Antitrust 101: Schwinn and *Sylvania*

Once again this term (in *Leegin*), the Supreme Court is reviewing a case involving the analytical framework for vertical restraints challenged under Section 1 of the Sherman Act. But this is not the first time the Supreme Court has considered making a major change. Some antitrust oldtimers have started talking again about the good old days of the Supreme Court's opinions in *Schwinn* and *Sylvania*. What are they talking about?

The fundamental issue is whether vertical restraints are per se violations of the Sherman Act or whether they should be judged under the rule of reason. Two Supreme Court cases, *Schwinn* and *Sylvania*, illustrate that the Court's treatment of vertical restraints has not always been consistent — *Schwinn and Sylvania* involved non-price restraints. But these cases also show that antitrust law continues to evolve, and the Court will reverse itself, and established precedent, when necessary to promote the policies and goals of the antitrust laws.

Vertical nonprice restraints, the rule of reason, and the per se rule

A vertical nonprice restraint is a restriction imposed by agreement between firms at different levels of distribution. The restriction, for instance, can be a manufacturer prohibiting a retailer from selling the manufacturer's goods outside the retailer's assigned territory. This is commonly referred to as a territorial restriction. Other examples include exclusive distributorships, customer restrictions, location clauses, and area of primary responsibility clauses.

From a litigation standpoint, when a party charges that a vertical nonprice restraint is a violation of Section 1 of the Sherman Act, application of the per se rule over the rule of reason can effectively determine the outcome of a case. With application of the per se rule, a plaintiff must prove only that an agreement existed. The plaintiff's burden is greater, however, when the rule of reason applies, requiring the plaintiff to show that the agreement at issue is an unreasonable restraint of trade, with no requirement on behalf of the defendant to prove that the practice is reasonable.

Courts generally apply one of these two methods of analysis—the rule of reason or the per se rule—for determining whether an agreement unreasonably restrains competition under Section 1 of the Sherman Act. Application of one method over the other often turns on the type of agreement or restraint at issue.

The rule of reason is considered the prevailing standard for assessing the effect on competition for most categories of agreements that are not per se illegal. The rule of reason requires an in-depth market analysis of the effect of the agreement on competition in a relevant market. In *Sylvania*, the Court explained that under the rule of reason, "the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an

"Once again this term (in *Leegin*), the Supreme Court is reviewing a case involving the analytical framework for vertical restraints challenged under Section 1 of the Sherman Act. But this is not the first time the Supreme Court has considered making a major change. Some antitrust oldtimers have started talking again about the good old days of the Supreme Court's opinions in *Schwinn* and *Sylvania*. What are they talking about?"

(Continued on page 5)

Antitrust 101: Schwinn and *Sylvania*

(Continued from page 4)

unreasonable restraint on competition." *Continental T.V., Inc v. GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977). Fundamentally, the rule of reason asks whether the agreement promotes or suppresses competition, *i.e.*, do the anticompetitive effects of the restraint outweigh its procompetitive benefits?

Certain agreements, however, are conclusively presumed to be unreasonable because the practice at issue "facially appears to be one that would always or almost always tend to restrict competition and decrease output." *Broadcast Music Inc. v. CBS*, 441 U.S. 1, 19-20 (1979). Unlike the rule of reason, the per se rule precludes an in-depth analysis of the reason for the restraint, including consideration of its nature, extent, and effect on competition. As a result, the Supreme Court has limited its application of the per se rule to agreements that are by their nature manifestly anticompetitive. Examples of agreements that are subjected to per se treatment are naked price-fixing, big-rigging, and market-allocation agreements among competitors.

Supreme Court treatment of vertical nonprice restraints: per se or rule of reason?

In *White Motor Co. v. United States*, 372 U.S. 253 (1963), the Court considered the validity of a manufacturer's assignment of exclusive territories to its distributors and dealers. The Court was asked to treat the exclusive territorial restriction as a per se violation, but it refused and applied the rule of reason instead. The Court determined that too little was known about the competitive impact of this vertical nonprice restriction to warrant treating it as per se unlawful under the Sherman Act. *Id*. at 263.

