THE MONSANTO CASE AND THE EVOLUTION OF RPM POLICY IN THE U.S.

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The recent decision of the U.S. Supreme Court in Monsanto Co. v. Spray-Rite Service Corp. carries important implications for the evolution of antitrust policy respecting resale price maintenance (RPM).[1] While the Court did not overturn the per se rule regarding the illegality of vertical price fixing, its statements regarding the effects of the practice in Monsanto foreshadow a re-assessment of the rule in future cases. The Court's ruling in this case also fortifies its previous decisions permitting non-price vertical restraints and unilateral action by manufacturers to maintain resale prices, by raising the standard of proof required to establish the existence of a vertical price fixing conspiracy. While the type of civil antitrust action represented by Monsanto is more common in the U.S. than in Canada, the economic and doctrinal arguments raised in the case are of interest in view of the prohibition of price maintenance under the Canadian Combines Investigation Act[2] and the position taken by the U.S. Department of Justice in the case, urging abolition of the per se rule.

The purpose of this note is to review the Monsanto decision and the underlying policy issues. In particular, Part I briefly examines the evolution of the U.S. RPM policy and the developments leading to reconsideration of the per se rule. Part II examines the Monsanto decision and its implications. Part III reflects on the policy issues raised by the case.

I Evolution of U.S. RPM Policy

The issues in the Monsanto case arise from the tension between the Court's previous decisions on the application of section 1 of the Sherman Act to price and non-price vertical restraints. Section 1 does not prohibit specific practices, but instead provides that "every contract, combination or conspiracy, in restraint of trade... is declared to be illegal." It is left to the courts to develop doctrines and standards for determining the treatment of those practices which are considered likely to restrain trade. Under the relevant doctrines, unambiguously pernicious practices such as horizontal price fixing are considered illegal per se; while the legality of other practices that may or may not be harmful to consumer welfare is determined by weighing the likely pro-competitive and anti-competitive effects in particular cases ("rule of reason" approach). Whether a type of arrangement is dealt with under the per se approach or rule of reason is of critical importance, since in practice arrangements subject to the rule of reason are not likely to be challenged.[3]

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The status of RPM under U.S. law has undergone considerable change since the passage of the Sherman Act in 1890. In the 1911 case of Dr. Miles Medical Co. v. John D. Park & Sons Co., the U.S. Supreme Court held that vertical price fixing, or the maintenance of resale prices by concerted action between manufacturers and distributors, was harmful to competition in most instances, and therefore illegal per se under section 1 of the Act.[4] This decision was based on two premises to be examined below: (i) that RPM harms consumers by restricting competition among retailers; and (ii) that the practice serves no legitimate interest of manufacturers. More generally, the Court reasoned that the manufacturer "having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic."

The per se rule was effectively suspended by the U.S. Miller-Tydings Act of 1937, which exempted RPM agreements from the antitrust laws when authorized by state "fair trade" legislation. The McGuire-Keough Act of 1952 went beyond the Miller-Tydings Act to authorize enforcement of fair trade contracts against non-signing distributors -- i.e., all distributors within a state could be bound to minimum price agreements as long as one seller had signed a contract to this effect. These statutes were passed under strong lobbying pressure from retail trade associations, apparently for the purpose of closing down discount outlets.[5]

The per se prohibition of vertical price fixing in Dr. Miles was effectively re-instated in 1975, when Congress repealed the Miller-Tydings and McGuire-Keough Acts. It is important, however, to note that this repeal did not codify the prohibition; it merely withdrew the statutory provisions which previously had over-ridden the 1911 ruling of the Court. As part of the "common law" of antitrust, Dr. Miles may still be overturned by the U.S. Supreme Court, as its policy under section 1 of the Sherman Act evolves.[6] This is unlike the situation in Canada, where the prohibition of RPM is prescribed by section 38 of the Combines Investigation Act, and repealing it would require legislative action.

The U.S. antitrust treatment of non-price vertical restraints developed differently from the doctrine on RPM, and provides much of the impetus for re-consideration of the per se rule on vertical price fixing. In the landmark case of Continental T.V., Inc. v. G.T.E. Sylvania Inc. (1977), the Supreme Court held that restrictions on the territories within which a distributor may sell, or the customers to whom he may sell, were to be judged under the rule of reason.[7] The Court considered that such restraints are frequently beneficial to consumers, in that they enable manufacturers to establish more efficient, service-oriented distribution systems, that would otherwise be undermined by "free riders". If such dealer restrictions were not permitted, low service discount outlets could skim off sales from higher priced distributors that provide necessary services, undermining the overall efficiency of the distribution system.[8] The treatment of non-price restraints under Sylvania in the U.S. is somewhat similar to their treatment in Canada under Part IV.1 of the Combines Investigation Act.

