers position in the market.[38]

In spite of these admissions, Mr Justice Frankfurter rather surprisingly brushed aside the application of this approach to exclusive dealing. He did so on the basis that it would be difficult to apply these tests. Firstly, the standard of proof required by such an analytical approach was virtually impossible to meet and most ill-suited for ascertainment by courts. A broad economic enquiry would be impractical and inconclusive. How could one determine, for example, whether Standard Oil had maintained its market position as against its competitors as a result of its use of this particular form of vertical restraint? Underpinning this particular notion of Mr Justice Frankfurter, one suspects, is the view that courts could not be expected to wrestle with complex economic issues or problems. Secondly, enquiry into the economic merits of these restraints would amount to a test of their reasonableness; a test which had rendered the Sherman Act impotent against certain abusive practices and which Congress had decided to remove by the passage of the Clayton Act.

In spite of all the factors which pointed to a rule of reason analysis, the majority of the Supreme Court held that the District Court was correct to refuse to consider the

[38] Ibid at 308.

competitive effects of these restraints and the reasons proffered by Standard as justification for the implementation of the restraint. The Supreme Court held that the use of these contracts created a potential clog on competition. It was the purpose of Section 3 to remove such obstructions. The Court's crucial holding, therefore, was that Section 3 was satisfied by proof that competition had been closed in a substantial share of the line of commerce affected.[39] Eventually, this became known as the test of "quantitative substantiality". Rather than deal in refined economic analysis which a rule of reason approach might entail, the Supreme Court preferred a straightforward quantitative test relating to the amount of business foreclosed.

Mr Justice Douglas in his separate dissenting judgment opposed the condemnation of Standard Oil's exclusive dealing contracts. In his view, the condemnation of these restraints would simply lead to the return of agency agreements as a means of product distribution or drive Standard Oil and others to integrate forward into distribution. In his view, this would have detrimental social repercussions in that entrepreneurs would become employees of absentee owners causing local leadership to be diluted.[40]

Mr Justice Jackson, writing for the minority agreed that Standard's exclusive dealing arrangement covered a substantial amount of outlets and a substantial number of products. This in his view, did not automatically bring the accused arrangements within the prohibition of the statute. He stated

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[39] Ibid at 314.
[40] Ibid at 318-319.

> "The number of dealers and the volume of sales covered by the arrangement ... was sufficient to be substantial. That is to say, this agreement operated on enough commerce to violate the Act, provided its effects were substantially to lessen competition or tend to create a monopoly. But proof of their quantity does not prove that they had this forbidden quality; and the assumption that they did, without proof seems to be unwarranted".[41]

Mr Justice Jackson roundly condemned the Court below for failing to allow the defendant to adduce evidence to show that such effects did not flow from the exclusive dealing arrangement. In the view of the minority, therefore, the lower Court's decree should be vacated with a direction to complete the case after consideration of evidence from both sides as to the effects of the restraint. While acknowledging that such an analytical approach might prove tedious, Mr Justice Jackson asserted, any other approach would amount to a "guess in the dark". In any event, if the Court was obliged to consider such issues without evidence being adduced, Mr Justice Jackson viewed these restraints as "... device(s) for waging competition" rather than suppressing it.[42] They were simply a "necessary means" to maintain the competitive struggle between suppliers. Dealers were mere conduits with no real economic independence or freedom and were, quite simply, the means by which competition was waged.

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[41] Ibid at 322.
[42] Ibid at 323.

The Standard Oil decision, usually referred to *as Standard Stations*, was the subject of much academic comment and the butt of much criticism.[43] Its approach was criticised for being too mechanical and depriving the consumer of the economic benefits of exclusive dealing. One of the main reasons, arguably the prime reason, for the refusal to consider all relevant economic factors in assessing the legality of exclusive dealing was the majority's interpretation of the political will of Congress in passing the Clayton Act. The majority, in *Standard Stations*, simply believed that to give effect to such a broad enquiry would stulify Congressional intent. In this respect, academics roundly condemned the case as being built upon an "... improper reading of the legislative history of Section 3".[44] The application by the majority of quantitative substantiality was based upon an improper and erroneous interpretation of Congressional intent. Unfortunately, it is beyond the scope of this work to consider in detail the machinations of Congress in passing the Clayton Act. In brief, however, the Judiciary Committee of the House of Representatives preferred a bill which contained a flat prohibition against all exclusive dealing. In its view, these arrangements were simply an illegal attempt to monopolise, punishable by a 5000 dollars fine and a sentence of one years imprisonment. The Senate, however, adopted a different position. It rejected a blanket prohibition, asserting that exclusive dealing could perform valuable economic functions. These arrangements, for example, could provide assistance to struggling newcomers trying to enter a market with an entrenched encumbent.[45] The Senate confined itself, therefore, to declaring illegal "patent tie-ins". The bill then proceeded to the Conference Committee which accepted that the two Chambers had adopted differing approaches to the matter. Not surprisingly a

[43] W.B. Lockhart and H.R. Sacks, "The Relevance of Economic Factors in Determining Whether Exclusive Arrangements Violate Section 3 of the Clayton Act", (1951-52) 65 *Harv L Rev* 913; F. Kessler and R.H. Stern, "Competition, Contract, and Vertical Integration", (1959) 69 *Yale LJ* 1.
[44] M. Handler, "Recent Antitrust Developments", (1961) 71 *Yale LJ* 75, 84.
[45] 51 Cong. Rec 14094; 14028; 14253.

compromise was reached. The Conference Committee adopted the House of Representatives basic approach and accommodated the Senate by including the competitive impact clause. This approach gave rise to vehement protests from the supporters of absolute prohibition. In their view, the Act would simply become a milk and water provision.

It is clear from the original opinion of Mr Justice Frankfurter, delivered on 13 June 1949, that the majority in *Standard Stations* erroneously concluded that both Houses favoured an outright prohibition on exclusive dealing. In his original opinion he stated "... it is significant that the qualifying language was added only after a *flat prohibition* of tying clauses and requirements contracts had passed *both* Houses of Congress" (emphasis added).[46] This view was used by the majority to support the contention that it would be unlikely that Congress would set up an express prohibition on exclusive dealing only to require a wide ranging rule of reason analysis into its effect. Within 4 months of the case being concluded the Court's erroneous statutory interpretation was ordered to be corrected. The amended wording now benignly reads "... in this connection it is significant that the qualifying language was not added until after the House and Senate bills reached Conference".[47]

Not surprisingly, this interpretative error precipitated much criticism. Handler suggests, for example, that the inclusion of the competitive impact clause "... was not meant as a mere gloss, without significant substantive effect".[48] *Standard Station's* contrary

[46] See M. Handler, note 44 above, 84-86.
[47] See *Standard Oil Co v US*, 338 U.S. 808 (1949).
[48] See M. Handler, note 44 above, 86.

intimations were, therefore, incorrect. In his view, Congress intended the Courts, when considering the legality of these restraints, to apply a "... discriminating judgment in differentiating between those arrangements which had a reasonable prospect of lessening competition to a substantial degree and those which did not".[49] Lockhart and Sacks also assert that the competitive impact clause must have been designed "... as the legislative history indicates to require consideration of other economic factors in appraising the overall effect upon competition".[50] Furthermore, in their view had this history been known at the time the initial decision was made, it might well have persuaded one or more justices to vote differently and give effect to the evident purpose of the qualifying clause.[51] As a result, a whole line of jurisprudential authority may well have developed in a significantly different manner.

The lower Federal and District Courts dutifully applied the Supreme Court test of quantitative substantiality. In fact, with one exception, the Courts found a section 3 infraction in every exclusive dealing case which came before them.[52] In the 1954 case of *Dictograph Products v FTC*[53] a manufacturer of hearing aids, Dictograph Products, appealed to the Second Circuit Court of Appeals against an Order of the Federal Trade Commission requiring it to eliminate from its distribution agreements clauses relating to exclusive dealing. Judge Medina, placing emphasis on *Standard Stations*, noted that the manufacturer's arrangement foreclosed its competitors from dealing with 22 per cent of the nations choicest outlets. This fact alone compelled a finding that section 3 had been

[49] Ibid 86-87.
[50] Lockhart and Sacks, note 43 above, 935-936.
[51] Ibid 937.
[52] See also *Pennsylvania Water & Power Co. v Consolidated Gas, Elec. Light & Power Co.*, 184 F. 2d 552 (4th Cir. 1950); *US v Sun Oil Co.*, 176 F. Supp. 715 (E.D. Pa. 1959).
[53] 271 F. 2d 821 (2nd Cir. 1954).

infringed. However, he noted that there was an industry wide practice of using exclusive dealing which also made market access difficult for newcomers.

In *Anchor Serum v FTC*[54] the Seventh Circuit Court of Appeals also applied the approach of quantitative substantiality. In rejecting Anchor Serum's (a manufacturer of animal health products) justifications for the use of such arrangements, Judge Mayor, concluded that Anchor's practices involved a substantial volume of business. It would require, therefore, a "naïve mind" to conclude that these arrangements could result in anything other than an adverse effect upon competition.

The one case in which an antitrust infraction was not found was that of *US v JI Case CO.*[55] Here the exclusive dealing arrangements of the Wisconsin based undertaking, engaged in the manufacture and distribution of farm machinery, was held to be acceptable. Chief Judge Nordbye accepted the argument that it would be contrary to "business acumen and prudence" not to permit exclusive dealing in this case. Comparatively few dealers could afford the necessary financial investment to run more than one line of farm machinery. The Court also accepted evidence which indicated that manufacturers were still able to gain market entry and that the Case Corporation was by no means the largest manufacturer in the field.

The Federal Trade Commission's response to the test of quantitative substantiality was initially receptive. By 1953, however, in the case of *Maico Co*[56] the position changed as

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[54] 217 F. 2d 867 (7th Cir. 1954).
[55] 101 F. Supp 856 (D. Minn. 1951).
[56] 50 F.T.C. 485 (1953).

the Commission concluded that it had the necessary expertise to deal with the complex economic issues surrounding exclusive dealing. Interestingly, during the *Maico* era the Commission never actually upheld as legal an exclusive dealing arrangement. By 1960-61 the Commission formally returned to the fold in the case of *Mytinger and Casselberry*[57].

B. Qualitative Substantiality And The Concept Of Incipiency

It is quite ironic, to say the least, that the Commission in 1960-61 announced its return to the doctrine of *Standard Stations* and its abandonment of its 7 year old *Maico* doctrine on the eve of the Supreme Court's decision to abandon its approach to Section 3 Clayton Act based on quantitative substantiality. As a result of fierce criticism the Supreme Court's doctrinal change was almost inevitable and it occurred in the case of *Tampa Electric Co v Nashville Coal Co.*[58] Here the Tampa Electric Company, a public utility, was engaged in the production and sale of electricity serving the City of Tampa and surrounding communities. As a public utility it operated under franchise granted by the State of Florida. In 1954, it operated two integrated generating plants which were comprised of eleven generating units. All of these units used oil in their burners to generate electricity. In 1955, in order to meet an increased demand for electricity, the corporation took the decision to expand its operations. It decided, therefore, to build the Francis J Gannon Station. This new plant would consist of 6 new generating units: the first two constructed would use coal rather than oil as a means of generating electricity.

[57] 57 F.T.C. 717 (1960).
[58] 365 U.S. 320 (1961).

In May 1955 Tampa Electric contracted with the Nashville Coal Company to provide its total fuel requirements for a period of 20 years. The new Gannon Station would *eventually* consume 2.25 million tons of coal annually at a cost of 128 million dollars. The Nashville Coal Co was one of 700 coal companies operating in the Appalachian region. Taking this region as a whole, Tampa Electric's total coal requirements would amount to only 1 per cent of all coal marketed there. Within peninsular Florida, however, where total coal consumption accounted for less than 6 per cent of all fuel consumed, Tampa Electric's coal consumption would account for a high proportion of all coal purchased.

Deliveries of coal were expected to commence in 1957. In April of that year, however, Nashville Coal advised Tampa Electric that their 20 year contract violated the antitrust laws. As such, deliveries would not commence. Tampa Electric had to purchase its coal requirements from another source at a price substantially higher than the original contractually agreed price. It, therefore, commenced proceedings in the District Court of Tennessee for a Declaration that the contract was valid and enforceable. In the District Court, Judge Miller emphatically stated that the contract was

> "... exclusionary to such a degree and the volume of commerce (was) manifestly so large that there (was) no escape from the conclusion that its efects under the circumstances disclosed (was) to 'probably lessen competition or create an actual tendency to monopoly'"[59]

[59] 168 F. Supp 456, 461 (1960).

The contract, therefore, violated Section 3 Clayton Act and was illegal and unenforceable. Accordingly, Tampa Electric was entitled to no relief.

An appeal was made to the Sixth Circuit Court of Appeals. Judge Shackelford Miller delivered the judgment of the divided Court and rejected Tampa Electric's contentions. The majority of the Court held that Tampa Electric had entered into a requirements contract (contrary to Tampa's assertions); the line of commerce affected was coal and the geographic market was peninsular Florida. Applying the Supreme Court's approach in *Standard Stations* Judge Schackelford Miller concluded that in the "... present case there is no question but that the effect of the contract will be to substantially lessen competition".[60] The Court of Appeals, therefore, affirmed the decision below.

Judge Weick, however, was the sole voice of dissent in the Court of Appeals. In his view the District Court's judgment should be reversed. He gave three main reasons. Firstly, it was in the public interest that such arrangements should not be condemned. Tampa Electric was a public utility and its needs were materially different from those of private industry. As a public utility it was obliged to provide a continuous supply of electricity to the public at prices fixed by the Public Utility Commission of Florida. These rates could not be fixed if it was dependent upon fluctuating market prices for boiler fuel. It was not in the public interest to "... require a utility to purchase boiler fuel on short term contracts or on the open market so that every time there was a shift in the market price the utility's rates to the public would have to be adjusted".[61] Secondly, Judge Weick accepted Tampa Electric's view that a requirements contract did not exist. In his view, Tampa Electric

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[60] 276 F. 2d 766, 772 (6th Cir. 1960).
[61] Ibid at 776-777.

was not prevented from using other suppliers or the products of other suppliers. Its contractual arrangements with its input suppliers simply obligated it to purchase its requirements from Nashville Coal for the first two coal burning units to be constructed at Gannon Station. It was left free, therefore, to convert existing oil burning units to coal and purchase its coal requirements from Nashville's competitors and to construct new coal burning units and purchase its requirements elsewhere. In fact, under the terms of its contractual arrangement, it could if it desired, reduce the quantity of coal purchased from Nashville by 15 per cent and purchase this requirement from other local suppliers.[62] Thirdly, even if the contractual arrangement could be construed as a requirements contract, Judge Weick's interpretation of the line of commerce meant that no antitrust violation had occurred. He stated

> "(i)t is my firm conviction that the line of commerce in which these parties were dealing was boiler fuels, not just coal. If the line of commerce is boiler fuels generally, then this contract could not come within the purview of Section 3 of the Clayton Act, as Tampa was certainly free to purchase boiler fuels other than coal from whosoever it chose".[63]

In Judge Weick's view coal, oil, gas and atomic energy were components of the general line of boiler fuels. As the contract related only to coal, Tampa Electric could not conceivably establish a monopoly in any line of commerce within the meaning of the Clayton Act.

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[62] Ibid at 778-779.
[63] Ibid at 779.

Tampa Electric appealed to the Supreme Court. Mr Justice Clark, writing for the seven member majority, delivered the judgment of the Supreme Court.[64] The majority concluded that the contract sued upon did "... not tend to foreclose a substantial volume of competition".[65] It, therefore, reversed the Court of Appeals and remanded the case to the District Court for further proceedings. In so doing the Supreme Court enunciated a three-step analysis for evaluating the legitimacy of exclusive dealing arrangements. This tripartite test eventually became known as the test of "qualitative substantiality".

In construing the competitive impact clause of Section 3, the Supreme Court stated that certain considerations must be taken into account. Firstly, the line of commerce involved in the exclusive arrangement must be determined. Secondly, the area of effective competition in the known line of commerce must be ascertained by careful selection of the market area. Any competitive foreclosure must relate to this geographic area. Finally, the competition foreclosed by the exclusive dealing arrangement must be found to constitute a substantial share of the relevant market.[66] Mr Justice Clark then indicated that quantitative substantiality, in terms of either dollar volume or market share foreclosed was not to be the controlling doctrine. He stated

> "To determine substantiality ... it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total

[64] Mr Justice Black and Mr Justice Douglas dissented. They would have affirmed the decision of the District Court and Court of Appeals. Neither, however, submitted a written Opinion.
[65] 365 U.S. at 335.
[66] Ibid at 327-329.

> volume of commerce in the relevant market area, and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein. It follows that a mere showing that the contract itself involves a substantial number of dollars is ordinarily of little consequence".[67]

This particular approach introduced greater judicial flexibility, in that the Courts were required to evaluate the restrictiveness and economic utility of the exclusive dealing arrangement.

Having enunciated these principles the Supreme Court then applied them to the facts of the case before it. Firstly, it assumed that the challenged restraint was, in fact, an exclusive dealing arrangement within the compass of Section 3. Secondly, the line of commerce was bituminous coal. However, the Supreme Court was critical of both the District Court and the Court of Appeals for failing to give consideration to the determination of the relevant market area. The Supreme Court viewed this omission as sufficient, in itself, to reverse the decision below. Mr Justice Clark stated "... the relevant market is the prime factor in relation to which the ultimate question, whether the contact forecloses competition in a substantial share of the line of commerce involved, must be decided".[68] Both the District Court and the Court of Appeals were satisfied that peninsular Florida comprised the relevant geographic market. Within this market area only 700 000 tons of coal was consumed in 1959. Oil and natural gas were considered to be the primary fuels. In contrast, Tampa Electric contended that the relevant geographic

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[67] Ibid at 329.
[68] Ibid.

market area was the Appalachian coal region which contained 700 coal producers. The Supreme Court upheld this contention and noted that in that area in 1954 alone, the region produced some 359,289,000 tons of coal of which only 78,716,000 tons were sold to the electric utilities.[69] Within this particular geographic market area "... the proportionate volume of the total relevant coal product as to which the challenged contract pre-empted competition, less than 1 per cent, (was) conservatively speaking quite insubstantial".[70] By redefining the geographic market the Supreme Court found the exclusive dealing arrangement before it to be legal and enforceable. In doing so, Mr Justice Clark, made a number of observations. He stated that this was not a case involving plainly restrictive tying arrangements like those of *International Salt*. Secondly, he distinguished *Standard Fashion* in that the Tampa Electric case did not involve a seller with a dominant market position. Thirdly *Tampa Electric* did not involve a large range of outlets with substantial sales volume, and an industry wide practice of reliance upon exclusive contracts as in *Standard Oil*. In the view of the Court, exclusive dealing possessed certain economic advantages. In the case of the buyer it assured supply and in the case of the supplier it reduced selling costs, furnished protection against price fluctuation and offered the possibility of predictable markets.[71] Mr Justice Clark then echoed some of the sentiment expressed by Judge Weick in the Court of Appeals. He stated that such contracts were necessary in the interests of the public. In the case of public utilities they assured a steady and ample supply of fuel which protected the consumer against "... shut downs and increasingly unjustified costs".[72]

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[69] Ibid at 332.
[70] Ibid at 333.
[71] Ibid at 334.
[72] Ibid.

The *Tampa Electric* decision was not without its critics. Derek Bok argued, for example, that its great weakness was "... its vagueness as a prescription for future cases".[73] The criteria enumerated by the Supreme Court as relevant to the determination of the legality of these arrangements were just too vague to act as guiding principles. R.H. Bork simply asserted that the law in this area had gained "... more complex inadequacy".[74] For the most part, however, *Tampa Electric* was welcomed as creating a sufficiently flexible doctrinal base which avoided the uncompromising prohibitions of *Standard Stations*. For some, the *Tampa Electric* decision meant a return by the Supreme Court to an interpretation of Section 3 which was "... faithful both to its legislative history and to the philosophy of antitrust".[75] The lower Courts responded favourably to the decision and consistently apply its standards to the construction of Section 3.[76]

At this point, it would not be unreasonable to assume that the Supreme Court had finally concluded its quest for an appropriate standard to determine the legality of these arrangements. The assumption, however, would be inaccurate. In the 1966 case of *FTC v Brown Shoe*[77] the Commission alleged that the exclusive dealing arrangements of the Brown Shoe Corporation, one of the worlds largest shoe manufacturers, amounted to an unfair method of competition contrary to Section 5 Federal Trade Commission Act 1914. The allegation revolved around Brown Shoe's franchise programme. This involved some 650 independent outlets all of which agreed to handle only shoes manufactured by Brown

[73] D.C. Bok, "The Tampa Electric Case And The Problem Of Exclusive Arrangements Under The Clayton Act", (1961) *Supreme Court Review* 267, 283.
[74] R. H. Bork, *The Antitrust Paradox*, (Reprint, New York, 1993) p.301.
[75] See, M. Handler, note 44 above, 81-82.
[76] See, for example, *Barr Laboratories Inc. v Abbot Laboratories*, 978 F. 2d 98 (3rd Cir. 1992); *Retaining Wall Systems Inc v Westrock Inc.*, 792 F. 792 F. Supp 1552 (D. Or. 1991); *Adolph Coors v FTC*, 497 F. 2d 1178 (10th Cir. 1974).
[77] 384 U.S. 316 (1966).

or other suppliers non-conflicting lines. This amounted to only 1 per cent of the total number of available outlets (approximately 70,000 nationwide) purchasing 25 million dollars worth of shoes from Brown; which amounted to only 1 per cent of the nations 2.5 billion dollars worth of annual sales. In return the Brown Shoe Corporation provided these outlets with valuable services including the provision of architectural plans, merchandising records, the services of a Brown Shoe field representative and the right to participate in cheaper group insurance.[78]

The Commission concluded, quite simply, that the franchise programme effectively foreclosed Brown's competitors from selling to a *substantial* number of retail shoe dealers.[79] This amounted, therefore, to an unfair method of competition contrary to Section 5. Accordingly a cease and desist order was issued.

Brown Shoe then appealed to the Eight Circuit Court of Appeals. This Court concluded that the Commission lacked the authority to declare the franchise programme unfair. In its view, the Federal Trade Commission Act 1914 was not intended to prohibit or limit such activities. The matter then proceeded to the Supreme Court. It took a different view. It concluded that the Commission had the authority to declare these methods of distribution unfair and contrary to Section 5. Mr Justice Black stated that the

> "... broad powers of the Commission is particularly well established with regard to trade practices which conflict with the basic policies of

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[78] Ibid at 384.
[79] Ibid.

the Sherman and Clayton Acts even though such practices may not actually violate these laws".[80]

The Supreme Court then unanimously concluded that Brown Shoe's program conflicted with the basic policy of the antitrust laws. That is, with the freedom of purchasers (dealers) to buy in an open market.[81] Accordingly, the Supreme Court rejected Brown's contention that an economic investigation must be conducted to determine the competitive effect of the restraint. Mr Justice Black stated

"We reject the argument that proof of this Section 3 element must be made ... the Commission has power under Section 5 to arrest trade restraints in their incipiency without proof that they amount to an outright violation of Section 3 of the Clayton Act or other provision of the antitrust laws".[82]

On this "incipency" basis, the Supreme Court upheld the Commission's decision. It represented a particular philosophical brand of antitrust, the roots of which were firmly planted in the traditionalist school. It was primarily concerned with keeping the channels of distribution open and not with distributive efficiency. The Court was prepared, therefore, to condemn any contractual restriction which prevented a dealer from purchasing freely in the open market. The fact that a substantial number of retail dealers were foreclosed to other competitors was sufficient to condemn the arrangement. This

[80] Ibid at 321.
[81] Ibid
[82] Ibid at 322.

approach went further than *Standard Stations* in that the market share percentage of dealers foreclosed was irrelevant.

This particular decision provoked much criticism. It seemed to allow the Clayton Act standard based on *Tampa Electric* to be totally interdicted. It moved to a form of absolutism in which restraints of trade, however reasonable, could be condemned. Historically, this position had been abandoned as early as 1711 in the English case of *Mitchell v Reynolds*.[83] In this respect, Milton Handler asked rather caustically "... (i)s it consonant with our democratic tradition to permit an administrative agency to refashion statutory standards of legality with no limit other than the vague concept of incipiency?"[84] However, he reserved his more critical comments for the underlying policy considerations of *Brown Shoe*. In his view, they were neither sound, viable nor wise. The freedom which "... should be protected is the freedom to contract, not the freedom to buy in a market untrammeled by *any* restriction, however reasonable".[85] Much of the vehement criticism directed at *Brown Shoe* proved only to be academic. In terms of precedential value, it was applied in only three subsequent cases.[86] The Supreme Court decision of *Tampa Electric* has proved more enduring and influential.

It becomes abundantly apparent that the US Courts and the Commission's approach to exclusive dealing has vacilitated considerably over the years. In this respect, exclusive dealing has certainly been an antitrust violation in search of a standard. The

[83] 24 E Rep 347 (K B 1711).
[84] M. Handler, "Some Misadventures in Antitrust Policy Making – Nineteenth Annual Review", (1966) 76 *Yale LJ* 92, 98.
[85] Ibid 101.
[86] *Adolph Coors v FTC*, 497 F. 2d 1178 (10th Cir. 1974); *L. G. Balfour Co v FTC*, 442 F. 2d 1 (9th Cir. 1971); *Lauria Bros & Co v FTC*, 389 F. 2d 487 (5th Cir. 1968).

Commission's current approach to these arrangements is in line with the *Tampa Electric* decision. In *Beltone Electronic Corp*[87] for example, the Commission stated that a proper analysis of these restraints should

> "... take into account market definition, the amount of foreclosure in the relevant market, the duration of the contracts, the extent to which entry is deterred and the reasonable justification, if any, for the exclusivity".[88]

In holding the restraint legal, the Commission in *Beltone* recognised that these restraints could be used to protect a suppliers capital investment and thereby prevent interbrand free riding.

III. EXCLUSIVE PURCHASING IN THE EUROPEAN UNION

A. The Development Of EU Case Law: From Beer To Ice-Cream And *Vice Versa*

In 1963 the Court of Justice was given an early opportunity to consider exclusive purchasing in the case of *Brasserie de Haecht SA v Wilkin-Janssens*.[89] Brasserie de Haecht, a Belgian brewer, entered into a number of contracts with a married couple called Wilkin-Janssens, the proprietors of "A la Ferme" café in Esneux. The Belgian brewer agreed to lend equipment and money to the value of 52,000 francs and, in return, the

[87] Trade Reg Rep (CCH) 21, 934 FTC (1982).
[88] Ibid 22, 391.
[89] Case 23/67 [1967] ECR 407, [1968] CMLR 26.

owners of the café undertook to obtain their supplies of beer, lemonade and other drinks from the brewery. In 1966 the brewery discovered that the exclusive purchasing obligation had been broken and sued for recission of the loan contract, return of the goods lent and damages in accordance with the contractual penalty clause.