But only four years later, in *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), the Court again faced the question of whether vertical nonprice restraints should be judged as per se unlawful or subject to the rule of reason. At issue in *Schwinn*, was the status of exclusive dealer territories and customer restrictions that prohibited wholesale distributors and franchised retailers from selling Schwinn bicycles (i) outside assigned territories and (ii) to non-franchised retailers.

The Court held that once Schwinn transferred title to its bicycles to a distributor, it could not impose territorial restrictions on the distributor, finding restrictions in these circumstances "so obviously destructive of competition" as to constitute a per se violation. *Id*. at 379. The Court explained that "it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it." *Id*. at 379. In addition to announcing this "bright line" per se rule for vertical nonprice restrictions, the Court also found that the rule of reason governs vertical nonprice restrictions when the manufacturer retains title, dominion, and risk of loss with respect to the product and the dealer in question is indistinguishable from an agent or salesperson of the manufacturer. *Id*. at 380.

Thus, according to the Court in *Schwinn*, application of either the per se rule or the rule of reason for vertical nonprice restrictions turned upon the role played by the distributor/retailer in the distribution system and the passage of title to goods. This framework led to contrasting, uneven results: The Court held that where distributors and retailers acted as wholesalers, buying and reselling Schwinn's bicycles, the territorial and customer restrictions were per se illegal. But where the distributors and retailers functioned under consignment and agency arrangements such that Schwinn retained title to and risk of loss for the bicycles until sale, then the same restrictions were to be judged under the rule of reason. As a result, *Schwinn* was the subject of continuing controversy and confusion in both law journals and federal courts. Scholarly opinion was critical of the decision and federal courts faced with similar vertical nonprice restrictions sought ways to limit *Schwinn's* reach.

Then, only ten years later, in *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977), the Court took the opportunity to revisit its decision in *Schwinn* and

Antitrust 101: Schwinn and *Sylvania*

(Continued from page 5)

reversed itself, overruling the per se rule announced in *Schwinn* and returning to the pre-*Schwinn* rule of reason analysis for evaluating vertical nonprice restrictions.

The restriction at issue in *Sylvania* was a location clause in a franchise agreement establishing the physical site from which the distributor and franchisee, Continental, could sell Sylvania television sets. Continental challenged the restriction, claiming a violation of Section 1of the Sherman Act. At the close of evidence in a jury trial of these claims, Sylvania requested that the District Court instruct the jury that its location restriction was illegal only if it unreasonably restrained or suppressed competition, effectively applying the rule of reason. Relying on *Schwinn*, however, the District Court refused this proffered instruction and instead instructed the jury that if it found Sylvania entered into a contract with Continental containing a location clause for products Sylvania sold to Continental, then they must find a violation of Section 1 of the Sherman Act, regardless of the reasonableness of the location restrictions. Applying the per se rule as instructed by the District Court, the jury found for Continental.

> "The Court overruled *Schwinn*, holding that vertical non-price restrictions are subject to the rule of reason. But it also reserved the possibility that in particular cases the application of the vertical nonprice restrictions may justify a per se prohibition, but such a departure from the rule of reason 'must be based upon demonstrable economic effect rather than—as in *Schwinn*—upon formalistic line drawing.'"

Sylvania appealed to the Ninth Circuit and, sitting *en banc*, it reversed the District Court. The Ninth Circuit concluded that the nature of the vertical nonprice restrictions at issue in *Schwinn* and *Sylvania* were different in terms of their competitive impact, finding that Sylvania's location restriction had less potential for competitive harm than the territorial and customer restrictions invalidated in *Schwinn*. Because the Court found *Schwinn* distinguishable, it ruled that Sylvania's location restriction should be judged under the rule of reason, rather than the per se rule stated in *Schwinn*.