Since 1977, the rationale of the permissive Sylvania rule for non-price restraints is increasingly seen as applicable to RPM as well.[9] Like non-price restraints, RPM can help to prevent the erosion of an efficient distribution system by rewarding full service distributors and preventing free riders. Indeed, as Mr. Justice White foresaw in a prescient concurring opinion in the Sylvania case, "the effect, if not the intention, of the Court's opinion (in Sylvania) is necessarily to call into question the firmly established per se rule against price restraints".[10]

An additional source of tension with Dr. Miles is the decision of the U.S. Supreme Court in United States v. Colgate & Co.[11] In that case, the Court held that resale price maintenance achieved through unilateral termination of distributors by the manufacturer — as opposed to the concerted action between manufacturers and distributors covered by Dr. Miles -- is permissible. That is, the manufacturer can announce its resale prices in advance and refuse to deal with those who fail to comply. The same result that would be unlawful if achieved through joint action is lawful if achieved unilaterally.[12] This is different from the law in Canada, where refusal to supply because of a distributor's low pricing policy is a specific offence under section 38(1)(b) of the Combines Investigation Act.

The tensions between Dr. Miles on the one hand and Sylvania and Colgate on the other have caused considerable difficulty in U.S. civil antitrust cases involving termination of dealers by manufacturers for unsatisfactory performance, since in practice it is not easy to distinguish the fact situations covered by the three rules.[13] In particular, the manufacturer may consider that he is terminating a low price dealer for providing inadequate pre-sale service, or failing to honour territorial restraints that should be valid under the Sylvania standard. Alternatively, the manufacturer may consider that he is merely taking unilateral action to terminate a distributor for reason of low prices, as permitted under the Colgate doctrine. The distributor may, however, assert that the real reason for termination is his failure to comply with resale price levels sought jointly by the manufacturer and other distributors, citing a record of complaints from other distributors about price-cutting policies. If the court accepts such evidence uncritically, as reflecting a vertical price-fixing conspiracy in violation of the per se rule, it can undermine the intended permissive policy toward unilateral action and non-price restraints. As discussed in Part II, the Monsanto case provided the Supreme Court with the opportunity to draw the line and restrict the application of Dr. Miles to proven vertical price-fixing conspiracies, thereby ensuring the efficacy of its more permissive policy toward non-price restraints and unilateral action.

II. The Monsanto Case and its Implications

The Monsanto case resulted from the termination of Spray-Rite Service Corp., a family owned discount wholesale distributor of agricultural chemicals and herbicides, by Monsanto Co., a chemical manufacturer for whom Spray-Rite was an authorized distributor from 1955 to 1968. In October 1967, Monsanto announced new measures intended to upgrade its distribution system.

In particular, its distributors would be appointed for one year terms, and renewal of distributorships would be based on compliance with new service-oriented criteria; including (i) the distributor's emphasis on soliciting sales to retail dealers; (ii) adequate training of salesmen on the technical aspects of Monsanto products; and (iii) whether in Monsanto's view the distributor could exploit fully the potential market in its geographic area of primary responsibility. In October 1968, Monsanto declined to renew Spray-Rite's distributorship, citing a failure to hire trained salesmen and promote sales to retailers adequately.

In response, Spray-Rite brought a civil antitrust action alleging that (i) Monsanto and some of its other distributors had entered a conspiracy to fix resale prices, in violation of section 1 of the Sherman Act; and (ii) Monsanto's termination of Spray-Rite, a distributor known for its low price, high volume operations, was in furtherance of the conspiracy. At trial, the judge instructed the jury that Monsanto's conduct was unlawful per se if it was in furtherance of a price fixing conspiracy, under the ruling in Dr. Miles. The jury heard evidence of numerous complaints from competing Monsanto distributors about Spray-Rite's price-cutting practices, and testimony by a Monsanto official that Spray-Rite was terminated because of the price complaints. Based on this evidence, the jury found that Monsanto's termination of Spray-Rite was indeed pursuant to a conspiracy between the manufacturer and one or more of its distributors to fix resale prices. The court awarded $10.5 million in (treble) damages for this and related actions of Monsanto.

On appeal, the Court of Appeals for the Seventh Circuit affirmed the trial court judgement, stating that "proof of termination following competitor complaints is sufficient to support an inference of concerted action."[14] Under this standard, the evidence heard by the jury would suffice to support its judgement. The Supreme Court of the United States granted certiorari to review the Court of Appeals statement of the necessary standard of proof in such cases. Subsequently, the U.S. Department of Justice and several other amici filed briefs urging the Supreme Court to take advantage of the opportunity presented by Monsanto to overturn the holding in Dr. Miles in favour of rule of reason treatment of RPM, based on the economic arguments and doctrinal inconsistencies noted in Part I.