The Wilkin-Janssens admitted that they obtained supplies in breach of their contractual obligations but contended that the arrangement was void under Article 81 (ex 85). To be successful the defendant café proprietors had to show that their rather modest contracts affected trade between Member States. They contended, therefore, that they should not be considered in isolation. Consideration had to be given, firstly, to the fact that the brewery had concluded similar arrangements with other café proprietors and, secondly, that other breweries had concluded analogous contracts with other licensees. The Belgian Court of Liege referred the matter to the Court of Justice asking whether it was possible to take into account the whole of the market in its economic context or whether it was necessary to keep to an examination of the effects on the market of the loan agreement in isolation.[90]

Advocate General Roemer stated that it was perfectly feasible for a single long term exclusive purchasing arrangement to infringe Article 81(1) (ex 85(1)). A highly technical product, for example, may have to be marketed by an undertaking with appropriate technical know-how. If only one such undertaking is established in a Member State and it is tied to a single producer, foreign manufacturers would be prevented from marketing their products in that Member State. The Advocate General, however, felt the contracts in question did not fall within this category. In assessing whether they violated Article 81(1)

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[90] Ibid 409.

(ex 85(1)) he concluded they should not be considered in isolation. Account had to be taken of the fact that they formed part of a network of similar agreements. Factors to be considered in this analysis included the number of such contracts, their duration, the quantities of goods involved, the proportion of goods sold thereunder in comparison with the amount sold by free distributors and the possibility of establishing other outlets.[91]

The Court of Justice, in a very brief judgment, accepted this analysis. It held that the affects of beer supply agreements had to be assessed in the economic and legal context in which they occur and where they might combine with others to have a cumulative effect on competition. The Court stressed, however, that this factor was not on its own determinative. Without enumerating other factors, the Court simply stated that the cumulative effect of several agreements was only one factor amongst others to be considered in this analysis.[92]

The Commission, however, has traditionally applied Article 81(1) (ex 85(1)) in a rather summary fashion, contrasting with the more nuanced approach of the Court.[93] It preferred to conduct any economic analysis within the parameters of Article 81(3) (ex 85(3)). This, of course, increased the Commission's jurisdictional reach. An example of its approach can be seen in the 1977 case of *Spices*.[94] Here Brook Bond Liebig, a spice producer with 39 per cent of the Belgian market entered into supply agreements with the three leading Belgian supermarket chains. The latter, whose combined sales of spices accounted for 30

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[91] Ibid 423-424.
[92] Ibid 414-415.
[93] See F. Bissocoli, "Exclusive Purchasing Obligations: The Italian Chapter Of The Ice Cream Distribution Saga", (1998) 19 *ECLR* 520; V. Korah, "Exclusive Purchasing Obligations: Mars v Langnese and Scholler", (1994) 15 *ECLR* 171.
[94] Comm. Dec. 78/172 OJ 1978 L53/20, [1978] 2 CMLR 116.

per cent of all such sales in Belgium, agreed to purchase and stock only Liebig's spices in addition to their own branded products. The Commission found that this arrangement infringed Article 81(1) (ex 85(1)) because it restricted the freedom of choice of the supermarkets in respect of the purchase and resale of spices. It also restricted competition between spice producers because it restricted other producers from distributing their products through the bound outlets forcing them to market their products through a larger number of smaller outlets.[95] The effects of this restriction were made all the more significant because Liebig imposed resale prices on its distributors preventing intrabrand competition. The Commission concluded that the agreements, had they been notified, would not qualify for exemption. They neither improved distribution nor benefitted the consumer.[96]

More recently in *Delimitis v Henninger Brau AG*[97] the Court of Justice confirmed and expanded upon its judgment in *Brasserie de Haecht(1)*. In this seminal case the Court held that exclusive purchasing obligations do not fall within the parameters of Article 81(1) (ex 85(1)) unless they foreclose market access to domestic or foreign competitors. The facts of the case are rather straightforward. Delimitis entered into a tie by type beer supply agreement with the Henninger Brau brewery in May 1985. The latter agreed to let to Delimitis one of its public houses in Frankfurt. Delimitis was contractually obliged to furnish a rental deposit as a form of guarantee. He also agreed to purchase a minimum quantity of beer from the German brewery, in the knowledge that failure to do so would result in the imposition of financial penalties for contractual non-performance. The tie by

[95] Ibid 23.
[96] Ibid 24-25.
[97] Case C-234/89 [1991] ECR I-935, [1992] 5 CMLR 210.

type beer supply agreement also contained an "access clause" which enabled Delimitis to purchase his beer requirements, should he wish to do so, from other breweries established in other Member States.

In December 1986, as a result of ill health, Delimitis terminated the agreement and the brewery deducted a sum in excess of DM 6000 from the rental deposit. In its view its tenant failed to meet its minimum purchasing requirements. Delimitis regarded the deduction as unlawful and alleged that the agreement violated Article 81(1) (ex 85(1)). He brought proceedings against the brewery before the Landgericht, Frankfurt am Main for recovery of the sum deducted. In February 1988 the German Court dismissed his claim. The Landgericht considered that the contract did not affect trade between Member States. In its view this would still be the case even if the contract constituted one element in a series of beer supply agreements. Delimitis appealed against this judgment to the Oberlandergericht. In order to resolve the dispute the Higher Regional Court referred the matter, in July 1989, to the Court of Justice for a preliminary ruling on the compatibility of tie by type beer supply agreements with the Community competition rules.

The parties to the proceedings, not unsurprisingly, adopted differing positions. Delimitis contended that case law indicated that a single beer supply agreement containing exclusive purchasing obligations was capable of falling within the provisions of Article 81(1) (ex 85(1)). This was also the case for a contract which constituted one of a bundle of similar agreements, the cumulative effect of which may be to affect intra-community trade. This would be the case if the bundle of contracts covered 40 to 50 per cent of the relevant drinks outlets in a Member State or a similar percentage of turnover. Delimitis contended, in any event, that 60 per cent of outlets were tied in the German market and this was sufficient to indicate that intra-community trade was significantly affected. Should the Court refuse to accept this figure, Delimitis argued that a number of other factors had to be taken into account. These included *inter alia* the number, duration, volume of trade covered by the bundle of contracts and the ratio of goods sold under these agreements in relation to the quantities sold by free distributors. Delimitis also argued that the geographic market should be determined on a regional basis and the product market should be limited to the sale of beer in bars.[98]

In contrast, the brewery argued that the agreement was not a standard beer supply contract. It did not contain an exclusive purchasing obligation, merely a requirement to purchase minimum quantities. It was also an "open-contract" permitting publicans to freely obtain supplies in other Member States. The brewery argued, therefore, that Article 81(1) (ex 85(1)) was not automatically applicable even though the contract restricted the freedom of action of the respective parties. In fact, limiting freedom of action was essential to proper contractual performance. With regard to intra-Community trade the brewery argued that the agreement could not affect trade between Member States because it contained an *access* clause. There was, therefore, no barrier to economic interpretation. Should, however, the Court consider that trade between Member States was affected, the brewery contended it could not be affected appreciably. The contract related to a small amount of beer and only to suppliers within Germany. Even if the contract formed part of a bundle of agreements it would only affect trade in exceptional cases.[99] The brewery made reference to the factors listed by Advocate General Karl Roemer in his Opinion in

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[98] Ibid 943-4.
[99] Ibid 945.

Brasserie de Haecht (1)[100] as pertinent to such an assessment. The brewery stressed, however, that the application of these factors was a matter for the national Court although the Court of Justice should provide operational guidelines. It then argued that the product market included not only the sale of beer in hotels, restaurants and public houses but also retail sales of beer. The geographic market was the Federal Republic of Germany. On this basis, the brewery concluded that there was no infringement of the competition rules.

The French Government submitted observations. In its view the national Court, when assessing the effect of intra-Community trade, must take into account the existence of similar contracts entered into by the brewery with its tenants and analogous contracts entered into by other breweries with their respective tenants. The French Government felt unable to set, in percentage terms, a figure relating to foreclosed outlets which would indicate that competition was restricted.

The Commission commenced its observations by defining the relevant market. The product market was limited to the sale of beer in hotels, restaurants and public houses and did not include retail sales. It noted, however, that there was a close interdependence because retail sales could be used by a foreign supplier to gain market acceptance for its products. The Commission concluded that the relevant geographic market was the Federal Republic of Germany. It then observed that the Court's case law indicated that network effects were relevant, amongst other factors, to the current analysis. These other factors included consideration of the number of outlets bound by exclusive purchasing obligations in comparison with free houses and the comparative volume of beer sold in tied houses. In this context the Commission emphasised market saturation and access to

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[100] Case 23/67 [1967] ECR 423-424.

the retail trade by foreign suppliers. Finally, the Commission stated that a bundle of contracts covering 30 per cent of public houses in a Member State was already capable of appreciably affecting trade between Member States.[101]

Advocate General Van Gerven delivered his Opinion on 11 October 1990. He agreed with the brewery, the French Government and the Commission that the relevant geographic market was that of the Federal Republic of Germany, observing that contracts of this type were generally entered into by parties established in the same Member State. With regard to the product market, he agreed with the position adopted by the Commission and Delimitis, confining it to the sale of beer in bars.[102] Concerning the effect on trade between Member States, the Advocate General noted that an extensive network of similar contracts not only reduced the freedom of the contracting parties but also had consequences for market structure, in that they could reduce the number of supply and demand possibilities. Ultimately, these contracts could be used to protect national markets from imports from other Member States. He concluded that the cumulative effect of a bundle of such contracts constituted one factor amongst others which may render an agreement, which at first sight appears insignificant, susceptible to Article 81(1) (ex 85(1)). He felt unable, however, to set down a percentage figure relating to the degree of market foreclosure which would render Article 81(1) (ex 85(1)) applicable. He merely concluded that a high proportion of foreclosure (between 40 and 60 per cent) seriously affected market competitiveness.[103]

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[101] [1991] ECR I-948.
[102] Ibid 964-965.
[103] Ibid 967.

The Advocate General then commented on those other factors which may be relevant to the assessment. They fell into two categories. Firstly, factors relevant to the actual agreement itself and secondly, factors relevant to the agreements falling within the network. Taking the second category first, the Advocate General attached importance to the volume of sales in tied outlets in relation to the overall beer market, the number, duration and volume of the tied outlet agreements.[104] In this connection, however, he noted that the available facts were "... too cursory and imprecise".[105] He concluded, therefore, that excessive importance should not be attached to the cumulative effect of a series of agreements. They merely provided an economic background to the individual agreement itself. With regard to the first category of factors the Advocate General attached importance mainly to the market position of the brewery and volume of sales. He noted that Henninger Brau ranked thirteenth out of a possible thousand breweries.[106] Finally, with regard to the access clause he observed that the Commission adopted a restrictive interpretation concluding that trade between Member States was still affected notwithstanding the inclusion of the provision. In his view this was a matter for the German Court.

In February 1991 the Court of Justice delivered its judgment. It stressed that Regulation 1984/83 did not apply to tie by type beer supply agreements. The latter failed to specify by brand or denomination the products forming the subject matter of the contract. This did not conform with Article 6 of Regulation 1983/84 as the brewer could unilaterally extend or vary the exclusive purchasing obligation.[107] The Court then outlined, briefly,

[104] Ibid 968.
[105] Ibid 967.
[106] Ibid 969-970.
[107] Ibid 989-990

the advantages of exclusive purchasing arrangements.[108] It stated, however, that where these arrangements do not have as their object the restriction of competition it was still necessary to consider whether they had that effect. It referred to the judgment in *Brasserie de Haecht I* and noted that the cumulative effect of these arrangements had to be considered amongst other factors in any assessment. It was necessary, therefore, to determine whether the present agreement, in conjunction with other agreements of the same type, affected the opportunities of national competitors or those from other Member State gaining access to the market for beer consumption or from increasing their market share.[109]

The Court then presented its cumulative two-step assessment for the determination of these issues. The first step involved the definition of the relevant market. With regard to the product market the Court concluded that it should be defined on the basis of the nature of the economic activity in question, in this case the sale of beer. From the consumers point of view, sales from public houses and restaurants could be distinguished from retail sector sales. In the case of the former, product purchase is linked to the provision of service which is generally reflected in higher prices. The product market was defined as on trade sales - the sale of beer in bars and restaurants.[110] The fact that there was a certain overlap between the on trade and off trade market (retail sales), in as much as retail sales allowed new competitors to gain product acceptance, did not affect the Court's findings. The geographic market was then defined as the market for the sale and consumption of

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[108] Ibid 983

[109] Ibid 984

[110] This definition reflected the position adopted by the Court of Justice in Case 27/76 *United Brands v Commission* [1978] ECR 207, [1978] 1 CMLR 429, para 12, where the product market was defined as including all goods or services perceived by the consumer (price, purpose, product characteristics) to be interchangeable

beer in premises on the German market.[111] The Court then moved on to consider the cumulative effect of several similar networks in order to determine the degree of market foreclosure. It emphasised the need to consider the number of outlets tied to national producers in relation to the number of public houses not so tied (numeric foreclosure); contract duration; the quantities of beer to which these contracts related and the proportion between these contracts and the quantities of beer sold by free distributors (volume weighted foreclosure). The Court then stressed that this finding was not, in itself, sufficient for a finding of market inaccessibility. Other factors had to be considered including, firstly, opportunities for market access and secondly, competitive market forces. With regard to the former the Court emphasised that consideration needed to be given to whether a new brewery could acquire an existing brewery with its network of sales outlets or open up its own public houses. This would entail consideration of *inter alia* the law on company acquisitions and the minimum number of outlets necessary to create a profitable distribution system. With regard to competitive market forces the Court emphasised the need to consider the number and size of producers, the degree of market concentration and brand loyalty. Market access is hindered to a greater degree where the market is saturated and customer loyalty to a particular brand is strong.[112]

The Court then turned to the second step in its analytical model. If having considered step one, there are no indications that market access has been denied to new national or foreign competitors, the bundle or network of agreements cannot be considered to be in violation of Article 81(1) (ex 85(1)) EC. If, however, access has been made more difficult it is necessary to consider whether the brewer's network of agreements had made "... a

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[111] Ibid 985.

[112] Ibid 986.

significant contribution to the sealing-off effect brought about by the totality of ... agreements in their economic and legal context".[113] If the contribution is significant the requisite Article is infringed. In this assessment the Court listed a number of factors to be considered: the market position of the contracting parties (the market share of the brewery and its group), the number of outlets tied to the brewery in relation to the total number of outlets on the relevant market not so tied and the duration of the agreements. With regard to the latter, the Court observed that manifestly excessive contract terms could render the contract violative of the competition rules.

The *Delimitis* judgment, with its more nuanced economic based approach to exclusive purchasing, has been welcomed by many commentators.[114] However, the Court's approach is not without criticism. Firstly, the first step in the *Delimitis* analysis was confined to the foreclosure effect produced by domestic manufacturers on the German market. Market foreclosure precipitated by ties concluded between foreign beer producers and German outlets were excluded from the analysis. The mere fact that the geographic market was confined to Germany was no justification for their omission. A tie to a foreign brewer could foreclose as much as a tie to a domestic producer.[115] Secondly, if the cumulative network effect indicated that market access was made more difficult, the *Delimitis* second stage analysis required consideration of the contribution made by the agreements of the brewery in question to this effect. Only if the contribution is significant will the agreement fall within Article 81(1) (ex 85(1)). In this respect the Court simply

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[113] Ibid.
[114] See K.P.E. Lasok, "Assessing The Economic Consequences Of Restrictive Agreements: A Comment On The Delimitis Case", (1991) 12 *ECLR* 194. V. Korah, "The Judgment In Delimitis: A Milestone Towards A Realistic Assessment Of The Effects Of An Agreement - Or A Damp Squib?" (1992) 14 *EIPR* 167.
[115] See V. Korah, note 114 above, 172.

listed factors to be considered and failed to define exactly what it meant by a "significant" contribution to market foreclosure. In many respects, therefore, everything seems relevant. Yet, the analysis need not consider all the beer supply agreements concluded by the brewery in question. The latter may, for example, conduct its business using two or three quite distinct standard form agreements. If the dispute relates to a specific network operating, under a specific type of agreement, the brewer's other networks operating under quite distinct standard form agreements may be excluded from the analysis.[116] Thirdly, the Court failed to provide clarification upon the degree of market foreclosure needed to implicate Article 81(1) (ex 85(1)). Fourthly, the matters raised by *Delimitis* are undoubtedly complex. Fears arose that national Courts, not versed or experienced in the complexities of competition law, may find the resolution of such disputes difficult. Perhaps, more fundamentally, the party seeking to establish an infraction of Article 81(1) (ex 85(1)) bears a heavy burden of proof beyond the financial means of most litigants. To avoid intolerably complex litigation Korah has argued that national Courts should develop a truncated analysis. That is, Article 81(1) (ex 85(1)) should not apply if the contracts are of short duration, barriers to market access low, the degree of free trade is capable of dealing with the output of a new entrant and the party has a low market share.[117] Finally, at the time of the Court's judgment it was uncertain whether *Delimitis* would be extended to other types of agreements. Indeed, it was uncertain whether the Commission would embrace the more nuanced approach of the Court.

Shortly after the *Delimitis* judgment the Commission turned its attention to the distribution practices of the ice-cream industry, a sector which has attracted the attentions

[116] See K.P.E. Lasok, note 114 above, 199.
[117] See V. Korah, note 114 above, 174.

of the regulatory authorities in Denmark, Greece, Italy, Portugal and the UK. The Commission, however, focused on the German and Irish ice-cream markets.

By way of background, it should be noted that the US multinational Mars Incorporated acquired the US ice-cream company, Dove. Mars developed ice-cream versions of its confectionery brands and sought to introduce them into Europe via its wholly-owned European subsidiaries. The American corporation, however, felt that its attempts to penetrate the European market was hindered by the distributive practices of European manufacturers, in particular, those of the Unilever group. The wide-spread European practice of outlet and freezer exclusivity gave Mars cause for concern. Outlet exclusivity occurs when an ice-cream manufacturer requires its purchasers to enter into a supply contract whereby the latter agrees not to stock any rival brands at its retail outlet. Freezer exclusivity arises when a manufacturer provides the retailer with a freezer, subject to the obligation to only stock its products therein. The retailer is not, however, contractually prevented from selling other brands. In certain circumstances, freezer exclusivity can amount to *de facto* outlet exclusivity if, for example, the retailer has space constraints and cannot install another freezer from which to sell competing brands.

In September 1991 the American Corporation's subsidiary, Mars GmbH, complained to the Commission in relation to the exclusivity agreements concluded by Scholler lebensmittel GmbH and langnese-Iglo GmbH, a subsidiary of the Unilever group. Both these German undertakings manufactured and distributed ice-creams, frozen foods and pastries for the German market. The standard form supply agreements of both undertakings were similar in many respects. Both suppliers required their respective retailers to purchase their ice-cream products exclusively from themselves. In return retailers received, free of charge, a freezer cabinet from which to sell ice-cream products. Both German manufacturers believed this distributive method would enable them to utilise a large number of sales outlets which would not otherwise be available and, therefore, to exploit the new marketing opportunities arising in the former German Democratic Republic.

Scholler's standard agreements had been the subject of a comfort letter in 1985 in which the Commission stated they were compatible with the rules on competition. In December 1991, however, the Commission announced that it intended to reconsider the exclusive purchasing arrangements of both German undertakings. In *Scholler Lebensmittel GmbH & Co KG*[118] and *Langnese-Iglo GmbH*[119] the Commission decided that the outlet exclusivity typical of both distribution systems infringed Article 81(1) (ex 85(1)) and were ineligible for exemption. The Commission defined the relevant market, in each case, as that of the self service impulse ice-cream market. The geographic market comprised that of the German national market. At this point, the Commission's approach departed from that adopted by the Court of Justice in its *Delimitis* judgment. It developed its own three-tier test for the determination of compatibility with Article 81(1) (ex 85(1)).[120] Three questions had to be asked and answered. Firstly, does the exclusive purchasing agreement at issue have an appreciable effect on competition or trade between Member States? Secondly, if not, do all the agreements of this kind entered into by the undertaking concerned have this effect? Finally, if not, do all the agreements which exist on the

[118] Comm. Dec. 93/405 OJ 1993 L183/1, [1994] 4 CMLR 51.
[119] Comm. Dec. 93/406 OJ 1993 L183/19, [1994] 4 CMLR 51.
[120] EC Commission, *Twenty-Second Report on Competition Policy 1992* (Brussels, 1993) p.112.

relevant market have this effect? The Commission stated that if one of these questions was answered in the affirmative Article 81(1) (ex 85(1)) would apply.

The Commission turned to the issue of market foreclosure and noted that Scholler sold about 10 per cent of the total volume of industrial ice-cream on the relevant market and tied to itself, by means of these arrangements 10 per cent of traditional sales and grocery outlets. In contrast Langnese sold approximately 15 per cent of impulse ice-cream on the relevant market and tied about 15 per cent of outlets. Making reference to its 1986 Notice on Agreements of Minor Importance[121] the Commission concluded that contracts of this type would have no appreciable effect and would not be caught by Article 81(1) (ex 85(1)) if the goods which are the subject of the agreement do not represent more than 5 per cent of the relevant market or if the aggregate turnover of the participating undertakings does not exceed ECU 200 million. In the case of Scholler and Langnese numeric and volume weighted foreclosure amounted to 10 per cent and 15 per cent respectively and, therefore, exceeded the ceiling defining an agreement of minor importance. The second tier, of the three tier, test had been satisfied. The Commission, in each case, concluded that these

> "... facts alone (were) sufficient to establish that the supply agreements do appreciably restrict the scope for domestic and foreign competitors to establish themselves on the relevant market, or to increase their market share".[122]

[121] OJ 1986 C231/2. This notice has been replaced. See OJ 1997 C372/3 [1998] 4 CMLR 192.
[122] Comm. Dec. 93/405, note 118 above, para 105; Comm. Dec. 93/406, note 119 above, 104

In the Commission's view it was, therefore, unnecessary to examine network effects in accordance with the case law of *Brasserie de Haecht I* and *Delimitis*.

The Commission's analysis then turned to considerations of Article 81(3) (ex 85(3) EC. It rejected the contentions of both German undertakings that their respective supply agreements contributed to improvements in product distribution. While they may produce advantages to the respective suppliers they did not produce any appreciable objective benefits in favour of the public. They simply strengthened the market position of both undertakings which led to a lessening of competition. In fact, consumers failed to derive a fair share of the alleged benefits. Consumer choice was diminished in that they could only obtain one brand of product from tied outlets. It was not always the case that alternative outlets selling other brands existed within the neighbourhood and, even if this was the case, consumers found it "irksome" to have to visit a separate outlet to acquire another branded product.[123]

The Commission, in both cases, then considered whether effective competition existed on the relevant market and this entailed a consideration of barriers to market entry. The Commission considered, firstly, the insulating effect of the exclusive supply contracts of both German undertakings. It noted that the market comprised two distinct channels, namely, distribution through grocery stores and outlets of a more traditional nature such as ice-cream kiosks, cakeshops and petrol stations. In both channels Scholler and Langnese occupied leading market positions. In the grocery trade they accounted for over two-thirds of all sales. This rendered market access for prospective entrants and market

[123] Comm. Dec 93/405, note 118 above, para 123; Comm. Dec. 93/406 note 119 above, para 124

expansion for existing incumbents more difficult. Furthermore, a strong supply side concentration meant that incumbents would take action to defend their market positions. A similar picture emerged for distribution through traditional outlets. Once again, Scholler and Langnese accounted for over two thirds of sale volume. Here, the Commission emphasised the extent to which the respective undertakings exclusive supply agreements contributed to market foreclosure. While this effect could be mitigated by short term agreements the contracts of both parties could not be considered as agreements with short durations. Secondly, the Commission noted the absence of independent middlemen on the market. Prospective entrants, therefore, had either to collaborate with or acquire existing incumbents. Only Scholler and Langnese were available for this purpose and their market positions were so strong that it was not possible to compete effectively. In fact, collaboration simply perpetuated existing market structures. Thirdly, the Commission considered that the technology and know-how needed for the production of impulse ice-cream and consumer preferences built up over many years of consumption and marketing all contributed to insulating the relevant market. Finally, the Commission concluded that freezer exclusivity amounted to a barrier to market entry. By accepting freezer cabinets from the respective German undertakings retailers avoided capital investment and maintenance costs. Even if prospective entrants were willing to provide a similar service, market entry was still dependent on their ability to persuade retailers to replace their existing freezer. Retailers would, therefore, have to be convinced to give up selling the products of their current supplier who occupied a strong market position. This was not likely to happen if the prospective entrant was not well known or offered a partial product range. Lastly, the installation of additional freezers may prove problematic because of outlet space constraints or the availability of space in an appropriate position usually close to the check out desk. The existence of these barriers to market entry prevented any substantial shift in market shares and the duopolistic market structure meant that competition between the duopolists was limited. Accordingly, the Commission condemned the outlet exclusivity of both undertakings.[124]

In April 1992 in *Scholler Lebensmittel GmbH v Commission*[125] and *Langnese-Iglo v Commission*[126] the two German undertakings appealed to the Court of First Instance seeking annulment of the Commission's Decisions. They both argued that the Commission should have adopted a more expansive market definition to include ice-cream, in general, and scooping ice-cream, in particular. The Court of First Instance agreed but concluded that this failure did not substantially effect its assessment, in particular, as to whether access to the market was closed or considerably hindered.