The Supreme Court granted Continental's petition for *certiorari* to resolve the question of what method of antitrust analysis applies to vertical nonprice restrictions: the per se rule or the rule of reason. The Court disagreed with the Ninth Circuit, finding that there is no principled basis for distinguishing the customer restriction in *Schwinn* from the location restriction at issue in *Sylvania*. According to the Court, the intent and competitive impact of each restriction was the same because in both cases the restrictions limited the freedom of the retailer to dispose of products as the retailer desired. *See* 433 U.S. 46. Sylvania argued that if *Schwinn* could not be distinguished, then it should be reconsidered. The Court agreed.

The Court noted that *Schwinn* was "an abrupt and largely unexplained departure from *White Motor*" and no sound basis in terms of competitive impact existed for the distinction drawn between sale and consignment transactions sufficient to justify application of a per se rule in one situation and the rule of reason in the other. *Id.* at 50-51, 57. Indeed, the *Schwinn* Court did not refer to the accepted requirements for per se violations set forth in prior decisions, such as *Northern Pacific R. Co. v. United States*, 356 U.S. 1 (1958). To classify a restriction as a per se violation, the Court must examine the actual impact the arrangements in question have on competition

(Continued on page 7)

Antitrust 101: Schwinn and *Sylvania*

(Continued from page 6)

and find that the restrictions have such a "pernicious effect on competition and lack . . . any redeeming virtue" such that they must be presumed to be unreasonable and therefore illegal. *Id.* at 5.

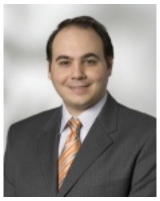
The Court in *Sylvania* then undertook an analysis of vertical nonprice restraints under *Northern Pacific R. Co.*., which the *Schwinn* Court had failed to do. The Court explained that the market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition. 433 U.S. at 51-52. (Interbrand competition is the competition among manufacturers of the same generic product. Intrabrand competition is the competition between the distributors of the product of a particular manufacturer.) On the one hand, vertical restrictions reduce intrabrand competition by limiting the number of sellers of a particular product competing for the business of a given group of buyers. On the other hand, vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of its products.

The Court then noted that economists found that vertical nonprice restrictions did indeed have economic utility. Economists had identified a number of ways in which manufacturers can use vertical nonprice restrictions to compete more effectively against other manufacturers (interbrand competition). 433 U.S. at 55. Further, economists had argued that manufacturers have an economic interest in maintaining as much intrabrand competition as is consistent with the efficient distribution of their products. *Id.* at 56.

With this background, the Court then turned to the standard of *Northern Pac. R. Co.* for determining whether vertical nonprice restrictions must be conclusively presumed to be unreasonable under the per se rule. The Court found that varying forms of vertical nonprice restrictions are widely used in the free market and that there is substantial scholarly and judicial authority supporting their economic utility. Thus, there was not a sufficient showing that vertical nonprice restrictions are likely to have a "pernicious effect on competition" or that they lack any redeeming virtue, thereby justifying application of the per se rule rather than the rule of reason.

The Court overruled *Schwinn*, holding that vertical non-price restrictions are subject to the rule of reason. But it also reserved the possibility that in particular cases the application of the vertical nonprice restrictions may justify a per se prohibition, but such a departure from the rule of reason "must be based upon demonstrable economic effect rather than—as in *Schwinn*—upon formalistic line drawing." *Id.* at 58-59.

Following *Sylvania*, lower courts have applied the rule of reason to vertical nonprice restraints and found that such restrictions typically do not violate Section 1 of the Sherman Act. When examining these restrictions under the rule of reason, courts will review the purpose of the restriction, the effect of the restriction in limiting competition in the relevant market, the market share of the upstream market participant imposing the restraint, and the net impact on competition after weighting the procompetitive benefits of the restraints.



*David Fioccola is an associate with Morrison & Foerster LLP in New York.