Mr. Justice Powell, in his opinion for the Supreme Court on the case, did not overturn Dr. Miles but restricted its application by raising the standard of proof for establishment of a vertical price-fixing conspiracy in such cases. The Court based its analysis on a potentially far-reaching statement of its view of the economic benefits of co-operation and co-ordination between manufacturers and distributors. The statement reveals the extent to which the Court has accepted the free rider argument and the view that restricted distribution can be efficiency-enhancing:

> A manufacturer and its distributors have legitimate reasons to exchange information about the prices and the reception of their products in the market.... The manufacturer often will want to ensure that its distributors earn sufficient profit to pay for

> programs such as hiring and training additional salesmen or demonstrating the technical features of the product, and will want to see that "free riders" do not interfere.
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> (Supreme Court, p. 8)

From this perspective, the Supreme Court argued that the standard adopted by the Court of Appeals in Monsanto would undermine the intended permissive regime for both non-price restraints and unilateral manufacturer action to set resale prices:

> It is of considerable importance that independent action by the manufacturer, and concerted action on non-price restrictions, be distinguished from price-fixing agreements, since under present law the latter are subject to per se treatment and treble damages.... If an inference of such an agreement may be drawn from highly ambiguous evidence, there is a considerable danger that the doctrines enunciated in Sylvania and Colgate will be seriously eroded.
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> (Supreme Court, p. 8)

The new standard adopted by the Court fortifies the Sylvania and Colgate doctrines by restricting the application of Dr. Miles to proven vertical conspiracies. The Court stated that in future, an unlawful agreement between manufacturer and distributors may not be inferred merely from termination in response to complaints of price cutting. Even constant communication between the manufacturer and distributors about prices will not suffice. To establish a conspiracy, there must be evidence that "tends to exclude the possibility that the manufacturer and nonterminated distributors were acting independently" and that demonstrates "a conscious commitment to a common scheme to achieve an unlawful objective." (Supreme Court, p.9). Applying its new standard the Court considered, perhaps surprisingly, that the available evidence could support the trial jury's finding of a conspiracy in Monsanto.[15]

While ostensibly concerned with an evidentiary issue, the holding in Monsanto carries broader doctrinal implications. By re-inforcing the Colgate doctrine -- permitting unilateral manufacturer action to enforce resale prices --the Court has affirmed an important exception to the prohibition of resale price maintenance that is not generally available in Canada.[16] The reasoning of the Court suggests that, even in restricted form, the per se rule against vertical price fixing may not survive long. The Supreme Court did not reject the urging of the Department of Justice to overturn Dr. Miles on the merits, but side-stepped the issue on the basis that the validity of the judge's per se instructions to the jury was not raised on the initial appeal. The Court recognized explicitly that "the economic effect of...unilateral and concerted vertical price setting, agreements on price and non-price restrictions is in many, but not all, cases similar or identical." (p. 7). This statement, coupled with the Court's above-noted more general observation regarding the efficiency benefits of vertical restraints, foreshadows a more thorough-going reconsideration of Dr. Miles. As Professor Easterbrook points out, "The decision to endorse Colgate in strong terms must reflect substantial dissatisfaction with Dr. Miles.... The days of Dr. Miles may be numbered."[17]

III. Summary of Policy Issues

The reasoning of the U.S. Supreme Court in Monsanto indicates that, to a considerable extent, the Court has accepted the "Chicago School" view that (i) manufacturers have a legitimate interest in maintaining standards for the marketing of their products; (ii) this interest may extend to influencing resale prices, and (iii) such co-ordination may facilitate establishment of more efficient distribution systems, to the benefit of consumers. While additional cases are required for the full implications of this viewpoint to be worked out, it seems likely to serve as the primary basis for the U.S. antitrust treatment of vertical restraints for some time to come. This policy judgement of the Court is of direct interest in Canada, in view of the prohibition of price maintenance under section 38 of the Combines Investigation Act. It is important, however, to note some significant qualifications to this view of RPM and its economic impact.

First, some ambiguity remains regarding the consumer welfare effects of RPM, even when the practice is adopted for the purpose of stimulating sales through enhanced pre-sale services. In many such cases RPM might make the overall market more competitive, by assisting firms to find appropriate price-quality niches. As F.M. Scherer and W.S. Comanor have pointed out independently, however, customers who do not need the additional pre-sale services made possible by vertical restraints are made worse off by the concomitant higher prices. In some cases their losses may exceed the gains to the additional customers attracted by the extra services.[18]

Second, while the efficient pre-sale service justification may be applicable, for example, to sales of computer hardware and software, it seems less applicable to the numerous cases in which RPM has been used to support the retail prices of easy-to-use but highly differentiated consumer goods such as designer jeans, knit shirts, boxed candy, vitamins and hair shampoo.[19] An alternative justification sometimes advanced in such cases - - that RPM is necessary to preserve product image — seems substantially less satisfactory from the consumer welfare perspective. In such circumstances the combination of RPM with market power derived from product differentiation and advertising may raise prices significantly above marginal costs. The manufacturer can be "paid" for its role in policing the elimination of price competition among distributors of his brand by obtaining a higher wholesale price. One factor lending credence to this concern -- that RPM can be used to facilitate a distributors' cartel for specific products -- is that historically, the main political impetus for "fair trade" legislation has been the retail industry lobby groups, not manufacturers.[20]