The German undertakings also contended that their respective supply contracts did not fall within the parameters of Article 81(1) (ex 85(1)). The Commission had failed, in their view, to conduct a sufficiently far reaching market analysis. It failed to take into account the first step in the two stage *Delimitis* test. Had the Commission embarked upon this nuanced approach, it would have concluded that the amount of foreclosure was less than 30 per cent, a figure which the Commission in *its Fifteenth Report on Competition Policy* (1985, point 19) had previously considered acceptable. Indeed, the Commission had failed to take account of the relatively short duration of these contracts in mitigating market foreclosure. The German undertakings also argued that the cumulative effect of these networks were not sufficient, in themselves, to sustain a conclusion of market

[124] Comm. Dec. 93/405, note 118 above, 124-147; Comm. Dec. 93/406, note 119 above, paras 125-148
[125] Case T-9/93 [1995] ECR II-1611, [1995] 5 CMLR 602.
[126] Case T-7/93 [1995] ECR II-1533, [1995] 5 CMLR 602.

foreclosure. Other legal and factual circumstances had to be taken into account. Consideration of these factors would indicate that the market was not foreclosed. Langnese, firstly, pointed to the fact that numerous outlets remained untied and were immediately available to other competitors. Secondly, the ice-cream market was expanding rapidly as a result of new marketing opportunities emerging in the German Democratic Republic. If Mars encountered difficulties in gaining market access this was attributable to its inappropriate commercial strategy. It should have set up its own outlets rather than confining itself to sales through existing outlets. Finally, with regard to technological barriers to market entry the applicants contended that Mars had the requisite technology and considerable financial resources to market its products.[127]

The Court of First Instance agreed with the Commission that outlet exclusivity, as practised by Scholler and Langnese, fell within Article 81(1) (ex 85(1)). It rejected, however, the Commission's analytical approach and substituted the two stage approach of *Delimitis*. With regard to network effects the Court, in both cases, considered numeric and volume weighted market foreclosure concluding that the degree of foreclosure exceeded 30 per cent. It then considered other factors pertinent to the legal and economic appraisal of the agreements in question. Agreeing with the Commission, the Court concluded that freezer exclusivity and rebates granted to enforce such schemes, the lack of independent distribution intermediaries, brand strength and contract duration all constituted barriers to market entry. The Court then applied the second stage of the *Delimitis* test and concluded, in view of the respective applicants market shares and strong market positions, that the individual networks of Scholler and Langnese "contributed significantly" to market

[127] Case T-9/93, note 125 above, 1637-1641; Case T-7/93, note 126 above, 1565-1570.

foreclosure.[128] With regard to the applicability of Regulation 1984/83 and the possibility of exemption the Court upheld the Commission's decision. The undertakings respective agreements were subject to "tacit renewal" and could be regarded, therefore, as concluded for an indefinite period rendering the block exemption inapplicable. Individual exemption was not possible as the two undertakings could not show that their distributive methods displayed appreciable objective benefits.[129] The applicants were, however, successful in one respect in that the court upheld their contention that the Commission did not have the legal basis to withhold the benefit of the block exemption from future supply agreements concluded by them.

In August 1995 Langnese perpetuated the saga by appealing to the Court of Justice in the case of *Langnese Iglo GmbH v Commission*[130] asking it to set aside the lower Court's judgment. The Court of Justice gave its ruling in October 1998. Langnese supported its appeal of three grounds. Firstly, it maintained that the Commission was bound by its assessment made in its comfort letter of September 1986 and addressed to Scholler. To depart from it would breach the principle of the protection of legitimate expectations. The Court of First Instance held that new circumstances had arisen which required a more detailed market examination. Mars and Jacob Suchard had entered the market and the Commission became aware of additional barriers to market entry. The Court of Justice, therefore, rejected this ground of appeal. Secondly, Langnese contested the conclusion that its exclusive supply agreements were incompatible with Article 81(1) (ex 85(1)). It contended that it had presented documentary evidence to the Court of First Instance

[128] Case T-9/93, note 125 above, 1641-1646; Case T-7/93, note 126 above, 1571-1576.
[129] Case T-9/93, note 125 above, 1651-1666; Case T-7/93, note 126 above, 1585-1600.
[130] Case C-279/95P [1998] ECR I-5609, [1998] 5 CMLR 933.

indicating that market foreclosure was less than 30 per cent. Furthermore, the lower Court merely accepted the Commission's arguments that freezer exclusivity amounted to a barrier to market access without requiring evidence to be adduced in support. In the view of the applicant, the facts indicated that market access was not impeded. The Court of Justice rejected this ground in its entirety. The appellant simply did not specify the errors of law allegedly committed by the lower Court and because matters of evidence were for the Court of First Instance to assess.[131] Finally, the Court of Justice rejected the applicant's claims that the principles of proportionality and equal treatment were infringed.[132] It should also be noted that the Court of Justice rejected the Commission's cross-appeal holding that it was not entitled to prohibit the applicant from concluding such agreements in the future.[133]

The condemnation of the distribution arrangements in the German ice-cream cases related to outlet exclusivity. The Commission considered the issues of freezer exclusivity in the Irish market in *Van Den Bergh Foods Ltd.*[134] Once again the two main protagonists were the Unilever Group and Mars Incorporated. The legal and factual background to the case, is to say the least, rather convoluted. HB Ice Cream Ltd (HB) succeeded Hughes Brothers Ltd an Irish diary company formed in 1924. In 1968 it acquired its principal rival, Premier Dairies. Since that date it has become Ireland's principal manufacturer and distributor of ice-cream products. In 1974 it was taken over by the Unilever Group and reformed, in 1993, as Van den Bergh Foods Ltd as part of Unilever's internal reorganisation. Masterfoods Ltd trading as Mars Ireland (Mars) is the wholly-owned

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[131] Ibid 5640-5642.
[132] Ibid 5642-5646
[133] Ibid 5652.
[134] Comm. Dec 98/531 OJ 1998 L246/1, [1998] 5 CMLR 530.

subsidiary of Mars Incorporated. Valley Ice Cream (Ireland) Ltd manufactured its own ice-cream products and, prior to its liquidation in 1997, acted as principal distributor of Mars ice-cream products in Ireland. For many years HB made available to retailers, freezer cabinets for the storage and display of its ice-cream products. The cabinets were either loaned to the retailer at no charge or leased for a nominal rent which was rarely collected. Cabinet repair and maintenance was performed by HB and the cabinets were supplied under a standard form contract which provided that they were to be used exclusively for storing HB's products. When Mars entered the Irish ice-cream market, many retailers stored its products in their cabinets in contravention of their agreements with HB.

In March 1990 Mars brought an action in the Irish High Court seeking a Declaration to the effect that the exclusivity provisions in HB's cabinet agreements were void under the competition rules. HB brought a separate cross-action claiming injunctions to restrain Mars from inducing retailers to breach their exclusivity agreements. In April 1990 interlocutory injunctions were granted in favour of HB pending outcome of the trial. In September 1991 Mars, once again, complained to the Commission alleging that it was being hindered from gaining market access. In May 1992 in *Masterfoods v HB Ice Cream Ltd*[135] the Irish High Court dismissed the action brought by Mars holding that HB's freezer exclusivity agreements did not violate domestic law or the Community rules on competition. It also made the interlocutory injunction permanent. The Court did, however, recognise that HB occupied a position of market dominance. In July 1992 Valley Ice Cream (Ireland) Ltd also complained to the Commission in terms similar to

[135] [1992] 3 CMLR 830.

that of Mars. In September 1992 Mars appealed to the Irish Supreme Court against the judgment of the High Court. The former, seeking a preliminary ruling on certain issues, referred the matter to the Court of Justice.[136]

In July 1993 the Commission addressed a Statement of Objections to HB in which it provisionally concluded that its system of distribution infringed both Article 81 (ex 85) and 82 (ex 86).

HB vigorously contested this view. Following discussions with the Commission, however, it agreed to introduce changes to its system. A package of measures were introduced designed, in the short term, to increase the number of non-exclusive retailer owned cabinets and, in the long term, to make it easier for retail outlets to buy their own non-exclusive cabinets as an alternative to the present system. In August 1995 the Commission announced its intention to take a favourable view of the new system.[137] These alterations failed to bring about the structural change which the Commission expected to achieve and in January 1997 the Commission initiated proceedings. In March 1998 it concluded that the use of freezer exclusivity by HB violated Article 81 (ex 85) and Article 82 (ex 86).

Interestingly, the Commission's approach now seems to conform with the Court's ruling in *Delimitis*.[138] It defined the product market as comprising single wrapped items of impulse ice-cream as distinct from take home products and the geographic market was

[136] Case C-344/98, [1999] 4 CMLR 167.
[137] OJ 1995 C211 4.
[138] Case C-234/89 [1991] ECR I-935, [1992] 5 CMLR 210.

confined to Ireland.[139] Turning to network effects and the issue of market foreclosure the Commission concluded (on the basis of the economic survey conducted by lansdowne on its behalf) that numeric foreclosure amounted to 41 per cent. Volume weighted foreclosure, however, amounted to 40 per cent.[140] The Commission then examined other factors which made market access more difficult. It concluded that disincentives existed which made it unlikely that retailers would purchase their own cabinets, use the cabinets of prospective entrants or install additional freezers. These included the need to rupture relations with HB the capital investment necessary to acquire the necessary equipment, shortage of floor space, the lack of independent wholesalers, brand strength and customer loyalty. As a result, sales outlets were *de facto* exclusively tied to HB.[141] The Commission then concluded that these restrictions made market penetration more difficult for foreign suppliers and that HB's network "contributed significantly" to the foreclosure of the relevant market.[142] Exemption under Article 81(3) (ex 85(3)) was also refused by the Commission. HB's system of distribution reduced the ability of retailers to choose the products they wished to sell and created space inefficiencies in those outlets.[143] Freezer exclusivity also reduced consumer choice by reducing the availability of different brands of ice-cream. Consumers did not share, therefore, in the alleged benefits of HB's distribution system. The imposed restrictions were not indispensable. They simply contributed to the perpetuation of structural inertia resulting in a reduction of interbrand competition. Accordingly, the Commission condemned the arrangement.

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[139] Comm. Dec. 98/531 OJ 1998 L246/1, [1998] 5 CMLR 530, paras 130-140.
[140] Ibid paras 153-156.
[141] Ibid paras 157-186.
[142] Ibid para 200.
[143] Ibid paras 221-246.

Two brief points should be made. Firstly, the cocktail of legal actions may have ramifications for subsidiarity. At the time of the Commission's intervention the Irish High Court, with concurrent competence in the area of competition law, had already adjudged HB's practice to be in accord with domestic and European law. Yet, the Commission decided to "second guess" this judgment. As a result, the Commission's decision condemns the very practice which the High Court's injunction is designed to protect. The Irish Supreme Court, in its preliminary reference to the Court of Justice, has been critical of the Commission's approach commenting that co-operation is a double edged sword. If Irish retail outlets are confused as to their legal position it is, perhaps, unsurprising. In fact, scope for further confusion may arise as a result of HB's appeal to the Court of First Instance seeking annulment of the Commission's decision.[144] Secondly, HB's legal representatives have questioned the degree to which European business can rely on the Commission as a body with which they can do business. Any deal struck with the Commission, in their view, offers limited legal security. They point to the fact that HB had agreed with the Commission to kick start a movement to freezer cabinet ownership by selling 20 per cent of its freezers. To subsequently deny negative clearance or exemption to the revised agreements, therefore, defeated HB's legitimate expectations.[145]

In 1999 the Commission revisited the issue of tie by type beer supply agreements as a result of notifications received from three leading UK brewers, namely Whitbread plc, Bass plc and Scottish and Newcastle plc. The respective notifications related to the provisions, by each brewer, of fully fitted-out on licensed public houses with a tie for

[144] Case T-65/98 (pending).
[145] M. Rowe, "Ice Cream: The Saga Continues", (1998) 7 *ECLR* 479, 480.

beer. The lessees agreed to purchase all their beer requirements from their respective brewers or landlords with the exception of a "guest beer" which they were permitted to acquire from any other source. In each case the Commission gave notification of its intention to adopt a favourable position with regard to each notification. As a result the Commission received a number of observations from interested third parties, in particular, action groups representing disgruntled tenants wishing to have the leases declared void. The Commission resisted this course of action and in February 1999 in *Whitbread plc*[146] and June 1999 in *Bass plc*[147] and *Scottish and Newcastle plc*[148] it concluded that these arrangements infringed Article 81(1) (ex 85(1)) but were eligible for exemption

Significantly, the Commission's approach to these arrangements followed closely the Court's approach in *Delimitis*. It interpreted Regulation 1984/83 strictly concluding that tie by type beer supply agreements could not benefit from the block exemption because they did not fulfil the requirements of Article 6 of the stipulated Regulation.

With regard to the applicability of Article 81(1) (ex 85(1)) the Commission, in each case, commenced its analysis by defining the product and geographic market. The product market, in each case, was that for the distribution of beer in premises for the sale and consumption of drinks. The relevant geographic market was confined, in each case, to the UK. The Commission, in contrast to its approach in the German ice-cream cases, embraced the two step test of *Delimitis*. As a first step it considered network effects noting that in 1997 volume weighted foreclosure fell between 50 and 58 per cent. The

[146] Comm. Dec. 1999/230 OJ 1999 L88/26, [1999] 5 CMLR 118.
[147] Comm. Dec. 1999/473 OJ 1999 L186/1, [1999] 5 CMLR 782.
[148] Comm. Dec. 1999/474 OJ 1999 L186/28, [1999] 5 CMLR 831.

bundle of agreements, therefore, had a considerable effect on the opportunities for gaining access to the UK on trade beer market.[149] The Commission then acknowledged that cumulative network effects was only one factor, amongst others, which had to be appraised. On the basis of paragraph 21 of the *Delimitis* judgment the Commission, in each case, considered opportunities for market access. It noted that most foreign brewers gained market access by licensing a major UK brewer to sell its products. This route was chosen for a number of reasons. Firstly, in view of the UK's licensing laws it was not easy to open a substantial number of new pubs. Secondly, as the average price of a UK freehold pub was £200,000 a prospective entrant would be obliged to make substantial capital investment to either acquire an existing network or establish its own. Thirdly, the Commission noted that takeovers by foreign brewers had occurred but in most cases the foreign brewer divested itself of its interest. Finally, the lack of independent wholesalers made it difficult for foreign brewers to gain market access. The Commission then considered, on the basis of paragraph 22 of *Delimitis* the competitive forces operating on the relevant market. It observed that the UK market was going through a supply side concentration whilst demand in the on-trade market was declining or at best remaining static. The increasing costs of advertising acted as an incentive for foreign brewers to gain market access via licensing agreements. Furthermore, the small size of the UK off-trade provided only limited opportunities to build brand reputation to gain market access. The Commission, having considered all these factors, concluded that the first *Delimitis* test was satisfied in each case.[150]

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[149] Comm. Dec. 1999/230, note 146 above, para 118; Comm. Dec. 1999/473, note 147 above, para 135; Comm. Dec. 1999/474, note 148 above para 105.
[150] Comm. Dec. 1999/230, note 146 above, paras 120-125; Comm. Dec. 1999/473, note 147 above, paras 137-142; Comm. Dec. 1999/474, note 148 above, paras 107-112.

It then moved on to consider whether the contribution to market foreclosure made by each of the brewer's networks was significant. In each case it found an infraction of Article 81(1) (ex 85(1)). With regard to Whitbread the Commission noted that in 1990-1991 it owned 6,162 pubs falling to 4,490 pubs in 1996-1997. This amounted to 4 and 3 per cent respectively of the total number of on-licensed premises. During the same period its tied sales amounted to 7.59 per cent and 6.12 per cent of the UK on-trade market volume.[151] In the case of Bass the Commission observed that in 1991 it owned 3.8 per cent of pubs (5,555) declining to 2.8 per cent (4,182) in 1996-1997. During the same period its tied sales amounted to 18 per cent and 13.7 per cent of the on-trade market volume.[152] Finally, with reference to Scottish & Newcastle numeric foreclosure amounted to 0.57 per cent in 1990-1991 and 1.9 per cent in 1997-1998. Volume weight foreclosure during the same period amounted to 6.1 per cent and 9.44 per cent respectively.[153] The Commission, concluded, therefore, that each brewer's network of agreements contributed significantly to market foreclosure.

It seems the Commission is prepared to adapt its approach to Article 81(1) (ex 85(1)) to equate with the more nuanced approach of the Court of Justice in *Delimitis*. However, while finding an Article 81(1) infraction in each case the Commission was prepared to grant individual exemption to the agreements of Whitbread, Bass and Scottish & Newcastle. In the view of the Commission tie by type agreements generally improved distribution by making it easier to establish, modernise, maintain and operate public houses. They also facilitated the introduction of brands of beer from foreign or new

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[151] Comm. Dec. 1999/230, note 146 above, para 136.
[152] Comm. Dec. 1999/473, note 147 above, para 153.
[153] Comm. Dec. 1999/474, note 148 above, para 123.

competitors as their tenants consent was not required for the introduction of the new product. Thereby, increasing consumer choice. This type of contractual structure, therefore, increased opportunities for market entry. While the Commission acknowledged that certain disadvantages existed, it accepted the brewers' arguments that lessees received countervailing benefits including the provision of rent subsidies, procurement services (discounts on glassware, gas supply, rates and insurance), repair services and free business planning and development initiative services.[154]

B. Regulation 1984/83 And Market Foreclosure

Regulation 1984/83 which deals specifically with agreements for the resale of goods (see Annex II) attempts to overcome the problem of market foreclosure in three main respects. Firstly, it limits the scope or range of the dealers purchasing obligation is agreed for more than one type of goods where these are neither by their nature nor according to commercial usage connected to each other. Under Article 3(c), however, it is permissible to sell more than one product together provided they belong to the same range of goods. This is the case if they are linked because of technical (eg machine accessories or spare parts) or commercial reasons (eg several products must be used for the same purpose) or the goods are linked by commercial usage (goods customarily sold together). Secondly, the block exemption limits the permissible length or duration of these agreements. Article 3(d) provides that the block exemption will not apply if the agreement is concluded for an indefinite duration or for a period of more than 5 years. According to Recital 18 this is designed to ensure that dealer's commercial freedom is maintained and to ensure access to

[154] Comm. Dec 1999/230, note 146 above, paras 150-177; Comm. Dec 1999/473, note 147 above, paras 165-195; Comm. Dec 1999/474, note 148 above, paras 137-164.

the retail level of distribution on the part of other suppliers. Dealers become free after the expiry of 5 years to look for more competitive suppliers. Conversely, suppliers become free to look for more cost efficient distribution outlets. Exclusive purchasing agreements for fixed terms that are automatically renewable unless either party gives notice to terminate also fall outside the parameters of the Regulation. Similar provisions also apply to beer supply and service station agreements. In both cases the agreement must not exceed 10 years. In beer supply agreements this period is reduced to five years if the agreement covers both beer and other drinks. In both types of agreement the duration of the arrangement may be extended if the supplier owns the premises from which the beer or petrol is sold to cover the whole period for which the reseller operates from the premises. Finally Article 14(b) provides that the Commission can withdraw the benefits of the exemption if the agreement, to a significant extent excludes the supplier's competitors from the market or makes access difficult.

C. Exclusive Purchasing Obligations In Other Systems of Distribution

In exclusive distribution systems it is not uncommon for a dealer, in return for being granted an exclusive territory, to enter into an exclusive purchasing obligation with its supplier. In fact, Article 2(2)(b) of Regulation 1983/83 expressly permits the imposition of such an obligation. Moreover, the obligation is exempted for the duration of the agreement.

In contrast, the Commission and Community Courts have demonstrated their hostility to obligations in selective distribution or franchise agreements which require authorised dealers or franchisees to source the contract goods exclusively from the supplier or franchisor. This hostility is of long-standing. As early as 1974 the Commission, in examining the selective distribution networks of Christian Dior and Lancome, insisted on the removal of a number of clauses.[155] One such clause prevented authorised dealers from purchasing contract goods from any source other than their national distributor. The prohibition on cross-supplies could lead to market fragmentation.[156]

In the case of franchise agreements the Court of Justice, in *Pronuptia v Schillgalis*,[157] that franchise networks must not operate to prevent franchises from obtaining intra-network supplies. The Commission has subsequently reinforced this position.[158] Finally, Article 4(a) of Regulation 4087/88 provides that franchisees cannot be prevented from sourcing the contract goods from other franchisees.

D. Exclusive Purchasing Obligations And Abuse Of Dominance

It is important to stress that exclusive purchasing can also fall foul of Article 82 (ex 86) EC. This occurs where the party imposing the restraint abuses its dominant market position.[159] The abuse can take many forms. The use of fidelity rebates, however, to induce *de facto* exclusivity is of particular importance. In *Hoffmann - La Roche & Co AG*

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[155] EEC Commission, *Fourth Report on Competition Policy: 1974* (Brussels, 1975) p.60.
[156] Case 26/76 *Metro Grossmärkte GmbH v Commission* [1977] ECR 1875, [1978] 2 CMLR 1; Case 86/82 *Hasselblad (GB) Ltd v Commission*, [1984] ECR 883; [1984] 1 CMLR 559.
[157] Case 161/84 [1986] ECR 353, [1986] 1 CMLR 414.
[158] Comm. Dec. 87/17 *Pronuptia de Paris SA* OJ 1987 L13/39, [1989] 4 CMLR 355; Comm. Dec. 87/14 *Yves Rocher* OJ 1987 L8/49, [1958] 4 CMLR 592; Comm. Dec. 87/407 *Computerland Europe SA* OJ 1987 L222/12, [1989] 4 CMLR 259, Comm. Dec. 89/942 *Charles Jourdan* OJ 1989 L35/31, [1989] 4 CMLR 591.
[159] The Court of Justice has indicated that a 50 per cent market share creates a presumption of market dominance, although the Court has found market shares of 40 per cent to be sufficient. See Case C-62/86 *Akzo Chemie BV v Commission* [1991] ECR I - 3359, [1993] 5 CMLR 215; Case 27/76 *United Brands v Commission* [1978] ECR 207, [1978] 1 CMLR 429.

v Commission[160] the world's largest manufacturer of vitamins was fined by the Commission under Article 82 (ex 86) for excluding its competitors from the market by giving fidelity rebates to 22 large buyers. Although Roche, in its appeal was successful in having its fine reduced by one-third, the Court upheld the central elements of the Commission's decision. The rebate was designed to prevent customers from obtaining their supplies from competing producers. It also resulted in dissimilar conditions applying to equivalent transactions in that two purchasers paid different prices for the same quantity of the same product. In *Michelin v Commission*[161] the Court upheld the Commission's condemnation of Michelin's annual rebates granted to dealers meeting sales targets. The discount system was not sufficiently objective or transparent and amounted, therefore, to abuse within the context of Article 82 (ex 86). In *British Gypsum v Commission*[162] the Court of Justice dismissed the applicant's appeal holding that it abused its position of dominance by paying rebates to all UK dealers who refused to handle plasterboard manufactured in Spain, imported in the UK and sold at prices which undercut those of British Gypsum. More recently in the Irish Ice-Cream case[163] the Commission condemned HB's practice of supplying and maintaining, free of charge, freezer cabinets to retailers as an abuse of its dominant market position. The inducement interfered with the retailers freedom to choose suppliers on the basis of the merits of their products, harming the interests of HB's competitors and consumers generally.

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160 Case 85/76 [1979] ECR 461, [1979] 3 CMLR 211.
161 Case 322/81 [1983] ECR 3461, [1985] 1 CMLR 282.
162 Case C 310/93P [1995] ECR I - 865, [1995] 4 CMLR 718.
163 Comm. Dec. 98/531 *Van den Bergh Foods Ltd* OJ 1998 L246/1, [1998] 5 CMLR 530.

IV. CONCLUSION

On both sides of the Atlantic it is generally accepted that exclusive dealing or purchasing has procompetitive benefits. The Supreme Court and the Court of Justice, in the cases of *Standard Stations* and *Delimitis* respectively, have enunciated the beneficial implications of these restraints. The European Commission has also endorsed these sentiments in the Recitals to Regulation 1984/83.

Antitrust concerns, however, do exist. They relate primarily to market foreclosure. In 1914 in its Report on the proposed Clayton Act, the House of Representatives expressed grave reservations over the possible anticompetitive aspects of these agreements. In its view "(w)here the concern making these contracts is all great and powerful, the exclusive (dealing arrangement) becomes one of the greatest agencies and instrumentalities of monopoly ever devised by the brain of men. It completely shuts out competititors".[164] Where the supplier has market power foreclosure becomes a real concern.

In 1983 the European Commission, in response to a Question from the UK Parliament, justified the introduction of its new rules on beer supply agreements on the basis they would loosen the combined effects of exclusive purchasing within the brewing industries. These arrangements had "... immobolize(d) competitive structures within the national markets affected".[165] This resulted in market partitioning and frustrated the imperative of market unification.

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[164] H.R. Report No 63-627, 63 Congress 2nd Session 12-13 (1914).
[165] Commission Answer to Parl. QU No. 17 64/82; OJ [1983] C93 22.

In the *Tampa Electric* case the US Supreme Court, revised its long-standing test of market foreclosure and annunciated its tripartite test of qualitative substantiality. This necessitated defining, firstly, the line of commerce involved. Secondly, ascertaining the relevant market and finally, calculating the amount of competition foreclosed by the arrangement. To fall foul of S.3 Clayton Act 1914 the degree of foreclosure had to be "substantial". To assist in this determination the Supreme Court listed a number of factors relevant to the assessment. These included *inter alia* the strength or position of the parties on the market, the volume of commerce involved and the consideration of the immediate and future effects of foreclosure.

In 1991 in *Delimitis* the Court of Justice developed its bipartite test. In order to determine whether domestic or foreign competitors were prevented from gaining market entry the relevant market had, firstly, to be foreclosed and secondly the agreements in question had to make a "significant" contribution to that foreclosure. In this analysis the Court of Justice listed a number of factors pertinent to each limb of the test. With regard to the first limb the Court emphasised, the degree of market foreclosure caused by all similar agreements, the length or duration of the agreements, the possibility of gaining entry through the acquisition of a competitor or establishing new outlets for product distribution, the degree of brand loyalty on the existing market, whether non-exclusive outlets are available and the structure of the market. With reference to the second limb (significant contribution) the Court emphasised the need to calculate the market share of the brewery in question, the overall contribution to market foreclosure by the agreements and contract duration.

In both jurisdictions market definition is crucial as market foreclosure can be diluted or concentrated depending on whether the market is defined widely or narrowly. Both tests, however, seem to lack a degree of precision as to what constitutes "substantial" or "significant" market foreclosure. Unlike the US market foreclosure is of evident concern in the EU because of the possibility of market compartmentalisation. Finally, whilst the European Commission initially refused to follow the *Delimitis* test it has recently indicated its willingness to embrace the more nuanced approach of the Court of Justice.

TYING ARRANGEMENTS

I. INTRODUCTION

Tying arrangements arise where a supplier agrees to sell a product on condition the purchaser buys an additional product or service, or at least agrees not to acquire that product or service from any other supplier. Bundling is a related concept and arises where a supplier requires a purchaser to take a package of products at a singular price. It is particularly prevalent in the manufacture and sale of computers, especially with regard to the configuration of computer specifications. Suppliers may wish to avail themselves of this particular type of arrangement for a number of reasons. Tie-ins may be used for quality control purposes. A supplier can reduce the incidence of product malfunction, which may detrimentally effect product reputation and goodwill, by ensuring consumables manufactured by itself are used in its primary equipment. Another conceptually related idea is the notion that tie-ins can be used as a means of public health protection. Tying may also be used as a means to discriminate between intensive and less intensive product users. This is of particular importance in relation to product leasing agreements. The use of the tied consumable, for example, enables the supplier to calculate intensity of use through the consumption of the tied product. This enables the supplier to cover product depreciation more effectively through its pricing policy. Manufacturers may also use tying as a means to increase primary product sales through price reductions which are offset by profits guaranteed by the contractual obligation to use the tied consumable. Indeed, this may also result in cost efficiencies in that suppliers in carrying out routine repair and maintenance work can, at the same time, deliver the tied product reducing *inter alia* transportation costs. Finally, tying can be used as a legitimate means to evade governmental price regulations. Undertakings bound to observe price in relation to a specific product can require the user to purchase another product priced above competitive levels.

