RECENT DEVELOPMENTS

ANTITRUST LAW—DUAL DISTRIBUTION SYSTEMS—MANUFACTURER-IMPOSED RESTRAINTS ON DISTRIBUTORS REQUIRE RULE OF REASON ANALYSIS. *Red Diamond Supply, Inc. v. Liquid Carbonic Corp.*, 637 F.2d 1001 (5th Cir.), *cert. denied*, 102 S.Ct. 119 (1981). Liquid Carbonic Corporation (Liquid) manufactured industrial gas products and distributed such products through independent distributors and direct sales.[1] Red Diamond Supply (Red Diamond), one of Liquid's independent dealers, brought suit under federal[2] and state[3] antitrust statutes, alleging that Liquid had conspired with its independent distributors[4] to maintain territorial and customer restrictions on the sale of Liquid's products in New Orleans. In addition, Red Diamond alleged that its failure to abide by these restrictions caused its termination as a Liquid distributor.[5] The district court instructed the jury that territorial and customer restraints imposed by a dual distributor are horizontal market allocations because the manufacturer sells its prod-

1. Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001, 1002 (5th Cir.), *cert. denied,* 102 S. Ct. 119 (1981). A marketing network using two separate distribution channels is a dual distribution system. Dual distribution systems operate in many different forms, including those in which the manufacturer distributes products through independent distributors and company-owned distributors (branch outlets), distributors in separate markets (sale of home appliances to retail outlets and to home builders), and two competing product lines (sale under trademarked name and under a private brand name). *See* Slowey, *Dual Distribution: Definition, Legislative Background And Specific Attempts At Regulation,* 48 ANTITRUST L.J. 1799 (1981).

2. Red Diamond alleged violations of §§ 1 and 2 of the Sherman Act. Section 1 of the Sherman Act, 15 U.S.C. § 1 (1976), provides: "Every contract, combination, in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations is declared to be illegal." Section 2 of the Act, 15 U.S.C. § 2 (1976), provides: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of trade or commerce among the several States, or with foreign nations, shall be deemed guilty . . . ." *Id.*

3. The primary state claim arose under LA. REV. STAT. ANN. § 51.122 (West 1965), which is similar to the provisions of § 1 of the Sherman Act. *See* note 2 *supra*. Section 51.122 provides: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce in this state is illegal . . . ." Red Diamond alleged also that Liquid's practices violated the Louisiana Unfair Trade Practices and Consumer Protection Law, LA. REV. STAT. ANN. § 51.1405 (West Supp. 1982).

4. 637 F.2d at 1002. Red Diamond named two of Liquid's independent distributors, Acme Welding and Supply Company (Acme) and Awisco Corporation, as co-defendants. Prior to its jury trial in the district court, Red Diamond settled its claims against Liquid but continued to press its claims against the other co-defendants. *Id.* at 1003.

5. Red Diamond alleged that Liquid had conspired with Acme to terminate Red Diamond's distributorship agreement. *Id.* at 1003.

ucts in direct competition with its independent distributors.[6] The jury ruled in favor of Red Diamond, but the district court granted judgment n.o.v. for Liquid on the ground that the evidence failed to support a finding of conspiracy.[7] On appeal,[8] the Fifth Circuit affirmed on different grounds and *held*: When the manufacturer is the source of territorial or customer restraints, those restraints result in vertical market allocations regardless of whether the manufacturer is a dual distributor.[9]

In *Continental T.V., Inc. v. GTE Sylvania, Inc.*[10] the Supreme Court held that although restrictive trade agreements among competitors are patently anticompetitive and deserve per se treatment,[11] some trade ar-

6. *Id.* at 1004.

7. *Id.* at 1003. Earlier in the case, the district court had directed verdicts for the defendants on the claims under § 2 of the Sherman Act and the Louisiana Unfair Practices Act. Although the jury ruled in favor of Red Diamond on the Louisiana counterpart to § 1 of the Sherman Act, it ruled for the defendants on the Sherman Act § 1 count, a seemingly inconsistent result.

8. Red Diamond's sole appeal was from the district court's judgment n.o.v. on the Louisiana counterpart to § 1 of the Sherman Act, LA. REV. STAT. ANN. § 51.122 (West 1965).

9. 637 F.2d at 1004.

10. 433 U.S. 36 (1977).

11. Trade agreements among competitors operating on the same distribution level are horizontal trade restraints. Horizontal arrangements often involve agreements to divide markets geographically or to fix prices. *See, e.g.,* United States v. Topco Assoc., Inc., 405 U.S. 596 (1972); United States v. Sealy, Inc., 388 U.S. 350 (1967); Ohio-Sealy Mattress Mfg. Co. v. Sealy, Inc., 585 F.2d 821 (7th Cir. 1978), *cert. denied,* 440 U.S. 930 (1979). *See generally* Note, *Antitrust Treatment of Intrabrand Territorial Restraints Within a Dual Distribution System,* 56 TEX. L. REV. 1486, 1486 nn.2-3 (1978).