As a final qualification it should be noted that, just as a per se prohibition may prevent use of RPM in some cases where it might be efficient, an unstructured rule of reason may not be effective in preventing the practice in some cases where it is harmful to consumer welfare. While the "rule of reason" is an evocative concept, the U.S. experience suggests that in many cases the scope of inquiry required may be prohibitively complex. In the Sylvania case, the Supreme Court suggested that territorial restraints should be

evaluated by weighing the increase in interbrand competition resulting from the restraints against the reduction in intrabrand competition. It is clear that a reduction in intrabrand competition can make possible an increase in interbrand competition, but it is less clear how one can be weighed against the other by a judge and jury.

One alternative approach, suggested by Easterbrook, is to adopt a structured rule of reason, that focuses directly on specific indicators that would help to distinguish beneficial from harmful restraints.[21] For example, in markets where closely substitutable products are available from alternative manufacturers, the restrictive impact of RPM may be minimal. Similarly, where entry barriers are known to be low, it seems unlikely that RPM can raise prices substantially. On the other hand, where the brand subject to RPM is known to have considerable market power, whether due to patents, copyrights, structural entry barriers, or product differentiation and advertising, RPM may be harmful to consumers. The rule adopted should attempt to identify such cases at reasonable administrative costs.

NOTES

1. Supreme Court of the United States, Monsanto Co. v. Spray-Rite Service Corp., No. 82-914, March 20, 1984.

2. Combines Investigation Act, R.S.C., c. C-23, section 38,as amended. This section is essentially a per se prohibition, in that conviction does not depend on separate proof of anticompetitive impact. It is, however, subject to certain defences, including (i) a belief that the product was being used as a loss leader; and (ii) failure by a distributor to provide the expected level of service. In addition to vertical price fixing, the language of s. 38 permits application to some cases of horizontal price maintenance. See R. v. Peter Campbell (1981) 51 C.P.R. (2d) 284.

3. Phillip Areeda, "The State of the Law," Regulation, January/February 1984, pp. 19-22.

4. 220 U.S. 373 (1911).

5. F.M. Scherer, Industrial Market Structure and Economic Performance (Boston: Houghton Mifflin, 2nd ed., 1980), pp. 590-594.

6. "Antitrust is part of the common law." See Frank H. Easterbook, "Vertical Arrangements and the Rule of Reason," Antitrust Law Journal, Vol. 53, Issue 1, 1984, pp. 135-173, at 136.

7. 43 U.S. 36 (1977).

8. This argument, associated with the "Chicago School" of antitrust analysis, was originally developed in Lester G. Telser, "Why Should Manufacturers Want Fair Trade," Journal of Law and Economics, vol. III, October 1960, pp. 86-105.

9. Areeda, supra note 3, at 21.

10. Concurring opinion of Justice White, 433 U.S. 36 (1977).

11. 250 U.S. 300 (1919).

12. Areeda, supra note 3, pp. 21-22.

13. See the useful discussion in Areeda, supra note 3, at 21.

14. 684 F. 2d 1226 (1982); see also discussion in Supreme Court of the United States, supra note 1, at 3.

15. See Supreme Court of the United States, supra note 1, at 10-13.

16. To some extent, however, those cases where RPM is helpful to the maintenance of an efficient distribution system might be addressed under section 38(9)(d) of the CIA, which provides a defence to a charge of RPM where the distributor fails to provide the expected level of service.

17. Easterbrook, supra note 6, at 171.

18. That is, the additional services provided to attract marginal customers may represent excessive costs to intra-marginal customers, and the overall welfare impact may be negative. F.M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Journal, vol. 52, 1983, p. 687; see also William S. Comanor, "Vertical Price Fixing and Market Restrictions and the New Antitrust Policy," Working Paper in Economics, No. 233, University of California at Santa Barbara, February 1984.

19. Robert Pitofsky, "Why Dr. Miles Was Right," Regulation, January/February 1984, pp. 27-30.

20. Concern about the role of distributors in initiating vertical price fixing is reflected in section 38(6) of the CIA, which prohibits attempts (by distributors) to induce a supplier to refuse to supply a product to other distributors because of their low pricing policies. A conviction under this provision was obtained in the case of S. & E. Furnishings Limited (see Annual Report of the Director of Investigation and Research, Combines Investigation Act, for the year ended March 31, 1984, p. 23).

21. Easterbrook, supra note 6 at pp. 153-168.