While this list is by no means exhaustive there are, however, contrary arguments against the use of these agreements. In particular it is often alleged that tie-ins reduce the purchaser's freedom of choice as to where he or she acquires the tied product. Furthermore, tying can deny market access to competing suppliers by denying them access to outlets. Finally, it is often asserted that tie-ins may be used to lever market power from the tying product market to the tied product market thereby enabling the supplier to extract monopoly profits from both.

In the US tying arrangements, which include tie-in leases as well as sales, are generally governed by s.3 Clayton Act 1914 or S.1 Sherman Act 1890. Where the arrangement involves *commodities* - goods, wares, merchandise, machinery or supplies - the antitrust litigant brings his or her action under the provisions of the Clayton Act. If commodities are not involved (the tie may relate to the provision of services) the antitrust action must be pursued under the provisions of the Sherman Act.

In 1984 the Supreme Court acknowledged that tying may simply be an attempt to "compete effectively" and that packaged sales may be beneficial to consumers.[1] Yet tie-ins remain illegal *per se*. It must be stressed, however, that tying arrangements are not treated in the same manner as other agreements considered to be illegal *per se*. In

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[1] *Jefferson Parish Hospital District No 2 v Hyde*, 466 U.S. 2, 12 (1984).

the case of RPM, for example, it is sufficient to hold an agreement illegal upon proof that the agreement exists. In the case of tying the Courts must, firstly, determine whether two products are involved and if so, whether they are actually tied. Oddly, the Supreme Court failed to make any judicial pronouncements as to how this analysis was to be conducted until 1984. In this vacuum the lower Courts developed their own inconsistent tests which were applied in a random fashion. Secondly, tie-ins are illegal *per se* only if the seller is shown to have "... sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product".[2] These threshold requirements have furnished the judiciary with a greater degree of flexibility with regard to the invocation of the *per se* rules than one might have initially anticipated. Indeed, the Supreme Court has manipulated these thresholds on several occasions, in order to conform to the prevailing or current notion of antitrust. During the Warren Court era, threshold levels were set low in order that the standard of *per se* illegality could be easily satisfied. Provided a *de minimis* amount or a not insubstantial amount of interstate commerce in the tied product market was affected the Supreme Court was quite prepared to *infer* that the seller had the requisite economic power in the tying product market to render the arrangements illegal *per se*.

In 1969, with the appointment of Chief Justice Burger the Warren Court's precedents were gradually overhauled. These judgments were deemed to lack objective benchmarks.[3] A gradual erosion of the scope and applicability of *per se* rules took place. In *Fortner II*[4] the Supreme Court signalled that it was no longer prepared to rely on *inference* to show that a seller had the requisite economic power in the market

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[2] *Northern Pacific Railway Co v US*, 356 U.S. 1, 6 (1958).
[3] *Continental TV Inc v GTE Sylvania*, 433 U.S. 36, 53 (1977).
[4] *United States Steel Corporation v Fortner Enterprises*, 429 U.S. 610 (1977).

for the tying product. If the rules of *per se* illegality were to be invoked a greater evidentiary showing of sufficient economic power had to be made. This, of course, involved market analysis. In 1984, in its *Jefferson Parish* decision, the Supreme Court reinforced this analytical realignment. It linked for the first time sufficient economic power to the concept of market power and anticompetitive forcing. The threshold levels of *per se* illegality were heightened. This situation prevailed until 1992 when the Supreme Court in the case of *Eastman Kodak Co* v *Image Technical Services*[5] shocked some antitrust observers by holding that market power could be gained through market imperfections. In particular, information costs and switching costs. For some, the lowering of the threshold levels amounted to a return to a multi-dimensional antitrust. For others *Kodak* was to be construed narrowly and confined to its own peculiar facts.

In the EU tying arrangements can fall foul of Article 81 (1) (e) (ex 85 (1) (e)) and Article 82 (d) (ex 86 (d)) EC. Both Articles specifically include as falling within their respective parameters the "... conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to their common usage, have no connection with the subject of such contracts". While receiving little praise, tying agreements do not appear to be a Commission enforcement priority. Veltrop suggests that this is "... perhaps out of recognition that tying does not necessarily impose exclusivity".[6] Where such exclusivity exists, however, tying precludes the application of Regulation 1984/83 and, perhaps, Regulation 1983/83. Article 3(c) of the former Regulation provides that the block exemption does not apply if the exclusive purchasing obligation is agreed for more

[5] 504 U.S. 451 (1992).
[6] J.D. Veltrop, "Tying and Exclusive Purchasing Arrangements Under EC Competition Law", (1994) 31 *CML Rev* 549, 533. See also D. Waelbroeck, "The Compatibility Of Tying Agreements With Antitrust Rules: A Comparative Study Of American And European Rules", (1987) 7 *YEL* 39.

than one type of good where by their very nature or commercial usage they are not connected. In the Commission's view this ensures access for undertakings to the different stages of distribution and prevents market foreclosure and market compartmentalisation.

In comparison with the US, case law in the EU with regard to tying is relatively sparse. This is particularly true of Article 81 (ex 85). Article 82 (ex 86) is only implicated where a party abuses its dominant market position. However, the authorities, through the use of narrow product market definitions, have held that secondary aftermarkets for specific branded products comprise separate markets for the purpose of Article 82 (ex 86) and the imposition of tying arrangements in these markets can also amount to an abuse.[7] The contradictory views expressed by the Commission in *Pelikan/Kyocera*[8] and *Digital*[9] leaves the issue of whether a manufacturer can enjoy dominance in the secondary aftermarkets if it is subject to intense competition in the primary markets somewhat unresolved. Finally, the authorities have stretched the jurisdictional reach of Article 82 (ex 86) in the case of *Tetra Pak II*[10] by concluding that the imposition of tying arrangements by a dominant undertaking acting in a market in which it is not dominant can still amount to an abuse contrary to the requisite Article. Parts II and III of this chapter explores the way in which the law has developed in the US and EU respectively.

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[7] Case 22/78 *Hugin v Commission* [1979] ECR 1869, [1979] 3 CMLR 345; Case 238 87 *Volvo v Erik Veng Ltd* [1988] ECR 6211, [1989] 4 CMLR 122; Case 53/87 *Maxicar & Others v Renault* [1988] ECR 6211, [1990] 4 CMLR 265; Case C-53/92P *Hilti v Commission* [1994] ECR 667, [1994] 4 CMLR 614

[8] EC Commission, *25th Report on Competition Policy 1994* (1995) p.41.

[9] Commission Press Release IP/97/868 of October 10, 1997.

[10] Case C-333/94P *Tetra Pak International SA v Commission* [1996] ECR I-5951, [1997] 4 CMLR 662

II. TYING AGREEMENTS AND US ANTITRUST LAW

A. Patent Law And Early Tie-In Case Law

As early as 1896 in the *Button - Fastener* case[11] the Sixth Circuit Court of Appeals upheld the tying of unpatented wire staples (the tied product) to a patented device (the tying product) designed to attach buttons to high button boots. In the view of the Court a tie-in was a legitimate means of exercising a lawfully granted monopoly. It neither violated the Sherman Act nor was contrary to public policy. In 1912 the Supreme Court also upheld the validity of tying arrangements in the case of *Henry* v *A B Dick Co.*[12] Here the AB Dick Co sold a stencil duplicating machine to a Miss Skou. A metal notice affixed to the machine informed purchasers that it was to be used only in conjunction with ink supplied by the AB Dick Co. Sidney Henry, sold a can of ink to Miss Skou in full knowledge that it would breach Miss Skou's licence agreement. An action was initiated, therefore, for breach of licence restriction. The majority of the Court viewed tie-ins as legitimate. It was better, in their view, to allow a patentee to impose conditions determining the subsequent use of its product rather than lose the patented product from the market altogether. Mr Justice White, writing for the minority, took the view that the Court's ruling simply enabled the patentee to extend its patent rights by use of private contract.

In 1913 the case of *US v Winslow*[13] came before the Supreme Court. Here, for the first time, the Government stressed the possible anticompetitive effects of tie-ins. In the main it stressed that tie-ins deprived purchasers of their freedom in the tied product

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[11] *Heaton - Peninsular Button-Fastener Co v Eureka Speciality Co.*, 77 F. 228 (6^{th} Cir. 1896).
[12] 224 U.S. 1 (1912).
[13] 227 U.S. 202 (1913).

market and foreclosed the tied product market to other independents. Shortly after the enactment of the Clayton Act in 1914 the Supreme Court, once again, considered the legality of tie-ins in the case of *Motion Picture Patents Co v Universal Manufacturing.*[14] The case involved the tying of unpatented supplies to patented film projection equipment. Here the Supreme Court overruled the decision in the *Button Fastener* case and the *AB Dick* case and held the tie-in illegal. In short, it held that a patentee's legal rights could not be extended by private contract to include unpatented supplies.

In 1918, however, in the case of *US v United Shoe Machinery Co of New Jersey*[15] the Supreme Court curtailed the importance of the decision in the *Motion Picture* case. It held that tie-ins were illegal only in contracts of sale. Where, however, the tying arrangement was contained in a lease, neither patent law nor antitrust law was infringed. In 1922 the Government successfully closed this loophole in the case of *United Shoe Machinery v US*[16]. Mr Justice Day concluded that tying agreements must necessarily lessen competition and tend to monopoly. Accordingly, tie-ins were to be condemned whether the arrangements was contained in a contract of sale or lease.

B. From International Salt To Fortner I: (1947-1969)

While the Supreme Court condemned a tying arrangement in 1936 in the case of *International Business Machines v US*[17], the first major antitrust tie-in case was heard in 1947 in *International Salt Co v US.*[18] In 1947 International Salt was one of the

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[14] 243 U.S. 502 (1917).
[15] 247 U.S. 32 (1918).
[16] 258 U.S. 451 (1922).
[17] 298 U.S. 131 (1936).
[18] 332 U.S. 392 (1947).

largest producers of salt for industrial use in the United States. The corporation owned patents on two machines - the "lixator" and "saltomat". The latter injected salt tablets into canned products during the canning process and the former dissolved rock salt into brine for use in various industrial processes. These machines were leased by the corporation on condition that the lessees purchased all of their salt requirements from it. The lixator leases contained a provision that enabled lessees to purchase their salt requirements from other producers provided their salt was of equal quality and sold at lower prices. In contrast, the saltomat leases simply provided that the lessee was guaranteed to receive International Salt's own lowest price.

The US Government felt that these tying restrictions violated the provisions of the Sherman Act and Clayton Act. It, therefore, initiated an antitrust action in the District Court of New York. The Court granted summary judgment in favour of the Government and International Salt appealed directly to the Supreme Court. International Salt argued against the summary judgment on four grounds. Firstly, it asserted that the District Court's judgments was "unauthorised" because it precluded trial of alleged issues of fact as to whether the restraint was unreasonable within the Sherman Act or substantially lessened competition or tended to create a monopoly within the Clayton Act. Secondly, the corporation asserted that the provisions of the leases saved them from unreasonableness and the tendency to create monopoly. Thirdly, it asserted that the tie-in insured that its lessees used its salt which had a high degree of purity (it had an average sodium chloride content of 98.2 percent) thereby ensuring that the machines functioned efficiently and correctly. Finally, the appellant argued that the tying clauses had not been insisted upon in all its leases, nor had they been enforced when they were included.

Despite these contentions, the Supreme Court unanimously found in favour of the US Government and upheld the District Court's summary judgment order. Mr Justice Jackson delivered the Court's decision and his analysis focused almost exclusively on the tied product market - the market for salt. With regard to the tying product market Mr Justice Jackson stated that the appellant's machine patents gave them "... a right to restrain others from making, vending or using the patented machines".[19] However, the patents themselves conferred no right to restrain trade in the market for unpatented salt. With regard to the tied product market Mr Justice Jackson stated that "(t)he volume of business affected by these contracts cannot be said to be insignificant or insubstantial and the tendency of the arrangement to accomplishment of monopoly seems obvious".[20] In this respect 119,000 tons of salt, worth approximately 500,000 dollars, was the volume of business affected by the appellants tie-in. Mr Justice Jackson also stressed that these arrangements may foreclose competition in the tied product market for which patents confer no immunity from antitrust laws.

In reaching its decision the Supreme Court dealt with each of the appellants' arguments. With regard to the first contention that the summary judgment order was "unauthorised" the Supreme Court stated "(w)e think the admitted facts left no genuine issue. Not only is price fixing unreasonable, *per se*, ... but also it is unreasonable, *per se*, to foreclose competitors from any substantial market".[21] The Supreme Court also rejected International Salt's second contention. In its view, the provisions contained within the leases did nothing to "... avoid the stifling effect of the agreement on competition".[22] With regard to International Salt's third argument, the Court took the view that it was legitimate for a lessor to impose reasonable restrictions

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[19] Ibid at 395.
[20] Ibid at 396.
[21] Ibid.
[22] Ibid at 397.

on a lessee if such restrictions were imposed to ensure the proper functioning of the machine. However, in the view of the Court, the same result may be achieved by the less onerous method of manufacturer's specifications rather than the imposition of tying arrangements. As Mr Justice Jackson stated the leased machines are not "... allergic to salt of equal quality produced by other competitors".[23] Finally, the Court quickly dispatched the appellant's fourth argument. The fact the appellant did not insist upon tying arrangements being included in all its leases, or enforced them when included, did not, in the view of the Court, justify the general use of such restrictions.[24]

It is apparent, then, that the Court's analysis in the *International Salt* case centred mainly on the tied product market. In respect of the tying product market, Mr Justice Jackson, made few comments of note. As a result, one can only speculate with regard to the Court's intention in this area. D. F. Turner has suggested a number of possible interpretations.[25] Firstly, the Supreme Court may have presumed that as a result of its patents, International Salt had the requisite economic power in the tying product market. Alternatively, economic power may have been presumed to exist on a showing that the tying product had some element of distinctiveness or some unique aspects which made buyers prefer it over competing products. Finally, the Court may have been intimating that economic power in the tying product market was either unnecessary or presumed to exist from the existence of the tie-in itself. In any event, this particular aspect of antitrust law lacked coherence and clarity.

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[23] Ibid 398.
[24] Ibid.
[25] D.F. Turner, "The Validity Of Tying Arrangements Under The Antitrust Laws", (1958) 72 *Harv L Rev* 50, 53-54.

Legal commentators hoped that the Supreme Court would take the next available opportunity to clarify this rather unsatisfactory position. This occasion presented itself in 1953 in the case of *Times - Picayune Publishing Co v US*.[26] Here the Times - Picayune Publishing Co owned and published two newspapers - a morning daily known as the "Times-Picayune" and an evening paper known as the "States". The only other significant competitor in the area was the Item Co Ltd which owned and published the "Item". In 1950 the Times-Picayune Publishing Co, introduced a "unit plan" which applied to its general and classified advertisers. The plan required advertisers wishing to acquire space, to purchase combined insertions only. That is, to purchase space in both the morning and evening papers jointly. The Government considered that these forced combination contracts violated antitrust laws. As the case did not involve commodities within the meaning of the Clayton Act, the Government was obliged to institute antitrust proceedings in the District Court of Louisiana on the basis that the tying arrangements violated section 1 and 2 Sherman Act.

The District Court determined that the Times-Picayune newspaper was dominant in terms of advertising and circulation. Moreover, the adoption of the unit plan caused a substantial rise in the amount of advertising in its "sister" newspaper - the States. It took the view, therefore, that this plan reduced consumer choice and the competitive vigour of the Item. The tying arrangements violated the provisions of the Sherman Act. Both the publishing company and the Government appealed directly to the Supreme Court. The former appealed the merits of the District Court's judgment and the latter appealed seeking greater protective relief.

[26] 354 U.S. 594 (1953).

Mr Justice Clark delivered the Supreme Court's verdict. He noted that tying arrangements "... fare harshly under the law forbidding restraints of trade".[27] They "... flout the Sherman Act's policy that competition rules the marts of trade".[28] Basic to that policy is the faith that products must stand the test of competition. Tying arrangements, however, may undermine this test. Firstly, they may insulate the tied product from competitive stresses by conditioning its sale on the purchasers acquisition of the tying product. Secondly, they can effectively foreclose the tied product market to other competitors. However, as this case did not involve industrial property rights the Supreme Court had to expressly address the issue of economic power in the tying product market. In this respect Mr Justice Clark stated:

> "When the seller enjoys a monopolistic position in the market for the 'tying' product, or if a substantial volume of commerce in the 'tied' product is restrained, a tying arrangement violates the narrower standards expressed in S3 of the Clayton Act because from either factor the requisite potential lessening of competition is inferred. And because for even a lawful monopolist it is 'unreasonable *per se*, to foreclose competitors from any substantial market', a tying arrangement is banned by S1 whenever *both* conditions are met".[29]

Unfortunately, Mr Justice Clark never fully explained why the Court made this distinction between the Sherman Act and the Clayton Act. In any event, as the present case was an action under the Sherman Act both conditions, according to Mr Justice Clark, had to be satisfied if the Times-Picayune tying arrangements were to be held

27 Ibid at 606.
28 Ibid at 605.
29 Ibid at 608-609.

illegal *per se*. Times-Picayune had to enjoy a monopolistic position in the tying product market and the tie-in had to restrain a substantial volume of commerce in the tied product market.

With regard to the tied product market the Supreme Court simply assumed that the volume of commerce affected by the arrangement was not insignificant or insubstantial.[30] However, with respect to the tying product market Mr Justice Clark stated "(u)nlike any other 'tying' cases where patents or copyrights supplied the requisite market control, any equivalent market 'dominance' in this case must rests on comparative marketing data".[31] Economic power over the tying product market could not be inferred but could only be determined after analysis of the market had been conducted. The Supreme Court, therefore, focused its analysis on the market position of the Times-Picayune newspaper. In the view of the majority this newspaper operated as a dual trader in separate though interdependent markets. The newspaper sold news and advertising to its readers and the readership, in turn, was sold to the buyers of advertising. In the Court's view the relevant market was the newspapers advertising market. The Times-Picayune share of this market hovered around 40 per cent and this figure could not be taken to indicate the existence of market dominance.[32] On this basis a finding of *per se* illegality could not be sustained. As if to reinforce this finding the Supreme Court also held that the District Court's holding that the Times-Picayune and the States were two distinct products was clearly erroneous. To advertisers both newspapers were indistinguishable products. Accordingly, the Supreme Court reversed the decision of the District Court.

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[30] Ibid at 610 n.28.
[31] Ibid at 611-612.
[32] Ibid at 612-613.

Justices Black, Burton, Douglas and Minton dissented. In their view the relevant market was the morning newspaper market. Here the Times-Picayune, as the only morning newspaper, had a complete monopoly of access to morning newspaper readers in the New Orleans area. In the view of the dissenting minority the Times-Picayune Publishing Co, used this position to "... restrain ... the competition between its evening newspaper, the New Orleans State, and the independent New Orleans Item, in the competitive field of newspaper advertising".[33] In the view of the minority the unit-plan violated the provisions of the Sherman Act.

The *Times-Picayune* case did little to clarify the law relating to tying arrangements. If anything, it added to the confusion by its insistence that dual standards be applied to tie-ins depending on whether the proceedings were commenced under the Clayton Act or Sherman Act. With the appointment of Chief Justice Warren the Supreme Court addressed this duality of treatment. In 1958 the case of *Northern Pacific Railway Co v US*[34] came before the Supreme Court. Once again the case did not involve commodities and the action was brought under the Sherman Act. In 1864 and 1870, Congress granted the predecessor of the Northern Pacific Railway Company approximately 40 million acres of land in several states in order that a railway line be built from Lake Superior to Puget Sound. By 1949, the company had sold approximately 37 million acres subject, in certain circumstances, to the reservation of mineral rights. Most of the unsold land was leased. In a large number of sale contracts and most of the leasing agreements the Railway insisted upon the inclusion of "preferential routing clauses". The disposition of the land was tied to the condition that the vendee or lessee ship over the Railway's lines all articles produced or manufactured on the land sold or leased. This condition, however, was subject to the

[33] Ibid at 628.
[34] 356 U.S. 1 (1958).

proviso that the vendee or lessee was free to ship with competing lines if their rates were lower or their service was better.

The Government considered these "preferential routing clauses" to be in violation of Section 1 Sherman Act. It sought a Declaration to that effect in the District Court of Washington. After a number of pre-trial proceedings the US Government moved for summary judgment. The District Court granted the motion and enjoined the Northern Pacific Railway Co, from enforcing the existing clauses and from entering into similar agreements in the future. The Railway appealed directly to the Supreme Court.

Before the Supreme Court, Northern Pacific proffered three main arguments. Firstly, it contended that the full force of *per se* illegality as defined in *International Salt* was not applicable. It applied only to patented tying products. Secondly, Northern Pacific asserted that *International Salt* was restricted by the decision in the *Times-Picayune* case. In the latter case, the Supreme Court made "monopoly power" or "dominance" over the tying product a necessary precondition to the application of *per se* illegality. Finally, the appellant argued that the preferential routing clauses were subject to so many exceptions and administered so leniently that they could not significantly restrain competition.

Once again, the Supreme Court, split with regard to its judgment. Dividing five to three the majority affirmed the District Court's decision. On behalf of the majority Mr Justice Black delivered the Court's Opinion He embraced the populist philosophical notion that the "Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfetteed competition as the rule of trade".[35] In

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[35] Ibid at 4.

the view of the majority certain agreements because of their pernicious effect on competition and lack of any redeeming virtue were presumed to be illegal *per se*. In this category, Mr Justice Black included price fixing agreements,[36] agreements to divide the market,[37] group boycotts[38] and tying arrangements.[39]

Mr Justice Black then addressed each of Northern Pacific's main arguments. The majority held, firstly, that the decision in the *International Salt* case had not confined the applicability of *per se* illegality to those situations in which the tying product was patented. The rule of *per se* illegality applied equally to non-patented cases.[40] The Court also dispatched Northern Pacific's third contention. The proviso which enabled the vendee or lessee to ship its products on competing lines, in certain circumstances, did not affect the legality of the restraint. The preferential routing clauses were still "... binding obligations held over the heads of vendees which (denied the) defendant's competitors access to the fenced off markets on the same terms as the defendant".[41] It was, however, Northern Pacific's second assertion that caused the division within the Court. The Majority of the Court acknowledged that in the *Times-Picayune* case the Supreme Court spoke of monopoly power or dominance in the tying product market as a necessary precondition for the applicability of *per se* illegality. However, in the present case, the majority construed the specific strictures of Mr Justice Clark in *Times-Picayune* as nothing more than "general language".[42] The Court, therefore, "watered down" the monopolistic prerequisite of *Times-Picayune*. Mr Justice Black stated that tying arrangements were illegal *per se*

[36] *US v Socony - Vacuum Oil Co.*, 310 U.S.130 (1940).
[37] *US v Addyston Pipe and Steel Co.*, 85 F. 271 (6th Cir. 1898).
[38] *Fashion Originators' Guild of America v FTC*, 312 U.S. 457 (1941).
[39] *International Salt Co v US*, 332 U.S. 392 (1947).
[40] 356 U.S. at 9.
[41] Ibid at 12.
[42] Ibid 521.

"... whenever a party has sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product and a not insubstantial amount of interstate commerce is affected".[43]

Unfortunately, the Supreme Court did not express with any degree of clarity what constituted sufficient economic power. It did, however, make three suggestions. Firstly, Northern Pacific possessed sufficient economic power by virtue of its extensive land holdings. Secondly, the majority seemed to suggest that the very existence of these arrangements was compelling evidence of the defendant's great power. Thirdly, the Supreme Court seemed to accept the Government's arguments that land, like patented or copyright articles, is inherently unique. If the tying product, therefore, possesses this element of uniqueness or distinctiveness, sufficient economic power is conferred. In this respect Mr Justice Black observed that the land sold or leased was strategically located within economic distance of transportation facilities. Common sense, indicated that this particular land was often prized by those who purchased or leased it and was frequently essential to their business activity.[44]

As a result of these findings, the Supreme Court concluded that the essential prerequisites of *per se* illegality were conclusively established in the Court below. Summary judgment was, therefore, affirmed. A dissenting minority, however, rejected this approach. In their view the *Times-Picayune* decision required *proof* of power over the tying product market.[45] A proper market analysis, in their view,

[43] Ibid at 7.
[44] Ibid at 7-8.
[45] Ibid at 13.

should have been conducted in order to determine whether, in fact, Northern Pacific had the requisite economic power. Reliance on common sense amounted simply to a "... poor substitute for the proof to which the Government should have been put".[46] In the view of the minority the summary judgment order should be reversed and the matter remanded to the District Court for trial.

The next development in the attenuation of economic power over the tying product market came in 1962 in the case of *US v Loew's Incorporated*.[47] Here six film distributors sold their pre 1948 copyright films to various television networks. The distributors conditioned the sale of their feature films upon the acceptance of a package of block-bookings. To obtain "Gone with the Wind", for example, television networks were obliged to purchase "Getting Gertie's Garter". The Government took the view that this form of film distribution violated Section 1 Sherman Act. An antitrust action was, therefore, initiated in the Southern District Court of New York. After lengthy consideration the District Court concluded that these arrangements violated the stipulated provisions.

Five of the film distributors appealed directly to the Supreme Court. The primary issue in the consolidated appeals was whether the Government had established sufficient economic power in the sense contemplated by the *Northern Pacific* Court for non-patented products. In this respect, Mr Justice Goldberg noted that "(m)arket dominance - some power to control price and to exclude competition - (was) by no means the only test of whether the seller has the requisite economic power".[48] This was merely only one species. Such power may also be inferred from the product's

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[46] Ibid at 525.
[47] 371 U.S. 38 (1962).
[48] Ibid at 45.

desirability or from its unique attributes. Furthermore, in those cases where industrial property rights are concerned the requisite economic power is presumed to exist. Thus, where the tying product is patented or copyrighted it should "... seldom be necessary to embark upon a full factual inquiry into the scope of the relevant market for the tying product".[49] The Supreme Court, therefore, upheld the District Court's judgment.

The next major tie-in case to come before the Warren Courts was the 1969 Supreme Court case of *Fortner Enterprises Inc v US Steel Corp.*[50] The facts of this particular case are, to say the least, rather convoluted. Fortner Enterprises was involved in the acquisition and development of land. In order to purchase land in Louisville Kentucky it entered into a loan agreement with US Steel Homes Credit Corporation to the value of 2 million dollars. Unusually, this loan agreement provided 100 per cent financing for the acquisition and development of the land. However, the loan (the tying product) was conditioned upon Fortner Enterprises agreeing to purchase and construct on each plot of land purchased with the loan proceeds, prefabricated housing (the tied product) manufactured by the credit corporations parent company - US Steel Corporation.

Having acquired the land, Fortner Enterprises soon began to complain about the quality of the housing components it was receiving from the US Steel Corporation. Windows leaked, closet doors did not fit and exterior building panels did not align correctly. The complaints, it seems, were not unjustified. In order, therefore, to extricate itself from its agreement, Fortner Enterprises made a proposal to pay off the loan, provided it was allowed to complete the development using conventional housing. US Steel Homes Credit Corporation refused the offer. At this point, one

[49] Ibid at 45 n.4.
[50] 394 U.S. 495 (1969).

might reasonably conclude that this was a typical commercial dispute which might have been resolved on the basis of contractual warranties or other consumer law concepts. However, Fortner Enterprises' lawyers had other ideas. They instituted an antitrust action alleging that the contractual arrangement between Fortner and US Steel, amounted to an illegal tie-in contrary to Section 1 and Section 2 Sherman Act.

After certain pre-trial proceedings the District Court of Kentucky entered summary judgment in favour of US Steel. It held, quite simply, that Fortner Enterprises had failed to establish the prerequisites of *per se* illegality. It arrived at this conclusion for two main reasons. Firstly, the District Court interpreted the standard of sufficient economic power over the tying product market as requiring a monopolistic position or one of dominance.[51] Secondly, it held that the amount of interstate commerce affected by the tie-in was insubstantial. Only a small proportion of land in the Louisville area was foreclosed to other developers.[52]

The matter then proceeded to the Court of Appeals which rather surprisingly affirmed the District Court's summary judgment order without passing opinion. The matter then proceeded to the Supreme Court. On hearing the appeal, the Supreme Court, once again, split over the issue of tying arrangements. Mr Justice Black delivered the Opinion of a five-man majority. In his view the case involved a tying arrangement of the traditional kind. However, he concluded that the Court below misunderstood the two controlling standards. With regard to the first controlling standard or threshold, the Supreme Court took the view that its "... tie-in cases have made unmistakenly clear that the economic power over the tying product can be sufficient even though the power falls far short of dominance and even though the power exists only with respect

[51] Ibid at 497-498.
[52] Ibid at 499.

to some buyers in the market".[53] Furthermore, in the view of the majority, prior case law rejected the requirement of explicit *proof* of requisite economic power. Its existence may simply be inferred, for example, from the "... tying products desirability to consumers or from uniqueness in its attributes".[54] Thus provided a seller has "... *some* power over *some* of the buyers in the market" this is sufficient to invalidate the tie-in.[55]

Having dealt with this particular controlling standard or threshold level, Mr Justice Black then applied this analysis to the facts of the case. He concluded that US Steel Homes Credit Corporation may have had sufficient economic power in the market for credit for two main reasons. Firstly, the majority acknowledged that US Steel's competitors sold their prefabricated houses at prices of 400 dollars less than US Steel's comparable models. The fact that Fortner Enterprises readily accepted the price differential, in itself, might indicate that the credit corporation had the requisite economic power in the market for credit. Secondly, US Steel Homes Credit Corporation actually provided Fortner Enterprises with 100 per cent financing. Evidence was given that credit financing of this nature was highly unusual and was not available elsewhere in the Louisville area. The Court concluded, therefore, that the respondent could exercise market power over borrowers in the credit market. In this respect, however, Mr Justice Black stated:

[53] Ibid at 502.
[54] Ibid at 503.
[55] Ibid

> "We do not mean to accept (the) petitioner's apparent argument that market power can be inferred simply because of the kind of financing terms offered by a lending company are 'unique and unusual'. We do mean, however, that uniquely and unusually advantageous terms can reflect a creditors unique economic advantage over its competitors".[56]

The Supreme Court also rejected the District Court's holding with regard to the second controlling standard or threshold level. That is, it rejected the lower Court's finding that the amount of interstate commerce affected by the tie-in was insubstantial. In the Supreme Court's view "... the controlling consideration is simply whether a total amount of business substantial enough in terms of dollar volume so as not to be merely *de minimis* is foreclosed to competitors by the tie".[57] As to this foreclosure requirement the total volume of the respondents annual sales under tying arrangements should be taken into account. While the respondents annual sales to Fortner Enterprises amounted to only 190,000 (a dollar volume which the majority did not consider to be "paltry" or "insubstantial") its total annual sales foreclosed by tying arrangements amounted to 4 million dollars in 1960; 2.8 million dollars in 1961 and 2.3 million dollars in 1962. Accordingly, the majority took the view that the District Court's judgment should be reversed with directions that the matter proceed to trial. There can be no doubt that Mr Justice Black's judgment reflected aspects of populist concern. In his view, competition should remain atomistic in terms of structure. His primary concern, therefore, was that US Steel and its subsidiaries with "vast sums of money in its treasury" might fence out local competitors from the market for credit. However, the two sets of dissenting minority judgments, adopted a differing

[56] Ibid at 505.
[57] Ibid at 501.

philosophical stance. Justices White and Harlan made up the first pairing and Justice Fortas and Stewart the second.

Mr Justice White delivered the judgment on behalf of the first pairing. In his view, tying arrangements were not entirely unmitigated evils. In certain circumstances they could be imposed for legitimate procompetitive reasons of efficiency. They should not, therefore, be readily condemned. Moreover, they should only be condemned if independent proof of market power in the tying product market exists. Applying this particular philosophical notion to the facts, Mr Justice White made a number of observations. Firstly, he expressed concerns that the use of credit financing may not actually involve a tie of two distinct products. Secondly, he rejected the notion that simply because buyers accept tie-ins this indicates that a seller has the requisite power in the tying product market. Sellers may offer tie-ins for reasons of promotion or efficiency. Thirdly, Mr Justice White argued that in the absence of independent proof of market power the majority's conclusions were erroneous. In his view, if other sources of credit financing were available to Fortner Enterprises, there was nothing inherently unique about US Steel's money except its low cost. But low cost financing neither proves nor disproves the existence of market power. If anything, in Mr Justice White's view, the absence of power is a more reasonable inference. Sellers with market power are more likely to raise prices than lower them.[58] If, on the other hand, other sources of credit were not available the fact that US Steel provided the financing actually stimulated competition. It was simply prepared to accept risks which others found unacceptable and engaged, therefore, in "... hard and risky competition which it is the policy of the Sherman Act to encourage".[59]

[58] Ibid at 515.
[59] Ibid at 517.

With regard to the second dissenting minority Mr Justice Fortas delivered the judgment. This pairing agreed substantially with the rationale of Mr Justice White. However, in their view, credit financing amounted simply to the sale of a single product with the incidental provision of financing.[60] The main transaction (the sale of houses) was perfectly lawful and the ancillary transaction (the provision of credit) should not render it violative of the antitrust laws. In fact, to condemn these arrangements under the tying rubric was in the view of this pairing "... to use the antitrust laws themselves as an instrument in restraint of competition".[61]

C. Tie-In Case Law Under The Burger Courts

In 1957 Ward S Bowman in his article "Tying arrangements And The Leverage Problem" challenged the traditional approach to tie-ins.[62] In his view there was a need for a revaluation of the law. Bowman argued that sellers could not impose tie-ins unless they offered a compensating advantage to purchasers[63] or they had monopoly power (which he defined as the ability to control supply) in the market for the tying product.[64] In the absence of these two prerequisites a seller attempting to impose a tie-in would simply be displaced in the market. Bowman quickly dismissed the possibility that sellers would offer a compensating advantage. In his view such a tie-in would serve no useful purpose. For Bowman, therefore, the main area of difficulty was that of monopoly power over the tying product market. He argued that this form of power had to be legitimate. If it were not it would be attacked, presumably, as an antitrust violation.[65] On the assumption that the monopoly power was legitimate, the

[60] Ibid at 522.
[61] Ibid at 525.
[62] (1957) 67 *Yale LJ* 19.
[63] Ibid 20.
[64] Ibid 19-20.
[65] Ibid 32.

seller could utilise it either to maximise its profits or create a new or second monopoly in the market for the tied product. Bowman concluded, therefore, that any revenue maximising tie-in was legitimate and should be perfectly legal. Thus tie-ins could legitimately be used to evade price regulations,[66] ensure quality of inputs thereby preserving goodwill,[67] act as "metering" devices[68] or assist in the creation of economics of joint production or sale.[69] According to Bowman, then, tie-ins should only be condemned where monopolistic leverage occurs. That is, where the tie-in is used to create a second or new monopoly in the tied product market.[70] An indication that this has occurred is a reduction in the total sales volume by all sellers in the tied product market. Bowman concluded, therefore, that tie-ins were generally procompetitive and should be condemned in limited circumstances only.

Bowman's article which departed from conventional wisdom, provoked debate over the appropriate treatment of tying arrangements. For other Chicagoans Bowman's theory, whilst a welcomed advance in terms of analysis, did not go far enough. Posner, for example, argued that tie-ins could not be used to lever power from one market to another.[71] In Bork's view the transfer of power theory was simply fallacious.[72] In their view all tie-ins were procompetitive and should be presumed legal. In direct contrast to this approach others adopted a differing philosophical stance. Slawson, for example, adopts the position that all tie-ins (whether created by

[66] War time whisky producers, for example, tied the sale of price controlled whisky to non-priced controlled rum and wine in an attempt to maximise revenue.
[67] Ibid 27
[68] Tie-ins can be used as a means of charging buyers according to the intensity of their use of the tying product.
[69] Ibid 29
[70] Ibid 20
[71] R.A. Posner, "Exclusionary Practices And The Antitrust Laws", (1974) 41 *U Chic LR* 506, 508-515
[72] R.H. Bork, *The Antitrust Paradox* (Reprint, New York, 1993) Ch. 19.

compulsion or inducement) lessen competition.[73] In fact, in his view, tie-ins created by inducement are equally as pernicious as those created by compulsion.

Throughout the 1970s and 1980s the views promulgated by Chicagoans that tie-ins were essentially procompetitive gained the ascendancy. Under the Reagan and Bush Administrations the Department of Justice and the Federal Trade Commission ceased prosecuting tie-ins. Any litigation in this area was pursued by the private antitrust litigant. In fact, by 1985, the Justice Departments Guidelines for Vertical Restraints declared that tie-ins were "often procompetitive" and generally did "... not have a significant anticompetitive potential".[74] A period of "anti-antitrust" or roll-back had been entered. To an extent the changes in economic analysis and political climate was reflected in the judicial approach to tie-ins. It should be emphasised that after the appointment of Chief Justice Burger in 1969 the Supreme Court did not fully embrace Chicago. In spite of repeated attacks, the Supreme Court albeit by a single vote, retained the *per se* illegality of tying arrangements. However, an analytical shift occurred which had the effect of reducing the scope and applicability of the *per se* rules. The Supreme Court altered the threshold levels which brought the rules of *per se* illegality into play. This alteration prompted Slawson to assert

> "... although tie-ins are still illegal in theory, they are legal in practice, because the obstacles the Court has erected in the way of proving illegality are practically insurmountable".[75]

[73] W.D. Slawson, "Excluding Competition Without Monopoly Power: The Use Of Tying Arrangements To Exploit Market Failure", (1991) 36 *Antitrust B* 457.
[74] Justice Department Guidelines for Vertical Restraints 5.1 (January 23, 1985).
[75] See W.D. Slawson, note 73 above, 457.

During this period the Supreme Court addressed the threshold levels of *per se* illegality in two major cases - *US Steel Corporation v Fortner Enterprises Inc (Fortner II)*[76] and *Jefferson Parish Hospital District No 2 v Hyde.*[77]

In the 1969 *Fortner I* case the Supreme Court held that Fortner Enterprises was entitled to an opportunity to show that US Steel had the requisite economic power in the tying product market. At trial the District Court simply directed that a verdict be entered in favour of Fortner Enterprises on the issue of liability and submitted only the issue of damages to the jury. In 1971 the finding was appealed to the Court of Appeals which reversed the District Court's directed verdict and remanded the matter for a new trial on liability.[78] At the new trial, the District Court heard additional evidence and held that US Steel had the requisite economic power to render the tie-in illegal *per se*. In 1975, the Sixth Circuit Court of Appeals affirmed this decision.[79] In 1977, US Steel appealed this decision and the matter came before the Supreme Court as *US Steel Corporation v Fortner Enterprises*[80] usually referred to as *Fortner II.*

The relatively brief judgment of the Supreme Court in *Fortner II* was delivered by Mr Justice Stevens. Under the Burger regime, Mr Justice Stevens made it abundantly clear that the Supreme Court was no longer prepared to permit a cursory analysis of what constituted sufficient economic power. The Court was no longer predisposed to rely on inference as a means of establishing *per se* illegality. Under the new regime a greater evidentiary showing of requisite economic power in the market for the tying product had to be made. In this respect, he echoed the dissenting sentiments of Mr

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[76] 429 U.S. 610 (1977).
[77] 466 U.S. 2 (1984).
[78] 452 F. 2d 1095 (6th Cir. 1971).
[79] 523 F. 2d 961 (6th Cir. 1975).
[80] 429 U.S. 610 (1977).

Justice White in *Fortner I* and stated quite simply that "... if the evidence merely shows that credit terms are unique because the seller is willing to accept a lesser profit - or to incur greater risks - than its competitors, that kind of uniqueness will not give rise to economic power in the credit market."[81] Yet in the view of the Supreme Court, this was all that the record indicated. As a result Fortner Enterprises had not satisfied the appropriate burden of proof and could not prevail in the litigation. Chief Justice Burger gave a one paragraph concurring judgment simply to emphasise that the present agreement involved a "peculiar arrangement" and that the antitrust laws cast "... no doubt on the legality of credit financing by manufacturers or distributors.[82]

The Supreme Court reinforced the *Fortner II* decision in the 1984 case of *Jefferson Parish Hospital District No 2 v Hyde*.[83] In 1971 shortly before the East Jefferson Hospital opened, it entered into an "Anaesthesiology Agreement" with a professional medical corporation known as Roux and Associates. This agreement provided that only anaesthesiologists designated by Roux could provide anesthesological services to the hospital. It was believed that this "closed group policy" was in the best interests of quality patient care. The hospital, for its part, agreed to supply and maintain the department as well as providing nursing personnel. In July 1977 Dr Edwin Hyde, a certified anaesthesiologist, applied for admission to the medical staff of the hospital The Credentials Committee and the Medical Executive Board, on the basis of its commitment to the closed group policy, denied the application. As a result, Dr Hyde instituted an antitrust action in the Louisiana District Court alleging that the anaesthesiology agreement violated Section I Sherman Act.

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[81] Ibid at 621-622.
[82] Ibid at 623.
[83] 466 U.S. 2 (1984)

Judge Mitchell in the Louisiana District Court held against Hyde. He did so primarily on the basis that East Jefferson Hospital lacked market power in the relevant geographic market. The Court defined this market as including the entire New Orleans Metropolitan area. Within this area there was at least 20 other hospitals and about 70 per cent of patients attended hospitals other than East Jefferson Hospital. The District Court concluded that the impact on commerce was minimal. The Court also seemed to intimate that the principles of *per se* illegality might not apply to a case involving the medical profession.[84]

Not surprisingly Hyde appealed to the Fifth Circuit Court of Appeals.[85] It concluded that the agreement was a tying arrangement by which users of the hospital operating rooms (the tying product) were required to purchase the anaesthesia service (the tied product) chosen by the hospital. It reversed the District Court rejecting as "clearly erroneous"the lower Courts finding that the agreement could be justified by quality considerations and its intimations that the principles of *per se* illegality did not apply to the medical profession. The Court of Appeals redefined the relevant geographic market narrowly to include only the East Bank of Jefferson Parish. Within this area it found that the hospital had the requisite economic power to render the tie-in illegal *per se*. The Court of Appeals found the existence of market power by relying on a theory of market imperfection. These imperfections enabled the hospital to charge non-competitive prices. This was the case for two main reasons. Firstly, insurers payment of health care bills reduced patients incentives to compare costs which reduced price competition. Secondly, a lack of adequate information rendered patients unable to compare the quality of services provided by competing hospitals.

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[84] *Hyde v Jefferson Parish Hospital Dist. No 2*, 513 F. Supp 532, 540-544 (1981)

[85] 686 F. 2d 286 (5th Cir. 1982).

Jefferson Parish appealed to the Supreme Court which reversed the decision of the Court of Appeals. In doing so, Mr Justice Stevens addressed two major concerns. Firstly, the problem of determining whether an arrangement involves two distinct products for the purpose of tie-in law.[86] Secondly, the issue of market power. With regard to the first concern, Mr Justice Stevens stated that whether one or two products are involved "... turns not on the functional relation between them, but rather on the character of the demand for the two items".[87] That is, whether there exists a separate market for each of the products. With regard to the issue of market power the majority of the Court embraced a particular philosophical approach. Anticipating arguments that were to be presented by the concurring minority Mr Justice Stevens stated that:

> "It was far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable *per se*".[88]

This particular rule had been repeatedly endorsed by the Supreme Court. However, the Court now believed that there was "... nothing inherently anticompetitive about packaged sales".[89] They could be of benefit to both purchaser and seller alike. In the case of the latter, the decision to enter into a tying arrangement may simply be an

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[86] Prior to 1984 the lower Courts, in the absence of any judicial pronouncement by the Supreme Court, used two main tests: the 'function of the aggregation test' which focused on whether the items were normally or should reasonably be sold together and the "duality test" which attempted to determine whether separate markets existed for the respective products. See (inter alia) *Siegal v Chicken Delight Inc.*, 448 F. 2d 43 (9th Cir. 1971) and *Washington Gas Light Co v Virginia Elec and Power Co*, 438 F. 2d 248 (4th Cir. 1971).

[87] 466 U.S. at 19.

[88] Ibid at 9.

[89] Ibid at 25.

attempt to compete more effectively and efficiently.[90] As a result, the majority took the view that tie-ins should be illegal *per se* only if the seller uses

> "... its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms".[91]

The *per se* condemnation of tying arrangements was linked to the concept of market power and anticompetitive forcing. In so doing, the Supreme Court heightened the threshold requirements of *per se* illegality. In effect, contracting the scope and applicability of the rules.

Having made these judicial pronouncements Mr Justice Stevens then applied them to the facts of the case. Firstly, he concluded that the arrangements involved the tie of two distinct products. Secondly, he acknowledged that the Court of Appeals had found the existence of sufficient economic power on the basis of market imperfections. However, in the view of the majority, whilst factors relevant to this theory may generate market power in some "abstract sense", they did "... not generate the kind of market power that justifies condemnation of tying".[92] In the majority's view, a lack of price or quality competition did not generate the anticompetitive forcing which the Supreme Court now viewed as necessary for *per se* condemnation. Accordingly, the Supreme Court reversed the decision of the Fifth Circuit Court of Appeals.

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[90] Ibid at 11.
[91] Ibid at 12.
[92] Ibid at 27.

Ms Justice O'Connor delivered the *concurring* opinion on behalf of Mr Justices Powell and Rhenquist. In their view

> "... tying may make the provision of packages of goods and services more efficient. A tie-in should be condemned only when its anticompetitive impact outweighs its contribution to efficiency".[93]

The concurring minority, influenced greatly by pro-Chicagoan theories, advocated the abandonment of the *per se* treatment of tie-ins in favour of an approach based on the rule of reason. Ms Justice O'Connor stated that "(t)he '*per se*' doctrine in tying cases always required an elaborate inquiry into the economic benefits of the tying arrangement. As a result tying doctrine incurs the costs of a rule of reason approach without achieving its benefits".[94] In other words, the *per se* doctrine calls for "... extensive and time-consuming economic analysis characteristic of the rule of reason, but then may be interpreted to prohibit arrangements that economic analysis would show to be beneficial".[95] In the view of the concurring minority the *per se* label generated more confusion than coherent law. To rectify this situation Ms Justice O'Connor proposed a tie-in test that required the plaintiff to satisfy three threshold requirements, in addition to showing that the restraint was unreasonable under the application of the rule of reason. Firstly, the seller must be shown to have power in the tying product market. Secondly, there must be a "substantial threat" that the tying seller will acquire market power in the tied product market. Finally, there must be a coherent basis for treating the tying and tied products as distinct.[96] If these threshold requirements are met, the tie-in must then be considered under a rule of reason

93 Ibid at 42.
94 Ibid at 34
95 Ibid.
96 Ibid at 37-40.

analysis. Applying this particular approach to the facts of the case, Ms Justice O'Connor assumed that East Jefferson Hospital had market power and that a substantial threat existed that it would acquire market power in the tied product market. However, in the view of Ms Justice O'Connor, there was no sound economic reason for treating surgery and anaesthesia as separate services.[97] There was no distinct products for the purpose of antitrust tie-in law. Mr Justices Brennan and Marshall concurred but delivered a one paragraph opinion to state that modification of the *per se* rules should be left to Congress.

D. The Eastman Kodak Decision And The Rise Of Market Imperfection

In the early 1990s, with the election of the Clinton administration, the political climate in the United States changed. Anne Bingamen was appointed Assistant Attorney General for Antitrust and with her appointment the 1985 US Department of Justice Vertical Restraint Guidelines were repealed. In her confirmation testimony she pledged to enforce the antitrust laws to accord with the wishes of Congress and in accordance with the facts of each case and not just according to economic constructs or models.[98] At that time, it was said "'Facts are back'... and never mind the niceties of Chicago's ... economic theorising". At roughly the same time the Supreme Court heard the case of *Eastman Kodak Co v Image Technical Services*,[99] a case which raised a veritable host of antitrust questions.

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[97] Ibid at 43.

[98] Nomination Hearing of Anne Bingamen to be Assistant Attorney General Antitrust Division Before the Senate Committee on the Judiciary - 9 June 1993. See also M.L. Popofsky and M.S. Popofsky, "Vertical Restraints In The 1990s: Is There a 'Thermidorian Reaction' To the Sylvania Orthodoxy?", (1994) 62 *Antitrust LJ* 730.

[99] 504 U.S. 451 (1992).

Eastman Kodak manufactured and sold complex business machines including high volume photocopiers and micrographic equipment. Replacement parts for this equipment was manufactured either by Kodak itself or according to Kodak's specifications by original equipment manufacturers (OEMs). These parts were compatible with Kodak's equipment only. In the early 1980s independent service organisations (ISOs) began to repair and service Kodak's equipment using parts purchased from OEMs, but also using parts acquired from Kodak itself, parts brokers and existing customers. The ISOs provided a service that was substantially lower in terms of price and, in the opinion of many customers, of superior quality. By the mid-1980s the ISOs had made substantial inroads into Kodak's share of the service market. In 1985 and 1986, therefore, Kodak implemented policy changes in relation to the provision of parts. It decided that it would only sell replacement parts to those customers who either repaired and serviced their own machines or who used Kodak's servicing facilities. The ISOs were effectively excluded from receiving new parts. Kodak buttressed its policy changes by ensuring that its original equipment manufacturers (OEMs) did not supply parts to anyone else other than Kodak itself. It also took steps to ensure that parts brokers and equipment owners refused to sell parts to ISOs. These policy changes were designed to make it difficult or impossible for the ISOs to service Kodak's equipment. In this respect Kodak was successful. The ISOs were either forced out of business or lost substantial revenues. Customers were forced to turn to Kodak for servicing even though they felt the ISO's provided a superior quality service.

In 1987, as a result of Eastman Kodak's actions, eighteen ISOs instituted antitrust proceedings in the District Court of California. They alleged that Kodak had unlawfully tied the sale of service (the tied product) to the sale of parts (the tying product) in contravention of Section 1 Sherman Act and had monopolised or attempted to monopolise the sale of service for Kodaks' machines in violation of Section 2. Kodak immediately filed a motion for summary judgment. The District Court, after limited discovery and without a hearing, held that the ISOs had not provided evidence of the existence of a tying arrangement between Kodak's *equipment* and *service* or *parts* and that Kodak had merely exercised a unilateral right to refuse to sell its parts to the ISOs. Accordingly neither provision of the Sherman Act was violated and Judge Schwarzer granted Kodak's motion.

The ISOs appealed to the Ninth Circuit Court of Appeals.[100] Sitting as a panel the appellate Court found that the issue was whether a tying arrangement existed between the sale of Kodak's *parts* and *service*. In the Court's view that was a disputed issue of fact. With regard to the issue of market power the ISOs conceded that Kodak lacked market power in the interband market.[101] It was accepted that the equipment market was highly competitive. Kodak relied on neo-classical economic theory, therefore, to assert that it could not have market power in the aftermarkets for its own parts. As the interband market for their equipment was vigorous this meant that it could not have market power in the derivative aftermarkets. A divided Court of Appeals agreed that this might be the case but it refused to uphold the District Court's summary judgment on a mere "theoretical basis". In this respect Judge Wallace dissented. In his view "... power in the primary interbrand market is a prerequisite to power in the derivative market for replacement parts".[102] In any event, the Court of Appeals concluded that the ISOs had presented evidence of actual *market imperfections* which enabled a reasonable trier of fact to conclude that "... competition in the (equipments) market

[100] 903 F. 2d 612 (9th Cir. 1980).
[101] Ibid at 616 n3.
[102] Ibid at 623.

does not, in reality, curb Kodak's power in the parts market".[103] Market imperfections could prevent Kodak's neo-classical price theory, about how consumers might act, from mirroring the reality of the situation. The Court of Appeals, therefore, remanded the matter for trial.

Kodak appealed to the Supreme Court and *certiorari* was granted. The Court's judgment was delivered by Mr Justice Blackmum. He stated that two main issues existed. Firstly whether a tying arrangement actually existed. Secondly, whether Kodak had the requisite economic power in the tying product market. Mr Justice Blackmum, quickly and succinctly, stated that Kodak's argument that parts and service could not be regarded as separate products was incorrect as a factual matter and not borne out by the evidence of the record.[104] In the view of the majority a tie-in actually existed.

The Court then focused on the issue of market power. In this respect the ISOs argued that Kodak had the requisite power for a number of reasons. Firstly, certain parts were available exclusively through Kodak. Secondly, Kodak exercised control over the availability of parts which it did not manufacture. Thirdly, by controlling the availability of parts Kodak excluded service competition, increased service prices and forced consumers to accept higher priced, lower quality servicing. On this basis the Supreme Court asserted "(u)nder our prior precedents, this evidence would be sufficient to entitle respondents to a trial on their claim of market power".[105]

[103] Ibid at 617.
[104] 504 U.S. at 463.
[105] Ibid at 465.

The Court then placed on Kodak the burden of showing that despite evidence of increased prices and excluded competition, an inference of market power was unreasonable. Kodak responded by arguing that the primary equipment market was highly competitive and within the interbrand market it did not possess market power. It was, therefore, not in a position to raise prices in relation to parts and service above a competitive level. To raise prices in the secondary or derivative aftermarkets would result in lower sales of primary equipment in the interbrand market with a corresponding diminution in profits. In short, a competitive interbrand market disciplines the aftermarkets. Kodak argued, therefore, that the Supreme Court should adopt a substantive legal rule that 'equipment competition precludes any finding of monopoly power in derivative aftermarkets".[106] On this basis there could be no genuine issue as to any material fact on the market power issue.[107] Thus, the Supreme Court should approve its application for summary judgment.

Kodak based its arguments on the two-twin pillars of neo-classical economic enlightenment - the decisions in *Matsushita Electric Industrial Co v Zenith Radio Corp*[108] and *Continental TV Inc v GTE Sylvania Inc.*[109] These cases reflect the Supreme Court's willingness to embrace some of the theoretical propositions of the Chicago School in developing antitrust doctrine. In the *Matsushita* case a number of American manufacturers of electronic products alleged that 21 Japanese competitors had engaged in predatory pricing in order to undercut their American counterparts and expand their share of the American market. After years of discovery the Japanese corporations moved for summary judgment. They asserted that the American corporations arguments made no economic sense. The Supreme Court agreed. In its

[106] Ibid at 466.
[107] Ibid.
[108] 475 U.S. 574 (1986).
[109] 433 U.S. 36 (1977).

view there was no rational motive to conspire. Such a 20 year long conspiracy would have required the Japanese corporations to sustain losses for decades with no foreseeable profits. A more plausible explanation was that they were simply engaged in hard competition.

Kodak also repeatedly relied on the *Sylvania* case in support of its contentions that interbrand competition in the equipments market would prevent the exploitation of the service and parts market. In *Sylvania* the Supreme Court stated "... when interbrand competition exists, ... it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product".[110] It should be emphasised, then, that Kodak's response to the ISOs arguments was based on purely theoretical economic arguments the roots of which were firmly planted in Chicago.

On behalf of the majority Mr Justice Blackmum proceeded to unravel the assumptions underpinning Kodak's proposed rule. He stated that Kodak's theory was based on an assumption about the cross-elasticity of demand in the interbrand equipment market and aftermarkets. If Kodak raised its parts or service prices above competitive levels, consumers would purchase similar products from other manufacturers. In Kodak's view this was a matter of basic economic reality which should be accepted as a matter of law. In the view of the Court, however, Kodak's claim while "intuitively appealing" was based on a "false dichotomy" that only two prices could be charged - a competitive price or a ruinous one. In the Court's view a further alternative existed. A middle or optimum price could be charged which generated increased revenues from higher priced parts or services which would compensate for lower revenue

[110] Ibid at 52 n19.

generated by lost equipment sales.[111] The Court concluded, therefore, that there was no immutable physical law or economic reality which held that "... competition in the equipment market cannot coexist with market power in aftermarkets".[112] The Supreme Court simply rejected Kodak's arguments. It did so because a fact based analysis proved inconsistent with Kodak's reliance on a purely theoretical Chicagoan economic construct.

In this respect the Court made four main observations. Firstly, it observed that the corollary of Kodak's theory was that lower service prices should increase primary equipment sales. If this was the case, why then did Kodak attempt to eliminate the lower priced servicing of the ISOs? In fact, the ISOs presented evidence to show that the price of Kodak's servicing had actually increased without any concomitant decrease in the sales of primary equipment.[113] Secondly, with regard to Kodak's reliance on *Matsushita*, the Court stated that the Court in that case did not hold that if the "moving party (Kodak) enunciates *any* economic theory supporting its behaviour, regardless of its accuracy in reflecting the actual market, it is entitled to summary judgment".[114] The Court interpreted *Matsushita* as demanding only that the ISOs inferences be reasonable in order to reach the jury". Thirdly, the Court rejected Kodak's reliance on the *Sylvania* decision as being inapposite. In the view of the majority the tying arrangement at issue in Kodak was a horizontal restraint on interbrand competition and not a vertical restraint on intrabrand competition.[115] Fourthly, and most importantly, the Supreme Court held that the ISOs offered a "forceful reason" why Kodak's theory may not prove persuasive. Kodak may have the

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[111] 504 U.S. at 471.
[112] Ibid.
[113] Ibid at 472.
[114] Ibid at 468.
[115] Ibid at 471 n18.

requisite market power on the basis of market imperfections, in particular, information costs and switching costs. With regard to information costs, for service prices to affect demand for primary equipment, consumers must engage in accurate life cycle pricing.[116] They must determine the total cost of the equipment, service and parts in comparison with other equipment. This involves a sophisticated analysis which is both difficult and costly. Moreover, the information to conduct this analysis may not be available or may be customer specific. Uunsophisticated consumers may fail to engage in the process and may, therefore, be charged inflated service prices. In fact the Supreme Court accepted evidence that this was the case with regard to certain Governmental agencies. Alternatively, Kodak may simply price discriminate between sophisticated and unsophisticated consumers, charging the former less or allowing them to take their business elsewhere. The second argument which the ISOs presented related to switching costs.[117] If the cost of switching from Kodak's product to that of another competitor is high, consumers are "locked in". They will tolerate some level of service-price increase before changing brands.[118] If switching costs are high relative to service prices, a seller can profitably maintain supracompetitive prices in the aftermarkets just as if it were a monopolist. On this basis, the majority of the Court did not feel that it was sensible to adopt Kodak's assumption that interbrand competition would prevent exploitation in the derivative aftermarkets.

Mr Justice Scalia delivered the dissent on behalf of himself and Justices O'Connor and Thomas. For the dissenting minority the crux of the matter was whether a manufacturer's conceded lack of power in the interbrand market for its equipment was consistent with its possession of market power in the secondary aftermarkets for that

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[116] Ibid at 473.
[117] Ibid at 478.
[118] Ibid.

equipment.[119] In their view the Court had supplied an erroneous answer. The minority asserted that any power which Kodak possessed in the derivative aftermarkets was simply an "inherent power" over its own brand of equipment which was not sufficient to bring into play the antitrust "sledgehammer".[120] This type of power is "... possessed by every manufacturer of durable goods with distinctive parts". This particular approach was roundly condemned by the majority as a "radical departure" from the Supreme Courts previous antitrust laws. Its effects, the majority asserted, would be to grant *per se* immunity from antitrust laws to those manufacturers competing in the service market.[121] In the view of the majority the minority had no authority to implement such a policy change.

Mr Justice Scalia then proceeded to analyse, in depth, the issue of market power. He stated that one of the Respondents original allegations, which was later abandoned, was that parts and services were actually tied to the sale of equipment. He asserted that had this claim proceeded it would have failed as it was accepted that Kodak did not possess market power in the interbrand equipment market. In the view of the minority it was simply anomalous that a manufacturer functioning in a competitive equipment market should be exempt from the *per se* rule when it bundles equipment with parts and service but not when it bundles parts and service. In the view of the minority, such reasoning made every market of unique parts a holder of market power for its own products irrespective of how unimportant its product might be in the market. With regard to the issue of market imperfection the minority rejected the arguments that information costs and switching costs could give rise to market power. In their view, gaps in the availability and quality of consumer information pervades

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[119] Ibid at 486.
[120] Ibid at 489.
[121] Ibid at 479 n29.

real world markets. Market imperfections, therefore, cannot create "... 'market power' of concern to antitrust where otherwise there is none".[122] Furthermore, the fact that consumers tolerate some levels of service price increase, as a result of their initial capital investment, occurs in all types of markets and is of no concern to the antitrust laws.[123] Mr Justice Scalia then asserted that the Court should follow Justice O'Connor's concurrence in *Jefferson Parish* and assess the legality of all tying arrangements under the rule of reason.

The approach adopted by the Court in *Kodak* and *Jefferson Parish* to the issue of market imperfections seem irreconcilable. In *Jefferson Parish* the Court held that market imperfections gave rise to an *abstract* form of market power, one that did not justify the condemnation of tying. In contrast and without explanation the Supreme Court in *Kodak* changed its position. This has provoked almost as much attention as the Dead Sea Scrolls. For some it is a return to traditional multi-dimensional values.[124] The Court simply concluded that tie-ins are facially anticompetitive and the very harm which antitrust laws are designed to prevent. For others *Kodak* does not amount to a rejection of economic theory in antitrust jurisprudence.[125] The Court simply embraced a theory of economics that readily explained the facts before it. Absent the circumstances which made the ISOs theory hold true foremarkets and aftermarkets should still be presumed responsive. In any event, they assert, *Kodak* did not address the degree of market power required to invoke the *per se* rules and

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[122] Ibid at 496.
[123] Ibid at 496-497.
[124] G.B. Spivak & C.T. Ellis, "Kodak: Enlightened Antitrust Analysis And Traditional Tying Law", (1993) 62 *Antitrust LJ* 203. See also E.M. Fox, "*Eastman Kodak Co. v Image Technical Services Inc* - Information Failure As Soul Or Hook?", (1994) 62 *Antitrust LJ* 759.
[125] See, for example, M.L. Popofsky and M.S. Popofsky, "Vertical Restraints In The 1990s: Is There A 'Thermidorian Reaction' To the Sylvania Orthodoxy?", (1994) 62 *Antitrust LJ* 729; T.E. Kauper, "Antitrust In 1992", (1993) 61 *Antitrust LJ* 347; G.A. Hay, "Is The Glass Half Empty Or Half Full?" Reflections On the Kodak Case", (1993) 62 *Antitrust LJ* 177; D.J. Gifford, "The Damaging Impact Of The *Eastman Kodak* Precedent Upon Competition: Antitrust In Need Of Correction", (1994) 72 *Washington University Law Quarterly* 1507.

substantial power is still required to satisfy the market power filter. Whatever position one adopts, however, the facts remain that *Kodak* represents the current position in the US and has taken a tough line with regard to the determination of market power.

E. Microsoft And The Browser Wars

The Microsoft Corporation, founded in 1975 and based in Redmond Washington, is the world's largest producer of computer software. In 1993, for example, its net profits amounted to 1 billion US dollars of which one-third was generated in the EU.

Over the last decade, however, Microsoft has been ensconced in antitrust investigations and litigation. In particular, Microsoft's bundling practice has been the subject of intense antitrust scrutiny. Mircosoft requires original equipment manufacturers (OEMs) to purchase its internet browser (IE) if they wish to obtain a license to pre-load its Windows operating system. Initially, this practice was of a purely contractual nature which eventually took on a technological dimension through the interlocking of the Internet Explorer code (IE.4.0) with its Windows 98 operating system. Deletion of the code performing the browser function precipitated system degradation through the loss of stability and security. This technological welding was also reinforced by contractually proscribing manufacturers from deleting the code prior to shipping to end users.[126]

Microsoft's practices have resulted in complaints from a number of undertakings including Netscape, manufacturer of the competing "Navigator" browser. In the US

[126] See A.J. Meese, "Monopoly Bundling In Cyberspace: How Many Products Does Microsoft Sell?", (1999) 44 *Antitrust B* 65; P. Ruttley, "EC Competition Law In Cyberspace: An Overview Of Recent Developments", (1998) 19 *ECLR* 186.

the Department of Justice attempted to have Microsoft held in contempt for violating Section IV (E) (I) of a 1995 consent decree, which prohibited Microsoft from tying the sale of its operating systems to the sale of its software products, concluded following tripartite negotiations between Microsoft, DOJ and the European Commission.[127] In December 1997, the District Court refused to hold Microsoft in contempt but issued a preliminary injunction against the bundling practice and referred the matter to a Special Master for fact-finding. Microsoft appealed arguing that its operating system and IE formed part of an integrated system. The US Court of Appeals for the District of Columbia reversed the injunction holding that Microsoft's IE programme was "integrated" into its Windows 95 operating system and not in violation of antitrust law provided "plausible" benefits stemmed from the arrangements.[128]

In May 1998 the DOJ, nineteen states and the District of Columbia filed suit against Microsoft, charging it was engaging in a pattern of anticompetitive behaviour contrary to s.1 and s.2 Sherman Act. Once again, it was alleged that Microsoft had engaged in illegal tying, forcing its customers to take IE as a condition of obtaining Windows. In contrast, Microsoft argued that its business tactics were common to the industry, beneficial to consumers and did not involve tying as it simply provided an "integrated" system.

Judge Jackson held in favour of the plaintiffs.[129] In his view the Court of Appeals did not intend to state a controlling rule of law for the purposes of the present case. It was primarily concerned with the construction of a single provision of a consent decree and

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[127] *US v Microsoft Corp.*, 1995 WL 505998, Civ No 94-1564 (DDC Aug 21, 1995); Commission Press Release IP/94/653 of July 17, 1994.
[128] *US v Microsoft Corp.*, 56 F. 3d. 1448 (D.C 1995).
[129] DOJ/Antitrust: Microsoft Conclusions of Law and Final Order, http://www.usdoj.gov/atr/cases/14400/4469.htm

contractual intent. The Court of Appeals' observations were strictly *obiter dicta* and not formally binding.[130] In any event the "plausible benefits" test enunciated by the Court of Appeals was undemanding and inconsistent with Supreme Court precedent. In this respect he reviewed the *Jefferson Parish* and *Kodak* cases and concluded the "character of demand" for the constituent components and not their functional relationship determined whether two products were actually involved. Commercial realities faced by consumers and not "abstract or metaphysical" assumptions about product configurations had to be taken into account.[131]

On this basis, Judge Jackson, concluded that commercial reality indicated that consumers perceived operating systems and browsers as separate products. The bundling was not derived from technical necessity or business efficiency. It was simply a "... deliberate and purposeful choice to quell incipient competition."[132] In condeming the tying, Judge Jackson had no difficulty in concluding that Microsoft had appreciable economic power in the tying product market and that not an insubstantial amount of commerce was involved.

Two final points. Firstly, on 7 June 2000 Judge Jackson, in the biggest antitrust break-up since AT&T in 1982, ordered Microsoft to be split in two and imposed immediate curbs on its business activities. He condemned Microsoft's entire pattern of anticompetitive behaviour and referred to the corporation as "untrustworthy". The break-up in his view, will revive competition. Undoubtedly, Microsoft will appeal.[133] Secondly, the European Commission in 1999 approved Microsoft's licensing

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[130] Ibid at 25.
[131] Ibid at 27-28.
[132] Ibid at 32.
[133] R. Wolffe, T. Formeski and C. Grimes, "Microsoft Ordered To Split In Two", *Financial Times*, 8 June 2000.

agreements with Internet Service Providers by means of comfort letter.[134] Approval was only forthcoming after Microsoft redrafted its agreements to ensure they did not foreclose the market for Internet browser software from Microsoft's competitors. However, following the ruling in the US the Commission has indicated its intention to investigate Microsoft's 2000 operating systems.

III. TYING AGREEMENTS AND EUROPEAN UNION COMPETITION LAW

A. The Development Of EU Tie-In Case Law

Tie-ins can fall foul of Articles 81 (ex 85) and 82 (ex 86) EC. In comparison with the US there have been remarkably few decisions relating to tying in the EU. This is perhaps a reflection that tying need not necessarily involve exclusivity. Where tying has been condemned under Article 81 (ex 85) the authorities analysis has been relatively terse. In the case of *Vassen/Moris*[135] a Dutch manufacturer of synthetic casings used in the production of sausages, complained to the Commission alleging that the commercial practices of Alex Moris and his company, ALMO, infringed Article 81 (ex 85) by impeding its access to the Belgium market. Moris had obtained a patent relating to a process and device for use in the making of sausages, particularly saucissions de Boulogne. A square shaped sausage made exclusively in Belgium out of a mixture of horsemeat, beef and pork. Moris granted ALMO a license to work his patents and the company, in turn, granted a number of sublicenses to other manufacturers including Imperial NV. Vassen, convinced that the patent was void, informed Belgian sausage manufacturers to this effect. As a result, Imperial placed an order with Vassen for 3000 sausage casings. Moris and ALMO responded by issuing

[134] Commission Press Release IP/94/317 of May 10, 1999.
[135] Comm.Dec. 79/86 OJ 1979 L19/30, [1979] 1 CMLR 511.

legal proceedings against Imperial. The latter agreed in November 1973, in order to settle the dispute, to recognise the validity of the patents and to purchase its future requirements from ALMO. The Commission concluded that this agreement infringed Article 81 (ex 85). Imperial was deprived of its freedom, which was open to everyone else to seek revocation of the patent. Furthermore, the tie-in that required the sublicensee to obtain its supplies of casings from ALMO whenever it used the patented process, deprived it of its freedom to obtain supplies elsewhere perhaps on more favourable terms and was not required by the industrial property right. In fact, the casings supplied by ALMO to Imperial were not covered by the patent. The tie-in simply resulted in the unlawful extension by contractual means of the monopoly given by the patent. In the Commission's view the agreement was simply not eligible for exemption because it did not contribute to improving the production or distribution of the goods in question.

In February 1986 the Court of Justice examined the commercial practices of Windsurfing International Inc, an American undertaking, engaged in the manufacture of sailboards. The latter is composed of a board made of synthetic material and a rig consisting essentially of a mast, a joint for the mast and a sail. In the 1970s the American undertaking decided to extend its operations to Europe where it submitted patent claims in the UK and Federal Republic of Germany. Between 1973 and 1980 the American undertaking granted licences for the production and sale of its sailboards to a number of European companies. Windsurfing placed an obligation on its licensees to sell the patented rigs only in conjunction with approved sailboards. Trade competitors complained to the Commission that this practice, amongst others, violated the rules on competition. As a result of comments received from the Commission, Windsurfing concluded a number of new licensing agreements. The Commission, nevertheless, instituted proceedings and concluded that the licensing agreement infringed Article 81 (ex 85) EC in a number of respects and imposed a fine of 50,000 ECUs.[136]

In the view of the Commission the tie-in restricted the licensees in their freedom to decide whether they wanted to act on the market as manufacturers of sailboards or suppliers of rigs. As regards the economic interests of the licensees the Commission observed that many of them did not manufacture rigs themselves (the production of boards and rigs involved distinct technological processes) preferring to acquire them from specialist contractors. To prevent this separate supply, which may have been of economic benefit to the licensees, amounted to an appreciable restriction of competition. The Commission also stressed that the German patent protection which extended to the rigs only, offered no protection from Article 81 (ex 85). With regard to Article 81(3) (ex 85(3)) the Commission concluded, quite succinctly, that the tie-in constituted a restriction in the distribution of the goods.

In September 1983 Windsurfing in the case of *Windsurfing International v Commission*[137] appealed to the Court of Justice for annulment of the Commission's decision. The Court, however, rejected the American undertakings arguments that there was only one market for the purchase of complete sailboards and that its German patent extended to the complete system. It accepted the Commission's view that two distinct markets existed and that the arrangement involved two products. The Court held that evidence from sales catalogues, advertising and information from manufacturers substantiated this. The Court also agreed with the Commission that the patent granted to the applicant covered only the rig for a sailboard and not the board

[136] Comm. Dec. 83/400 *Windsurfing International* OJ 1983 L229/1, [1984] 1 CMLR 1.
[137] Case 193/83 [1986] ECR 611, [1986] 3 CMLR 489.

itself.[138] In upholding the Commission's decision the Court stated that it could not "... be accepted that the obligation arbitrarily placed on the licensee only to sell the patented product in conjunction with a product outside the scope of the patent is indispensable to the exploitation of the patent".[139] The Court also rejected Windsurfing's claims in relation to health, safety and the need to sell sailboards and rigs together.

Article 82 (ex 85) relates to the abuse of a dominant position. Dominance has been held to exist where an undertaking has a market share of 50 per cent.[140] The imposition of tying arrangements is listed in Article 82 (d) (ex 86(d)) as a practice considered to be abusive. These arrangements may be imposed directly or indirectly. A dominant undertaking may indirectly tie others to itself by various means including the use of rebates and bonus schemes[141] or through refusals to supply except on conditions which amount to tying.[142]

In December 1980 the Commission commenced investigations into the direct tying practices of *International Business Machines* (IBM), the world's largest computer manufacturer.[143] The Commission alleged that IBM occupied a dominant position in the supply of its central processing units and operating systems for its System 370. It had abused this position, firstly, by failing to provide interface disclosure to enable competitors to ensure their products were architecturally compatible with IBM's

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[138] Ibid 647-650.
[139] Ibid 657.
[140] See Case C-62/86 *AKZO v Commission* [1991] ECR I-3359, [1993] 5 CMLR 215; Case 27/76 *United Brands v Commission* [1978] ECR 207, [1978] 1 CMLR 429 [Market shares below 50 per cent gave rise to dominance]. See also D.G. Goyder, *EC Competition Law* (3rd edn., Oxford, 1998) Ch. 15.
[141] See in this context, Case 85/76 *Hoffman La Roche v Commission* [1979] ECR 461, [1979] 3 CMLR 211; Case 322/81 *Michelin v Commission* [1983] ECR 3461, [1985] 1 CMLR 282; Case C-310/93P *British Industries Plc and British Gypsum Ltd v Commission* [1995] ECR I-865, [1995] 4 CMLR 718. Comm. Dec. 88/518 *Napier Brown - British Sugar* OJ 1988 L284/11, [1990] 4 CMLR 196.
[142] Case 311/84 *Centre Belge-Telemarketing v CLT* [1985] ECR 3261, [1986] 2 CMLR 558.
[143] EEC Commission, *Fourteenth Report on Competition Policy 1984* (Brussels, 1985) pp 77-79

systems. Secondly, IBM did not offer its System 370 without a compatibility of main memory included in the price, a practice known as memory bundling. Thirdly, IBM also engaged in software bundling and finally, refused to supply certain installation services to users of non-IBM equipment. IBM denied these allegations and in its reply to the Commission's Statement of Objections indicated that it had already began unbundling its software and that it intended to make installation services available to all users of its software. The issues of memory bundling and interface disclosure, however, remained outstanding. The Commission instituted formal proceedings as well as undertaking informal discussions with IBM. In August 1984, the Commission agreed to accept IBM's undertaking to offer its System 370 without main memory or with a limited capacity in order to facilitate system testing. Furthermore, IBM also agreed to expedite interface disclosure.

In 1988 the Commission also addressed the issue of tying in the case of *London European-Sabena*[144]. Here London European, a UK based undertaking operating a twice daily air service from Luton to Brussels and Amsterdam, complained to the Commission that Sabena, a Belgian owned company, had made access to its computerised ticket reservation system conditional upon accepting Sabena's ground handling services. In its very brief legal analysis the Commission had no difficulty in concluding that Sabena occupied a dominant market position.[145] It had abused this dominance by tying two unconnected services contrary to the provisions of Article 82(d) (ex 86(d)). A fine of ECU 100,000 was imposed.

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[144] Comm. Dec. 88/589 OJ 1988 L317/47, [1989] 4 CMLR 662.

[145] The market share of the Saphir computerised reservation system fell between 40 and 50 per cent with over 118 travel agents and all but two airlines operating from Brussels using the service.

B. Tie-Ins And Secondary Aftermarkets

It is not uncommon for a manufacturer of a particular product to produce spare parts or consumables for use in its own primary equipment. In such circumstances the manufacturer operates on both the primary and secondary markets. A number of antitrust concerns may arise, in particular, whether the primary and secondary markets are to be viewed as responsive. Does intense competitive activity on the interbrand market discipline the secondary aftermarkets preventing the exploitation of consumers?

In *Hugin*[146] the Commission found that a manufacturer's refusal to supply spare parts to Liptons, following its decision to set up its own UK based subsidiary, amounted to an abuse of a dominant position. Hugin's spare parts were not interchangeable and manufactured to its own design. While Hugin had only a 12 per cent market share in the primary equipment market the Commission concluded that it had a dominant position in the market for its own spare parts. On appeal the Court of Justice confirmed this position. However, it felt it unnecessary to adjudicate upon the issue of abuse as trade between Member States was not affected. As a result, it annulled the Commission's decision.

Ten years later the Court of Justice confirmed this position in the cases of *Volvo v Veng*[147] and its companion case of *Maxicar v Renault.*[148] Here both car manufacturers refused to license independent repairers to manufacture spare parts for their respective products. Advocate General Mischo delivered the Opinion in both cases and stressed

[146] Case 22/78 *Hugin v Commission* [1978] ECR 1869, [1979] 3 CMLR 345.
[147] Case 238/87 [1998] ECR 6211, [1989] 4 CMLR 122.
[148] Case 53/87 [1988] ECR 6039, [1990] 4 CMLR 265.

that manufacturers may hold dominant positions in the secondary aftermarkets. The Court agreed. This would be the case if it possessed intellectual property rights which prevented other manufacturers from producing substituable parts. He also emphasised, however, that even in the absence of these rights a manufacturer may still hold a dominant position. Firstly, its distribution network is usually the first port of call for consumers looking for replacement parts. Secondly, the use of non-original body parts may vitiate the manufacturer's guarantee. Thirdly, independent repairers only enter the market after a new model has been launched in order to conduct the "reverse engineering"necessary to produce copies of the original parts. Finally, parts produced by independents do not enjoy the prestige associated with the original label.[149]

In March 1994, the Court of Justice in the case of *Hilti v Commission*[150] examined the marketing strategy of Hilti AG, a large Liechtenstein based undertaking and world leader in the manufacture and distribution of fastening systems used in the construction industry. Hilti manufactures nail guns and consumables used therein - nails, cartridges and cartridge strips. Profix Distribution Ltd (formerly Eurofix) and Bauco (UK) Ltd manufacture nails for the use in such equipment. Both undertakings complained to the Commission alleging that Hilti was pursuing a commercial strategy designed to exclude them from the market in nails compatible with Hilti guns. In particular Hilti refused to supply its dealers with patented cartridge strips unless they also purchased a corresponding quantity of nails. Following these complaints the Commission conducted further enquiries and eventually initiated infringement proceedings.

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[149] Case 238/87, note 147 above, 6225; Case 53/87, note 148 above, 6063.
[150] Case C-53/92P [1994] ECR I-667, [1994] 4 CMLR 614.

In December 1987 the Commission concluded that Hilti infringed Article 82 (ex 86).[151] In arriving at its decision the Commission adopted narrow product market definitions concluding, significantly, that nail guns, cartridge strips and nails formed three distinct product markets. The Commission rejected Hilti's view that these products formed an integral system of powder actuated fastening (PAFs) which formed a constituent part of the wider market made up of fastening systems in general. The Commission arrived at this conclusion on the basis of supply and demand considerations. On the supply side, it noted that nails and cartridge strips were produced by different technological processes and often by different undertakings not engaged in the manufacture of nail guns. On the demand side, the acquisition of a nail gun is usually from capital expenditure and is a depreciating asset. In contrast, nails and cartridge strips are purchased from current expenditure according to requirements. The Commission also rejected the notion that Hilti's equipment formed part of a wider relevant market for fastening systems in general. The system lacked functional interchangeability. Indeed, if Hilti's PAF System formed part of a wider product market increases or decreases in the price of nail guns, nails or cartridge strips would have resulted in shifts of demand to or from other fastening systems. The Commission found no evidence of this. It concluded, therefore, that Hilti competed directly on the markets for consumables used in its own products.[152]

With regard to Hilti's market position the Commission concluded that it held a dominant position in both the primary and secondary aftermarkets with an estimated market share of 55 per cent in the market for nail guns and a similar share in the markets for nails and cartridge strips. Other factors also contributed to this dominance including inter alia, novel and technically advanced features on its nail guns protected

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[151] Comm. Dec. 88/138 *Eurofix - Bauco v Hilti* OJ 1988 L65/19, [1989] 4 CMLR 677.
[152] Ibid 31-33.

by patents and a strong research and development ethos supported by a well organised distribution system.[153]

The Commission also concluded that Hilti had abused its market position on eight separate counts. The first abuse related to the issue of tying. Hilti had tied its non-patented nails to its patented cartridge strips. This amounted to abuse for three main reasons. Firstly, it foreclosed access to the market for Hilti compatible nails. By limiting the availability of its cartridge strips independent producers of Hilti compatible nails were severely restricted in their ability to penetrate the market. Consumers were left open to possible exploitation because they had no choice over the source from which they purchased nails. In the view of the complainents they were forced to maintain artificially low production runs which increased their costs and damaged the market for nails, generally Secondly, Hilti's policy prevented the possibility of arbitrage. As independent nail producers could only acquire Hilti compatible cartridge strips with Hilti compatible nails the threat of using these strips with lower priced nails manufactured by others was reduced.[154] Finally, the Commission embraced the notion of leverage. It stated that Hilti's ability to carry out "... its illegal policies (stemmed) from its power on the markets for Hilti-compatible cartridge strips and nail guns (where its market position is strongest and the barriers to entry are highest) and aims at reinforcing its dominance on the Hilti compatible nail market (where it is potentially more vulnerable to new competition)".[155] The Commission also rejected Hilti's claim that the tie-in was necessary on the grounds of safety. Hilti had not taken any action to give expression to its concerns for product

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[153] Ibid 34-35.
[154] Ibid 35-36.
[155] Ibid 36.

safety or reliability. Article 82 (ex 86) was, therefore, infringed and a fine of 6 million ECU imposed.

In March 1988 Hilti appealed to the Court of First Instance seeking annulment of the Commission's decision.[156] The Court, however, agreed with the Commission that nail guns, cartridge strips and nails constituted distinct markets. From 1960, for example, there had been a number of independent nail producers making nails for guns. Some of these producers made nails for use in Hilti's tools. This was sufficient evidence to indicate that there was a separate market for Hilti compatible nails. To have held otherwise would have been tantamount to permitting producers of nail guns to exclude the use of consumables other than their own branded products in their tools". With regard to the issue of dominance the Court also upheld the position of the Commission. It stated that the figures provided by Hilti indicated that it occupied a position of dominance which was strengthened by its ownership of intellectual property rights. Hilti's commercial practices amounted to abuse contrary to Article 82 (ex 86) and the Court dismissed its appeal.

In February 1992 Hilti appealed to the Court of Justice[157] confining its action to the issue of dominance. It proffered seven pleas in support of its appeal. It argued, firstly that the Court below had wrongly concluded that separate markets existed for cartridge strips and nails. It was insufficient to rely on the fact that independent nail producers existed since 1960 producing nails for nail guns. The Court below simply ignored the question of demand substitutability between the various fastening system. The Court of Justice rejected this contention. The Court below had examined demand and supply

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[156] Case T-30/89 *Hilti v Commission* [1991] ECR II-1439, [1992] 4 CMLR 16.
[157] Case C-53/92P *Hilti v Commission* [1994] ECR 667, [1994] 4 CMLR 614.

side substitutability.[158] Secondly, the finding of the Court of First Instance that some users found it practically impossible to use fastening systems other than PAF systems, precluded it from finding that these systems were substitutable with others. The Court rejected this as this amounted to an issue of fact which could not be challenged before the present Court.[159] Hilti's third and fourth pleas related to the issues of technical specifications and the co-existence of other fastening systems. The fact that technical differences existed between various fastening systems and the fact other systems existed did not mean, in Hilti's view, that its system was not substitutable. The Court of Justice rejected this, stressing that the Court below had relied on other factors in arriving at its conclusion.[160] Hilti's remaining pleas relating to the issues of burden of proof, inappropriate appraisal of reports submitted in evidence and failure to consider all evidential matters were simply rejected.[161] The appeal was, therefore, dismissed.

The *Hilti* judgment is significant because it indicates that the market for consumables, like the market for spare parts, forms a distinct market for the purpose of Article 82 (ex 86) upon which a manufacturer can occupy a dominant position and act abusively through the imposition of tying arrangements. In 1995 the case of *Pelikan/Kyocera*[162] came before the Commission. Pelikan, a German undertaking, manufactures a range of products including the toner cartridges for use in photocopiers and computer printers made by the Japanese undertaking Kyocera. The German undertaking complained to the Commission alleging that Kyocera was attempting to drive it out of the market to supply users of Kyocera's equipment through various restrictive practices.

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[158] Ibid 700-702

[159] Ibid 702-703.

[160] Ibid 703-705.

[161] Ibid 705-709.

[162] EC Commission, *26th Report on Competition Policy: 1996* (Brussels, 1997) p87; [1996] *ECLR* R-57.

In December 1995, the Commission concluded that these allegations were unfounded. Kyocera had neither infringed Article 81 (ex 85) nor Article 82 (ex 86). Of particular interest is the Commission's position with regard to the application of Article 82. The Commission found that Kyocera did not occupy a dominant position in any relevant market nor was there evidence of abusive conduct. Kyocera was found to have a small market share in the primary market for laser and inkjet printers. In contrast, the Commission found that Kyocera had a large market in the secondary market for consumables used in its printers but this did not give rise to a position of dominance. The Commission reasoned that Kyocera was subject to intense competition in the primary market and this restrained its behaviour in the secondary market for its consumables. The Commission took the view that consumers were well informed about the price of consumables prior to the purchase and the cost of switching to another brand of printer was considered to be low. This decision, of course, stands in contrast to previous rulings. Here, the Commission accepted the argument that primary and secondary markets are responsive. If similar analysis had been applied in *Hugin* for example, presumably Lipton's complaint would have been rejected on the basis that Hugin, with a 12 per cent share of the primary market, faced intensive interbrand competition.

In October 1997 the Commission announced in *Digital*[163] that it had accepted an undertaking from the Digital Equipment Corporation in relation to the supply and pricing of its post sale services. Digital manufactures computer systems and provides a number of post sale services including hardware (HWS) and software (SWS) support services designed to provide users with operational and technical support, fault

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[163] Commission Press Release IP/97/868 of 10 October 1997. See also P. Andrews, "Aftermarket Power In The Computer Services Market: The Digital Undertaking" (1998) 19 *ECLR* 176. M Dolmans and V. Pickering, "The 1997 Digital Undertaking", (1998) 19 *ECLR* 109.

iagnosis and remedial repairs. In 1995 the Commission received complaints from vo third-party maintenance companies (TPMs). The complaints alleged that Digital ad prevented them from competing in the secondary aftermarkets for the provision of ervices. The Commission opened investigations and conducted "dawn raids" on igital's premises in Germany, the Netherlands and the UK. Digital responded by evising its post sale service agreements and in January 1997 it offered the ommission a draft undertaking in this regard. In May 1997 the Commission issued a tatement of Objections criticising Digital's business practices and its revised service greements. In particular, the Commission alleged that Digital had abused its ominant position in the markets for hardware and software services for Digital's ystems. Digital made it known that it would vigorously contest these allegations.

n the absence of a fully reasoned decision one cannot be totally sure of the ommission's approach. With regard to Article 82 (ex 86) and the issue of market efinition, the Commission undoubtedly regarded the primary market for computer ystems as distinct from the aftermarkets because services were offered separately om the purchase of the system itself. The aftermarkets were defined as the markets or software and hardware support services. The lack of substitutability meant that iese markets were separate from each other. In fact, Digital's software and hardware ervices were not interchangeable with similar services provided by other branded ompetitors. With regard to the issue of dominance the Commission may have onsidered transparency in terms of costs and whether consumers were "locked in" or hether they could switch to other brands in the event Digital raised the cost of its ervice provision.

In contesting these allegations Digital, on the basis of *Pelikan/Kyocera*, may have contended that the primary market was competitive and this would discipline the secondary aftermarkets. Attempts to exploit consumers in these markets would simply lead to a loss in interbrand sales. Additionally, Digital may have pointed to the fact that the secondary aftermarkets were competitive. Software updates were readily available at reasonable prices and consumers could, therefore, utilise other service providers.

The Commission contended that Digital had abused its position of dominance by engaging in exclusionary and predatory pricing and illegal tie-ins. With regard to tying, it alleged that Digital had engaged in both contractual and financial tie-ins designed to prevent competition in the market for hardware support. The contractual tying involved the tying of hardware support to software support services. The financial tying involved the tying of hardware and software support services by charging a package price for combined services (DSS) below the total price of the component pieces. This was designed, in the Commission's view, to prevent Digital users from switching to other suppliers of hardware services. Digital's package pricing made it uneconomical for users to purchase hardware support services from TPMs because the latter could not provide software support services. It was cheaper to buy both services from Digital. The latter denied this, contending that it was able to offer such package pricing as a result of cost savings and other countervailing benefits resulting from the provision of the combined services.

In any event the Commission eventually accepted Digital's undertaking. Article 1 of the undertaking addresses the issue of "Service Offerings for Digital Systems". Article 1.1 deals with the issue of contractual tying by incorporating the principle of *separate availability*. Digital agreed to provide all its standard services as separately available and separately priced products. Article 1.3 deals with the issue of package pricing. Digital agreed that its DSS service provision would not include additional work not provided in its other services if bought on an individual basis. Digital also agreed that its package price would be set at no less than 90 per cent of the sum of the published list prices of the component parts of the package. The published list prices for each Member State were to be made available to the public at a reasonable fee. Finally, quotes for the DSS service provision will also contain separate quotations for the components of the package if bought on a separate basis.

With regard to the issue of market power the Commission in *Digital*, seems to accept that undertakings subject to competitive pressures in the primary market may still occupy and abuse dominant positions in the secondary aftermarkets for the servicing of its own products. This is in marked contrast to the position adopted in *Pelikan/Kyocera*. The Commission's acceptance of the Digital undertaking, although understandable in that it avoided lengthy and costly proceedings, has resulted in a lack of clarity. Perhaps, the overall expense of purchasing a Digital system with service provision and the high costs of switching made the difference.[164]

C. Tetra Pak II, Close Associative Links And Tying

In the 1990s the Community authorities examined the commercial practices and standard form sale and leasing arrangements of Tetra Pak, a Swiss registered undertaking and one of the worlds leading packagers of liquid and semi-liquid foods in cartons operating in both aseptic and non-aseptic sectors. In the aseptic sector, Tetra

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[164] See P. Andrews, note 163 above, 178-179.

Pak utilises the so called "Tetra Brik" system, designed for packaging liquid foods particularly UHT milk in a sterilised fashion. Tetra Brik cartons are delivered to users in the form of rolls which are inserted into a filling machine, manufactured by Tetra Pak, and soaked in a sterilising bath of hydrogen peroxide. The liquid food flows to the carton in an aseptic environment. This process, designed to extend the life of the packaged food and enable it to be kept in a non-refrigerated environment, was first launched on the German market in 1968.

In the non-aseptic sector Tetra Pak manufacturers its "Tetra Rex" cartons designed for the packaging of fresh foods particularly pasteurised milk, intended to be stored in a refrigerated environment and consumed within a short period. This process does not require the same degree of sterility and calls for the use of less sophisticated equipment which Tetra Pak also manufactures.

Tetra Pak's agreements for the sale and leasing of its aseptic and non-aseptic filling machines required the purchaser or lessee to use only Tetra Pak's cartons which it must purchase exclusively from Tetra Pak. In September 1983, Elopak Italia complained to the Commission that Tetra Pak Italiana and its group of companies had engaged in trading practices, including predatory pricing and the imposition of unfair contract terms, amounting to an abuse of its dominant position. The Commission instituted proceedings in December 1988 which were concluded in July 1991. It found that Tetra Pak had engaged in a variety of anticompetitive practices including the imposition of tying arrangements. The Commission imposed an unprecedented fine of 75 million ECU.[165]

[165] Comm. Dec. 92/163 *Tetra Pak II* OJ 1992 L72/1, [1992] 4 CMLR 551.

In November 1991 Tetra Pak appealed to the Court of First Instance seeking annulment of the Commission's decision.[166] It argued *inter alia* that it did not occupy a position of dominance and the conduct complained of did not amount to abuse. Tetra Pak proffered three reasons in support of its lack of dominance. Firstly, it rejected the Commission's product market definitions. The latter had identified four product markets: the markets for aseptic machinery and aseptic cartons and the markets for non-aseptic machinery and non-aseptic cartons. In the view of the applicant the product market should have been defined more widely to include all liquid food packaging systems. Alternatively, it should have been defined on the basis of an integrated system consisting of filling machinery and cartons.[167] In rejecting these submissions the Court considered demand and supply side substitutability concluding that neither the machinery nor the cartons were interchangeable. These distinct markets were also "insulated" from the general market in systems for packaging liquid food. The Court also held that commercial usage did not support the applicant's view that machinery for the filling of cartons was indivisible from the carton itself. There existed independent manufacturers specialising in the production of non-aseptic cartons. In fact, the Court also rejected Tetra Pak's arguments that public health issues required that the filling machinery and its consumable product be treated as an integrated system. The protection of public health could be dealt with by the provision of technical specification or by means of legislation.[168]

Secondly, Tetra Pak contended that the relevant geographic market comprised the separate markets of the various Member States. The Court rejected this and upheld the Commission's geographic market definition. The entire Community comprised the

[166] Case T-83/91 *Tetra Pak v Commission* [1994] ECR II-755, [1997] 4 CMLR 726.
[167] Ibid 788-792.
[168] Ibid 792-801

relevant market. Demand was stable and not insignificant throughout the Community, customers could obtain supplies in Members States other than their own and transportation costs were low.[169]

Thirdly, Tetra Pak argued that even if it was in a dominant position in the aseptic markets, Article 82 (ex 86) did not apply to practices carried out in the non-aseptic market. The Commission found that in the aseptic markets Tetra Pak held a quasi-monopolistic position. It had a market share of 90 to 96 per cent, PKL was its only real competitor and industrial property rights and technological barriers to market entry existed. It was, therefore, in a dominant position. In contrast, the Commission found the non-aseptic markets more open but still oligopolistic. Tetra Pak had a market share of 52 per cent in the market for non-aseptic machines and a 48 per cent share in the market for non-aseptic cartons. Elopak and PKL were its two main competitors. Oddly, the Commission did not find that Tetra Pak occupied a position of dominance. Tetra Pak contended that an undertaking, not in a dominant position in a given market, cannot commit an abuse on that market. Furthermore, the Commission had failed to demonstrate any causal link between the abuses allegedly committed on the non-aseptic sector and Tetra Pak's dominant position in the aseptic markets.[170] The Court rejected these arguments. It stated that a dominant undertaking has a "special responsibility" not to allow its conduct to impair genuine undistorted competition. However, the scope of this responsibility depends upon the specific circumstances of each case. The Court observed that Article 82 (ex 86) applies where an undertaking dominant in a particular market reserves to itself, without objective necessity, an ancillary or dependant activity on a neighbouring but separate market where it is not in a dominant position, with the possibility of eliminating

[169] Ibid 803-808.
[170] Ibid 808-811.

competition.[171] Associative links existed between the aseptic and non-aseptic sectors. The filling machines and cartons in both sectors were used for packaging liquid food products. About 35 per cent of Tetra Pak's customers had purchased both aseptic and non-aseptic systems. Both Tetra Pak and PKL operated in both sectors. For producers of fresh and long life products Tetra Pak was an almost inevitable supplier of aseptic systems and a favoured supplier of the non-aseptic systems. It was unnecessary, therefore, to establish the existence of a dominant position on the non-aseptic markets because the existence of a dominant position in the aseptic sector, together with its prominent position as the non-aseptic sector combined with these close associative links imposed a "special responsibility" on Tetra Pak to maintain genuine competition.[172]

It will be recalled that Tetra Pak also argued that its conduct did not amount to an abuse. With regard to the issue of tying Tetra Pak contended that no connected sales took place. Commercial usage indicated that its systems were complete and indivisible. The Court rejected this. Tying could not be accepted in a market were competition was already restricted. It constituted an abuse because it deprived the customer of its ability to choose its source of supply and denied other producers access to the market.[173] As for Tetra Pak's justifications for the use of tying the Court emphasised that it had already rejected them in relation to its consideration of the product market. Technical justifications and those relating to product liability, protection of public health and business reputation must be assessed in the light of *Hilti*. Here the Court concluded that it was not the task of a dominant undertaking to

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[171] Ibid 813.
[172] Ibid 816-817.
[173] Ibid 770-1.

take steps to eliminate products which it regards as dangerous or at least inferior, in quality to its own. Tetra Pak's tie-in clauses were clearly abusive.

In November 1994 Tetra Pak appealed to the Court of Justice.[174] It based its appeal on five grounds. It argued, firstly, that the product market definition made by the Commission and accepted by the Court of First Instance was erroneous. The Court of Justice simply rejected this.[175] Secondly, Tetra Pak asserted that the notion of close associative links could not be used to render Article 82 (ex 86) applicable. In rejecting this the Court stressed that the relevance of these links could not be denied. Tetra Pak's position on the aseptic markets enabled it to act independently of other operators on the non-aseptic markets.[176] Thirdly, Tetra Pak stressed, once again, that natural links existed between the two products and the tied sale was in accordance with commercial usage. The Court rejected this. Other independent manufacturers specialised in the production of non-aseptic cartons. This factor alone ruled out the existence of the natural link claimed by Tetra Pak.[177] The applicant's fourth and fifth pleas related to issues of predatory pricing and mitigating factors in relation to the fine imposed. These were also rejected and the Court dismissed the appeal.

Undoubtedly, the Court's judgment in *Tetra Pak II* amounts to an extension of the jurisdictional reach of Article 82 (ex 86). It suggests that tying practised by a dominant undertaking, on a market on which it is not dominant, may still be captured by Article 82 (ex 86). Advocate General Ruiz-Jarobo Colomer suggests that the acceptance of the notion of close associative links amounts to the "furthest extent" to which it is possible to relax the rule that the dominant market and market affected by

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[174] Case C-333/94P *Tetra Pak v Commission* [1996] ECR I-5951, [1997] 4 CMLR 662.
[175] Ibid 6002-6006.
[176] Ibid 6009.
[177] Ibid 6010-6011.

the abuse must be the same.[178] The future scope of *Tetra Pak II* may, however, be confined by its own peculiar facts. The close association between neighbouring markets may occur only rarely and were markets are unrelated will not apply.[179]

IV. CONCLUSION

Tying is condemned on both sides of the Atlantic. Condemnation, however, is only appropriate in certain circumstances. It is important to establish, firstly, that two products are involved. In the US the Supreme Court has concluded that this will be the case provided separate markets can be shown to exist for each item. The approach in the EU is not dissimilar. The Community Courts look to the number of manufacturers involved, the nature of the technological processes employed and the type of expenditure incurred - capital or revenue. These issues can be crucial as evidenced in the *Microsoft* litigation.

In the US tie-ins are treated as illegal *per se* if the seller has sufficient economic power over the tying product market to restrain interstate commerce in the tied product market. The degree of restraint in the latter market is merely a *de minimis* requirement. The notion of sufficient economic power, however, has fluctuated over the years. The Warren Courts were quite prepared to infer the existence of market power. Thereby, sweeping within the ambit of the *per se* rules most tying arrangements. In contrast, the Burger Courts required an evidentiary showing of sufficient economic power linking the concept to market power and anticompetitive forcing. Thus, heightening the tie-in thresholds and reflecting an increased judicial

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178 Ibid 5977.

179 See N. Levy, "Tetra Pak II: Stretching The Limits Of Article 86?", (1995) 16 *ECLR* 104; V.Korah, "Tetra Pak II - Lack Of Reasoning In Court's Judgment", (1997) 18 *ECLR* 98 - criticising the Court for failing to consider Tetra Pak's reasons for imposing the tie-in.

acceptance of the possible efficiency enhancing aspects of tying. Market share was taken as a proxy for market power. In the 1990s, however, the Supreme Court, in examining tying arrangements in the secondary aftermarkets, concluded that market imperfections could give rise to market power.

In the EU tying seems to have engendered less concern. Undoubtedly, case law is rather sparse. However, concern does arise where the tie-ins are imposed by dominant undertakings. Market shares of 50 per cent give rise to the presumption of dominance. In *Tetra Pak II*[180] the Court held that a dominant undertaking operating on a market in which it is not dominant may still fall foul of Article 82 (ex 86) provided close associative links exist between the dominated and non-dominated markets and the undertaking occupies a prominent position on the latter. With regard to the issue of aftermarket power *Pelikan/Kyocera*[181] stands in contrast with the position adopted by the Supreme Court in *Kodak.*[182] The Commission found that competition in the primary equipment market disciplines the secondary aftermarkets preventing the exploitation of consumers. This approach ignores market power gained through market imperfections. In *Digital*[183] the Commission seems to have reversed its position falling in line with the position adopted in the US. That is, undertakings can enjoy dominance in the servicing of its own equipment and the imposition of tying arrangements can amount to an abuse. In accepting *Digital's* undertaking, however, the Commission lost the opportunity to provide a reasoned decision and clarify its position on the issue of aftermarket power.

[180] Case C-333/94P *Tetra Pak v Commission* [1996] ECR I-5951, [1997] 4 CMLR 662.
[181] EC Commission, *26th Report On Competition Policy: 1996* (Brussels, 1997) p.87, (1996) 17 *ECLR* R-57.
[182] *Eastman Kodak Co v Image Technical Services*, 504 U.S. 451 (1992).
[183] Commission Press Release IP/97/868 of 10 October, 1997.

THE REFORMATION OF THE EU DISTRIBUTION RULES

I. INTRODUCTION

One of the principal concerns of EU competition policy over the latter half of the 1990s has been the appropriate treatment of vertical restraints. The block exemptions enacted in the 1980s have recently expired, the increased use of information technology including JIT delivery, the reduced role of traditional wholesalers in the chain of distribution and shifts in power configurations away from manufacturers to large purchasers with huge buying potential precipitated changes in the nature of distribution. In fact, with the single market legislation largely in place the Commission has come under increasing pressure to focus on issues of economic efficiency. In 1997, therefore, it published its Green Paper on Vertical Restraints which outlined some of the main problems relating to distribution and set out reform proposals.[1] With the recent adoption of Regulation 2790/1999[2] the reform process is

[1] EC Commission, *Green Paper on Vertical Restraints in EC Competition Policy*, COM (96) 721 final.
[2] OJ 1999 L336/21, [2000] 4 CMLR 398.

drawing to a close. The following, very briefly, charts the period of reformation and considers some of the ramifications of the new regime.[3]

II. THE NEW SYSTEM

In its Green Paper review the Commission defined vertical relations as "(a)greements between producers and distributors".[4] On the basis of this narrow definition the Commission proposed a number of reforms in relation to the treatment of exclusive distribution, exclusive purchasing, franchising and selective distribution. The first proposal (Option I) simply involved maintaining the *status quo* by extending the validity of the current block exemptions and preserving the legal principles currently governing selective distribution.[5] After all, the current system has promoted market unification, protected competition, promoted consumer interests and allowed the development of new and innovative forms of distribution. Indeed, in the view of the Commission, the system also provided speedy and efficient enforcement together with legal certainty, consistency and the benefits of one-stop shopping.

The second proposal (Option II) promoted the retention of the current block exemptions but with amendments to increase their flexibility and scope.[6] Amendment

[3] A considerable amount has been written on the process of reformation. See, for example, H.H.P. Lugard, "Vertical Restraints Under EC Competition Law: A Horizontal Approach?", (1996) 17 *ECLR* 166; F.M. Carlin, "Vertical Restraints: Time for Change", (1996) 17 *ECLR* 283; F. Murray and J. Maclennan, "The Future for Selective Distribution Systems: The CFI Judgments on Luxury Perfume and the Commission's Green Paper on Vertical Restraints", (1997) 18 *ECLR* 230; D. Schroeder, "The Green Paper on Vertical Restraints: Beware of Market Share Thresholds", (1997) 18 *ECLR* 430; P. Kellaway, "Vertical Restraints: Which Option?", (1997) 18 *ECLR* 387; Z. Biro and A. Fletcher, "The EC Green Paper on Vertical Restraints: An Economic Comment", (1998) 19 *ECLR* 129; A.J. Riley, "Vertical Restraints: A Revolution", (1998) 19 *ECLR* 483; J. Nazerali and D.C. Cowan, "Reforming EU Distribution Rules – Has the Commission Found Vertical Reality?", (1999) 20 *ECLR* 159; M. Griffiths, "A Glorification of De Minimis – The Regulation on Vertical Agreements", (2000) 21 *ECLR* 241.

[4] EC Commission, *Green Paper on Vertical Restraints in EC Competition Policy*, COM (96) 721 final, Exec. Summary para 2.

[5] Ibid para 281.

[6] Ibid para 282.

proposals included *inter alia* coverage of multi-party agreements and those relating to the provision of services and to permit distributors to add value by transforming or processing the contract goods. This option also contained proposals for either the introduction of a selective distribution block exemption or a Commission's Notice.

Under Option III the Commission proposed the introduction of more focused block exemptions so as to apply only where the party's market shares are less than 40 per cent.[7] The final proposal (Option IV) related to the introduction of a negative clearance presumption for parties with no significant market power. That is, with market shares of less than 20 per cent.[8] For those agreements where the presumption is rebutted or where market shares exceed 20 per cent Option II or III could be applied. During the consultation process other options emerged including a presumption that all vertical restraints should be treated as compatible with Article 81 (ex 85), suggestions that national authorities should be empowered to grant exemptions under Article 81(3) (ex 85(3)) and the enactment of a single block exemption to cover all distribution arrangements.[9]

In 1998 the Commission published its follow-up to its 1997 Green Paper.[10] In this Communication the Commission set out the results of the consultative process and announced its policy proposals. The current block exemptions are to be replaced with a single, broad umbrella block exemption incorporating a market share threshold. Other "flanking measures", designed to reduce legal insecurity were to be introduced

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[7] Ibid para 286.
[8] Ibid, para 293.
[9] K.P. Rohardt, "The Green Paper On Vertical Restraints In EC Competition Policy - Is The Discussion Open?", (1997) 8 *EFLR* 179.
[10] EC Commission, *Communication From the Commission on the Application of the Community Competition Rules to Vertical Restraints (Follow-Up to the Green Paper on Vertical Restraints)* COM (98) 544, OJ 1998 C 365/3, [1999] 4 CMLR 281.

including amending Article 4(2) of Regulation 17/62 to permit the granting of exemptions on a retroactive basis, the issuance of guidelines detailing the Commission's policy with regard to granting exemptions above the market share threshold and withdrawal below and an increased role for national authorities in the administration of the competition rules. In September 1999 the Commission published its draft block exemption[11] and draft guidelines.[12] Regulation 2790/1999 entered into force in June 2000, after guidelines were formally adopted. This Regulation encompasses all forms of distribution covered by previous rules including that of selective distribution. Its scope includes not only goods for resale but also the provision of services and intermediate goods. The goods or services may be resold by the buyer or consumed as input goods in the production of other goods or the provision of services. Multi-party agreements now fall within the ambit of the new Regulation.[13]

Article 2(1) of Regulation 2790/1999 exempts agreements to the extent they contain restrictions capable of falling within Article 81(1) (ex 85(1)). The exemption applies to vertical agreements concluded between undertakings operating at different levels of the production or distribution chain. In common with the current rules, however, the new Regulation does not cover agreements between competitors except where the agreement is non-reciprocal and the buyer has an annual turnover not exceeding ECU 100 million (Article 4(a). Because of the dangers of market foreclosure the new Regulation does not apply to any direct or indirect non-compete obligations which

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[11] EC Commission, *Regulation on the Application of Article 81(3) of the EC Treaty To Categories of Vertical Agreements and Concerted Practices*, OJ 1999 C270/7, [1999] 5 CMLR 1167.
[12] EC Commission, *Guidelines on Vertical Restraints*, OJ 1999 C270/12, [1999] 5 CMLR 1176.
[13] Ibid para 24.

exceed five years or are concluded for an indefinite period (Article 5(1)). An exception exists, however, where the contract goods or services are sold from premises or land owned or leased by the supplier and provided to the buyer. In this case the non-compete obligation may be exempted provided it lasts no longer than the period of the tenancy. Similarly, post term non-compete obligations are not subject to exemption under the new block exemption unless the obligation is necessary to protect know-how transferred by the supplier to the buyer and the post term obligation is limited to a period of one year (Article 5(b)).

Regulation 2790/1999 also contains a list of hardcore or blacklisted clauses which if contained in an agreement renders the block exemption inapplicable and individual exemption unlikely. The first of these restrictions relates to the buyers ability to determine its own sale prices. Although maximum or recommended prices may be stipulated they will only be countenanced if they are not directly or indirectly enforced as minimum or fixed prices (Article 4(a)). Secondly, any restriction of the territory into which or the customers to whom the buyer may sell is not eligible for exemption. By way of derogation it is possible to restrict active sales into a dealers exclusive territory, to prevent members of a selective distribution network from selling to unauthorised dealers, and in certain circumstances, to restrict active sales to customer groups reserved to the supplier or to another buyer (Article 4(b)). Finally, agreements between OEMs and manufacturers of spare parts for use in the original equipment, designed to prevent the latter from selling the spare parts to independent repairers or service providers renders the block exemption inapplicable (Article 4(e)).

Provided agreements do not contain the aforementioned hardcore restrictions the block exemption creates a presumption of legality for agreements concluded between undertakings with market shares less than 30 per cent. Where this requirement is not satisfied agreements are not presumed illegal but need to be vetted on an individual basis.[14] In which case the Commission has the burden of proving the agreement violates Article 81(1) (ex 85(1)). In this analysis the Commission now intends to consider *inter alia* the market positions of supplier and competitor, entry barriers, buying power, maturity of the market, level of trade and the nature of goods or service. If the agreement falls within Article 81(1) the Commission will then consider the possibility of exemption.[15] In order to calculate market share the relevant market must be ascertained. The Commission's Notice on market definition sets out criteria and evidence to be relied upon in this assessment.[16] The data to be used for calculating market share must be based on figures from the undertakings preceeding financial years and must be calculated on the basis of sales value or sales volume. In order to cater for fluctuation in market share Article 9 provides that vertical agreements remain covered by the block exemption for a period of two years provided the market share threshold is not exceeded by 5 per cent. In the event this cap is exceeded by 5 per cent a grace period of one year applies.

Underpinning the Commission's decision to adopt a more economic based approach, is its acceptance that vertical agreements may prove to be procompetitive or anticompetitive depending upon the market structure in which they operate. Where markets are concentrated and interbrand competition is weak the more likely it is that vertical restraints have negative effects. Economists usually define market power as the ability to raise prices above competitive levels and obtain supra-national profits.

[14] Ibid para 22 and 52.
[15] Ibid para 114 and 127.
[16] EC Commission, *Notice on the Definition Of Relevant Market For The Purposes Of Community Competition Law* OJ 1997 C372/5, [1998] 4 CMLR 177.

In antitrust analysis, however, market share is usually taken as a proxy for market power. By introducing a market share cap of 30 per cent the Commission is simply linking the new block exemption to the concept of market power.

Article 6 and 7 permit the Commission and the competent authorities in each Member State to withdraw the benefit of the block exemption. Article 6 permits withdrawal by the Commission in respect of agreements which restrict competition on a relevant market which is wider than the territory of a single Member State. Where, however, the relevant market falls within the territory of a single Member State both the Commission and competent national authority have withdrawal competence (Article 7). The Commission is also empowered by virtue of Article 8 to disapply, by way of regulation, the block exemption where parallel networks of similar vertical restraints cover 50 per cent of the relevant market. The disapplication is not addressed to individual undertakings but concerns all undertakings whose agreements come within its scope of application.

III. The New System - Advantages and Disadvantages

A number of criticisms have already been voiced with regard to the new regime. Concerns have been raised that the 5 year limit attached to non-compete obligations may hinder the conclusion of long term industrial contracts; the list of hardcore restrictions are too long and too prohibitive, in particular Article 4(e) may result in vertical integration or the acquisition of sub-contractors by manufacturers and the power of withdrawal granted to national competition authorities may lead to political controversies between Member States.

Perhaps more significantly industry has consistently opposed the introduction of market share tests.[17] Fears exist that the introduction of the 30 per cent market cap may increase the complexity of the system, as assistance from economists and legal advisers may be required to advise on whether agreements fall within the market share threshold or require individual notification. Indeed, highly innovative undertakings with high market shares may feel themselves disadvantaged. Furthermore, the calculation of market shares is not an exact science nor indeed is it necessarily a reflection of market power. Fashions change and market shares can fluctuate rapidly in response, resulting in threshold cross-over. Crucial to the use of such thresholds is the ability to define the product and geographic markets. Past experience in the application of Article 82 (ex 86) has indicated how complex this process can be. Indeed, once these definitional issues have been dealt with, problems of calculation may still exist if the total volume of the market cannot be ascertained. While associations of industry or market research may be of help, reliable figures may simply not be available. Agreements of this nature will still need to be notified. Indeed, precautionary notifications may still be made amongst parties who market shares are close to threshold levels.

In defence of the Commission, however, it must be acknowledged that it has taken steps to cater for some of these problems. Article 9 of the new block exemption is designed to cater for fluctuations in market shares and the Commission's Notice on market definition together with the block exemption guidelines are designed to assist in this area. The modification of Article 4(2) of Regulation 17/62[18], which permits

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[17] UNICE, *Modernising EU Competition Policy* (1995).

[18] Council Regulation (EC) 1215/1999 adopted on 10 June 1999, Amending Regulation No 19/65 EEC On the Application of Article 81(3) of the Treaty To Certain Categories Of Agreements And Concerted Practices, OJ 1999 L148/1.

exemption on a retroactive basis, is designed to assist undertakings which incorrectly assess their market share and erroneously believe their arrangements to be covered by the block exemption. Finally, the complexity of market share issues coupled with the speed of commercial change may force undertakings to regularly audit their arrangements to ensure compliance with attendant costs of compliance.

Whilst undoubtedly a departure from previous policy the Commission considers that the new regime will allay criticisms of current policy, namely that it is form based, too legalistic with strait-jacket effects and with the real possibility of exempting agreements which distort competition. The new "black clause" approach defines, therefore, what is not exempt as opposed to defining what is exempted. The object of the new system is to treat different forms of vertical restraints which have similar effects in a similar way. Thus enabling undertakings to choose distributive methods on the basis of commercial merit and not according to exemptability. Commercial freedom is enhanced as undertakings may more readily tailor-make their agreements to satisfy their specific needs. As Regulation 2790/1999 has been extended in scope to cover services, intermediate products and multi-party agreements, a greater number of agreements will fall within its ambit. The Commission believes this will eliminate between 80 - 90 per cent of all notifications which in practice will be one of the most visible changes from the current system. Finally, the new changes seem to envisage greater participation by national competition authorities which will enable the Commission to focus on more pressing problems.

IV. CONCLUSION

Undoubtedly, the decision to introduce a single broad umbrella block exemption with a market share cap has proved controversial. In so doing, however, the Commission is adopting a more economic based approach designed to protect competition which protects consumer welfare and enhances efficiency. Vertical restraints, therefore, are to be examined in their market context. Despite this economic based approach market integration still remains a dynamic and enduring policy consideration. The importance of which becomes readily apparent when one considers the possibility of further Community enlargement. Not unsurprisingly, therefore, the Commission's willingness to move to this new approach remains subject to the insistence of the role of market integration as evidenced by the inclusion of hardcore restrictions in Article 4 of Regulation 2790/1999.

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CONCLUSION

In recent years the antitrust treatment of vertical restraints has generated interest, debate and controversy. Although economic issues surrounding these restraints are generally the same, policy direction in the US and EU has differed. This has had ramifications for the development of the law in both systems.

Antitrust enforcement, in the decentralized complaints based system of the US, is judicially focused. Antitrust actions are undertaken by the private litigant or public enforcement agencies. The lure of treble damages and the payment of legal fees on a contingency basis makes the private litigant proactive. Judgments of the District Court may be appealed to Circuit Courts of Appeals and, ultimately, to the Supreme Court.

The European Commission lies at the heart of the antitrust regime in Europe. While private antitrust action may be taken in the Courts of the Member States, complaint to the Commission is less costly and has traditionally been the preferred route. The goal of market unification, which requires consistency and uniformity of Treaty interpretation, has resulted in the centralization of power in the hands of the Commission. This position has been reinforced by the notification process and the Commission's sole right to grant exemptions under Article 81(3) (ex 85(3)). In fact, not only does the Commission adjudicate upon restrictions of competition or market abuse, it also performs an investigative and legislative ıction. In all of this, however, it is important to stress that the Community Courts have yed vitally important roles.

th regard to the US there may be, at any one time, a variety of competing ideological ɔroaches or schools of antitrust. Indeed, the birth and demise of these schools seems to ɔur with cyclical regularity. Two of the most influential schools have been the previously ainstream Traditionalists and the currently mainstream Chicago School. Currently, US ɪtrust policy embraces the notion of consumer welfare, defined in terms of economic iciency, as the sole goal of antitrust policy. Concerns not related to the generic benefits competition do not impact upon antitrust analysis. Markets are considered to have ıerent self-correcting properties in which the hidden hand of competition punishes the ɛfficient. This minimalist or abstentionist approach is founded on the notion that market ervention is misguided or less effective than market dynamics. Adherents to this view ısider that all vertical restraints should be legal *per se*. In contrast Traditionalists have vays advocated a more interventionist approach in order to secure *inter alia* market ɔoncentration, diffusion of economic power and the preservation of small business. cording to this view, intervention is justified in the area of vertical restraints because they ı be utilised for anticompetitive purposes.

J competition policy, rather than simply focusing on efficiency maximizing antitrust, ıbraces a variety of concerns. Similarities exist, in this regard, with the multi-dimensional ɔroach of the Traditionalists. This, of course, is not to deny the importance of efficiency. ter all, European business needs to be able to compete on a global stage. Some of the ıcerns embraced by EU policy has been the need to ensure equity and fairness in the market place, particularly with regard to State subsidies and the need to protect the interests of workers, users and consumers. Competition policy has also been used as a mechanism to assist in economic recovery and to combat structural unemployment by redirecting resources towards growing sectors and away from those with less promising futures. It has also been used to display a positive bias towards small business. The latter provide a valuable source of employment, are important to the economic performance of the various Member States and cross border cooperation between these undertakings is seen as assisting the process of integration. Above all, competition policy in Europe has assisted, in conjunction with other measures, in the process of market unification. This unique role has impacted upon institutional and substantive norms and provides the major distinction between US and EU policy.

The birth of the current legal approach to vertical restraints in the US is to be found in the seminal case of *Continental TV Inc v GTE Sylvania Inc.*[1] This case shifted the perception of the Sherman Act away from a multi-dimensional political statute to one based in economics. Three main points emerged. Firstly, interbrand competition became the primary concern of US antitrust. It acts to check the exploitation of intrabrand competition. Secondly, antitrust scrutiny is only necessary if market power is substantial. Finally, economic analysis is vital to the assessment of antitrust infringement.

Sylvania's legacy, however, has been two-fold. Firstly, it resulted in the bifurcation of the world of vertical restraints into price and non-price categories. The former are condemned

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

as *per se* violations of the Sherman Act. Although, of course, maximum price-fixing is now analysed under the rule of reason. Similarly, non-price vertical restraints are also analysed under the rule of reason. These include territorial allocation, exclusive dealing, customer restrictions, location clauses, areas of primary responsibility and profit passover clauses. The axis between price and non-price restraints has impacted upon analysis. Definitional issues have assumed importance in attempts to evade the standard of *per se* illegality. The American judiciary has been prepared to characterise restraints as non-price even though they impact upon price. Indeed, in *Monsanto Co v Spray-Rite Service Corporation*[2] the Supreme Court concluded that price fixing could not be inferred from price complaints from other distributors and the subsequent termination of the dealer. A conscious commitment to a common scheme designed to achieve an unlawful objective had to exist. In fact, in *Business Electronics Corp v Sharp Electronics Corporation*[3] the Supreme Court held that an agreement to terminate a dealer had to be scrutinised under the rule of reason, absent the imposition of price restraints.

The second legacy of *Sylvania* surrounds its failure to provide operational guidelines for the application of the rule of reason standard. *Sylvania* provided a standard without bounds. Subsequently, the judiciary has attempted to put flesh on the bones of this standard to provide business with legal certainty. The use of market power filters have been used widely. Underpinning this approach is the notion that suppliers lacking market power cannot raise prices above competitive levels without losing business to competitors. Market power analysis is also used in connection with tie-ins. In the US market power is generally

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[2] 465 U.S. 752 (1984).
[3] 485 U.S. 717 (1988).

defined in terms of market share. In addition to market share, however, the Courts have also taken into account barriers to market entry, the ability to increase rivals costs and charge supra-competitive prices, product differentiation and buyer power. A key related enquiry is the degree of market foreclosure caused by the restraint. Only where market power concerns cannot be eliminated is it necessary to weigh the procompetitive and anticompetitive aspects of the restraint. The increased use of economic analysis in the US has had three main effects. Firstly, the category of restraints subject to *per se* condemnation has been reduced. Secondly, there has been a reduction in the number of restraints being condemned under the rule of reason. Finally, the axis between price and non-price verticals has been subject to continual attack as lacking inherent economic justification.

In Europe while the European Commission may consider issues of market power under Article 82 (ex 86), it rarely does so under Article 81(1) (ex 85(1)). This is the case, firstly, because the Commission has traditionally defined a restriction of competition as a restriction on the economic freedom of market participants. Exclusive agreements, therefore, invariably fall within the parameters of Article 81(1) (ex 85(1)). Any economic analysis is reserved for examination under Article 81(3) (ex 85(3)). Exemption is granted only if the arrangements satisfies all the requisite conditions. Secondly, the goal of market unification occasionally entails the rejection of a particular outcome mandated by economic analysis. The goal of market integration has traditionally taken precedence over economic analysis.

The Community Courts, however, have taken a more nuanced approach to Article 81(1) (ex 85(1)) requiring a more economic based approach. The judgment of *Delimitis v Henninger*

Brau[4] illustrates this point most graphically. Here the Court of Justice concluded that exclusive purchasing does not necessarily fall within Article 81(1) (ex 85(1)) unless market foreclosure results and the agreement, in question, makes a substantial contribution to that foreclosure.

Unlike the US more importance is attached to intrabrand competition. Internal competition within the same product, particularly cross border trade, is seen as a vehicle for promoting market integration. This was first confirmed in the seminal case of *Consten and Grundig v Commission.*[5] Attempts to undermine the goal of unification, either directly or indirectly, have been treated with short shrift. RPM, for example, may result in price discrimination across Member States and reinforce market compartmentalization. Territorial allocation must be relative and not absolute. Parallel traders must remain unfettered to engage in parallel trade. Dealers must remain free to respond to passive sales opportunities. These concerns are reflected in the current block exemptions governing exclusive distribution and franchising. Exclusive purchasing and tying arrangements, if concluded on a national basis, can result in compartmentalization through market foreclosure. The exclusive purchasing block exemption attempts to curtail the impact of these concerns. In selective distribution networks quantitative restrictions are rarely permitted. Schemes which indirectly undermine market unification have also been condemned. These include *inter alia* dual pricing schemes, the use of guarantees schemes to prohibit parallel trade, the granting of rebates and bonuses to dealers to ensure they sell within home markets.

[4] Case C-234/89 [1991] ECR I – 935, [1992] 5 CMLR 210.
[5] Cases 56 and 58/64 [1996] ECR 299, [1966] CMLR 418.

The Commission's lack of economic analysis has given rise to much criticism. Calls have been made, therefore, for it to adopt a more economic based approach similar to that of the US. Over the latter half of the 1990s the Commission has been engaged in a process of review. This process is now reaching its conclusion and the Commission has stated that the "primary objective" of policy is now the protection of competition. This will enhance consumer welfare and create efficient resource allocation.[6] The Commission has also adopted the notion that vertical restraints only pose a problem for competition where interbrand competition is weak and market power exists at the level of supplier or buyer or both. The use of a 30 per cent threshold in the new block exemption (Regulation 2790/1999) is designed to link it to the issue of market power. Undertakings whose market share exceed 30 per cent must notify their agreements in the quest for legal certainty. There is, however, no presumption of illegality. The Commission simply intends to conduct a "full competition analysis" in order to determine whether Article 81(1) (ex 85(1)) applies. In this regard it intends to consider those factors which enhance or reduce market power. Factors include the market position of the supplier, entry barriers, buying power, maturity of the market and level of trade.[7]

This more economic based approach has not resulted in the abandonment of the market integrative focus. The list of hardcore restrictions, which if included in an agreement render the block exemption inapplicable, relate to the issue of market integration. The latter still remains of importance. Firstly, European business in the search for private profit may still attempt to fragment the market through the recreation of private barriers to cross border

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[6] EC Commission, *Draft Guidelines on Vertical Restraints* OJ 1999 C-270/12, [1999] 5 CMLR 1176.
[7] Ibid para 114.

trade. Secondly, the market integrative focus is reinvigorated by the prospect of an enlarged Community. Integrating the formerly centrally planned economies of the East may still present problems similar to those which faced the EEC in its formative years. Ultimately, it is this policy focus which renders symmetry of approach with the US unfeasible.

ANNEX I

Commission Regulation 1983/83 On Exclusive Distribution Agreements OJ 1983 L173/1

Applicability

Article 1 of the Regulation provides that Article 81(1) (ex 85(1)) does not apply to agreements to which two undertakings are party and whereby one party agrees to supply goods to the other for resale within the whole or a defined area of the Common Market.

- This Regulation does not exclude the operation of Article 82 (ex 86) and applies to concerted practices.
- The agreement must be bilateral although the Community law definition of undertaking applies.
- The Regulation relates only to the resale of goods as the provision of services are excluded.
- Territorial allocation can amount to the whole of the Common Market or a defined area.
- Agreements between competitors are excluded unless it is non-reciprocal and the parties turnover does not exceed ECU 100 million.

Territorial Exclusivity

The benefit of the block exemption is lost if the agreement confers absolute territorial protection (Articles 3(c) and (d)). Parallel importation must remain possible or consumers must be able to obtain the contract goods outside the contract territory. To ensure that relative or qualified territorial allocation is conferred, only those restrictions in Article 1 and Article 2(1) can be imposed on the supplier. The exclusive distributor must remain free to respond to passive sales in accordance with Article 2(2)(c).

Exclusive Purchasing Obligations

An exclusive distributor can agree to acquire the contract goods only from its exclusive supplier. This obligation must not extend beyond the contract duration (Article 2(2)(b)).

Non-Compete Obligations

The Regulation permits the exclusive distributor to agree not to manufacture or distribute competing goods, including spare parts and accessories. The obligation must not extend beyond the duration of the contract. (2(2)(a)).

Sales Obligations

The distributor must remain free to determine its own prices, although supplier price recommendation is possible (Recital 8). Article 2(3)(a) - (c) enables the imposition of obligations designed to increase sales including promotional advertising, the provision of customer services, sales in accordance with supplier specifications, network maintenance and the employment of suitably qualified staff.

Customer Restrictions

Agreements which limit the exclusive distributor's choice of customer can not be exempted.

ANNEX II

Commission Regulation 1984/83 On Exclusive Purchasing Agreements OJ 1983 L173/5

Applicability

Regulation 1983/84 applies to bilateral agreements and goods for resale defined in exactly the same manner as Regulation 1983/83. This particular Regulation is divided into 4 titles dealing with exclusive purchasing generally (Title I) and the specific peculiarities of the brewing and petroleum industries (Title II and III). The fourth title deals with miscellaneous provisions (Title IV). In its preamble to the Regulation the Commission recognises that exclusive purchasing can assist in forward planning, encourage optimal investment to strengthen dealer networks, stimulate interbrand competition, encourage market penetration and benefit consumers generally.

The Regulation also recognises, however, that market foreclosure is the main antitrust concern. The Regulation attempts to prevent this in three ways. Firstly, Article 3 (c) prohibits tie-ins unless the goods are connected by virtue of their nature or commercial usage. Secondly, the Regulation limits contract duration. Contracts concluded for an indefinite period or for more than 5 years are not covered by the block exemption. There are, however, special rules for beer and petrol agreements. Thirdly, the Commission can withdraw the benefit of the exemption.

Territorial Exclusivity

Exclusive purchasing agreements only benefit from the block exemption provided the agreement does not place any territorial restraints upon dealers. The supplier can, however, agree not to distribute the contract goods in the reseller's principal sales area (Article 2(1)).

Exclusive Purchasing Obligations

The dealer may be obliged to purchase all of its contract goods from the exclusive supplier. Although, the agreement may permit the dealer to obtain the goods elsewhere if the supplier cannot comply with its supply obligations. (Guideline 35). It is also permissible for the agreement to include an "English Clause" enabling the dealer to purchase the goods elsewhere if more favourable terms exist. The contract goods must also be specified by brand or denomination to prevent unilateral variation of contract terms and ensure precision with regard to bans on dealing in competing goods.

Non-Compete Obligations

The dealer may be obliged not to manufacture or distribute goods which compete with the contract goods. This obligation cannot extend beyond the duration of the contract (Article 2(2)).

Sales Obligations

While a supplier may recommend prices, dealers must remain free to determine their own prices. Dealers, however, may be obliged to advertise the contract goods, maintain certain levels of stock, provide customer guarantees and employ suitable qualified staff (Article 2(3)).

ANNEX III

Commission Regulation 4087/88 On Franchise Agreements OJ 1988 L369/46

Applicability

This Regulation applies only to bilateral retail and service franchise agreements. Industrial and wholesale franchise agreements are excluded. The Commission recognises that franchising performs valuable economic functions (Recital 7). Franchisor's, for example, are enabled to set up uniform distribution networks with limited financial investment and risk. This stimulates interbrand competition which is of benefit to the consumer. Certain restrictions of competition listed in Article 2 are, therefore, exempted by the Regulation. The Regulation also contains "white listed" clauses which if contained in the agreement do not violate Article 81(1) (ex 85(1)). Provided their imposition is necessary to protect the franchisor's industrial or intellectual property rights or to maintain the common identity or reputation of the network (Article 3(1)). Unconditional "white listed" clauses do not prevent the application of the block exemption (Article 3(2)). Agreements which contain "black listed" clauses render the block exemption inapplicable (Article 5). An opposition procedure exists to cater for those agreements which may contain clauses which do not automatically fall within the block exemption.

Territorial Exclusivity

The franchise block exemption permits territorial allocation. The franchisor may be obliged, therefore, not to grant to third parties the right to exploit all or part of the franchise in the allotted territory. The franchisor may also be obliged not to exploit the franchise or sell the franchised product or service within the franchisee's territory (Article 2(a)). The Regulation also exempts the use of location clauses and active sales restraints (Article 2(c) and (d)). The franchisee must remain free to respond to passive sales requests and to source the contract goods from other franchisees or other authorised distributors (Article 4(a)). Guarantees cannot be used as instruments of market compartmentalisation (Article 4(b)). The Regulation also "black lists" any clause which prevents the franchisee from supplying end-users because of their place of residence (Article 5(c)). Finally, Article 8(c) empowers the Commission to withdraw the benefit of the block exemption if either party uses differences in product specification between Member States in order to fragment the market.

Exclusive Purchasing Obligations

An exclusive purchasing obligation cannot be imposed upon a franchisee. The block exemption only applies if the franchisee remains free to purchase the contract goods from other franchisees or authorised dealers (Article 4(a)).

Non-Compete Obligations

The Regulation permits the imposition of two types of non-compete obligations. Firstly, the franchisor may oblige the franchisee not to manufacture or sell goods which compete with the contract goods (Article 2(e)). Secondly, the franchisee may be obliged to refrain from engaging in any competing business provided it is necessary to protect the franchisor's know-how or maintain the common identity of the network (Article 3(1)(c)).

Sales Obligations

The franchisee must remain free to set its own prices, although price recommendation is possible (Article 5 (e)). Obligations may be imposed, however, on the franchisee to use its best endeavours to sell the contract goods, to achieve minimum turnover and to provide customer and warranty services (Article 3(1)(f)).

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