A per se violation of the antitrust laws is an activity that is so blatantly anticompetitive in intent and "pernicious" in effect that a court need not inquire into the reasonableness of the activity or its actual effect on competition. The Supreme Court in Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958), said:

> [T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. This principle of per se unreasonableness not only makes the type of restraints which are proscribed by the Sherman Act more certain to the benefit of everyone concerned, but it also avoids the necessity for an incredibly complicated and prolonged economic investigation into the entire history of the industry involved, as well as related industries, in an effort to determine at large whether a particular restraint has been unresonable—an inquiry so often wholly fruitless when undertaken.

For a perceptive discussion of the per se rule, see ABA ANTITRUST SECTION, MONOGRAPH NO. 2, VERTICAL RESTRICTIONS LIMITING INTRABRAND COMPETITION 31 (1977); Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division,* 74 YALE L.J. 775 (1965); Stewart & Roberts, *Viability of The Antitrust Per Se Illegality Rule: Schwinn Down, How Many To Go?,* 58 WASH. U.L.Q. 727 (1980); Note, *supra.* In *Sylvania,* the Court reasoned that horizontal trade agreements exhibit blatant pernicious effects and thus deserve per se treatment. 433 U.S. at 585 rangements between manufacturers and distributors[12] are procompetitive[13] and require analysis under a rule of reason approach.[14] Because

n.28. The *Sylvania* decision merely affirmed the Supreme Court's earlier ruling in United States v. Topco Assoc., Inc., 405 U.S. 596 (1972) (holding agreements among an association of grocers a horizontal restraint and therefore per se illegal).

12. In the typical situation, manufacturers and distributors operate on different levels of the distribution chain. When parties stand on different distribution levels, agreements between them are vertical. Dual distribution systems present a unique problem because the manufacturer and the distributor operate on the same level of the distribution chain. *See* notes 18-21 *infra* and accompanying text.

13. The *Sylvania* Court recognized that vertical restrictions often enabled a manufacturer to compete more effectively on the interbrand level, that is, with other manufacturers marketing similar products. Because vertical restrictions reduce competition between its distributors at the intrabrand level, manufacturers can force their distributors to concentrate their efforts on interbrand sales. 433 U.S. at 583. Examples of procompetitive vertical restraints include exclusive distributorships and area of primary responsibility clauses. The appeal of using vertical restraints to improve a distributor's interbrand sales efforts is exemplified by profit passover clauses. A profit passover clause induces a distributor to concentrate his sales efforts in an assigned location by requiring him, when he sells outside of his primary location, to compensate the distributor in the area he invaded. This payment compensates the invaded dealer for his goodwill. Because the distributor will receive a greater profit on sales inside his assigned location, he will benefit by improving his interbrand competitiveness, thereby increasing his sales within his assigned location. For cases dealing with the validity of such clauses, see Eiberger v. Sony Corp., 622 F.2d 1068 (2d Cir. 1980); Ohio-Sealy Mattress Mfg. Co. v. Sealy, Inc., 585 F.2d 821 (7th Cir. 1978); Response of Carolina, Inc. v. Leasco Response, Inc., [1976-2] Trade Cas. (CCH) ¶ 61,045 (S.D. Fla.), *aff'd,* 537 F.2d 1307 (5th Cir. 1976); Superior Bedding Co. v. Serta Assoc., Inc., 353 F. Supp. 1143 (N.D. Ill. 1972). For a general discussion on the procompetitive aspects of vertical restraints, see Schildkraut, *Areas of Primary Responsibility And Other Territorial Restrictions In Channels of Distribution Under The Antitrust Laws: A Legal And Economic Analysis,* 11 COLUM. J.L. SOC. PROB. 509 (1975).

14. The classic formulation of the rule of reason was articulated by Justice Brandeis in Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918):

> The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question, the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences.

Although the *Sylvania* Court advocated a rule of reason approach to the legality of vertical restraints, it offered little assistance in applying the rule of reason to actual market situations. *See generally* Pitofsky, *The* Sylvania *Case: Antitrust Analysis of Non-Price Vertical Restrictions,* 78 COLUM L. REV. 1, 11 (1978); Posner, *The Rule of Reason and The Economic Approach: Reflections on The* Sylvania *Decision,* 45 U. CHI. L. REV. 1, 13-16 (1977); Stewart & Roberts, *supra* note 11, at 728 n.6. The confusion generated by *Sylvania* centers on the Court's statement that in determining the validity of a vertical non-price restraint under the rule of reason, a court must balance the competitive effects of the restraint on interbrand and intrabrand competition. Although the *Sylva-*

the *Sylvania* Court distinguished horizontal[15] and vertical[16] restraints, characterization of the restraints is a critical inquiry in analysis under section 1 of the Sherman Act.[17] Although characterization is relatively simple in most instances,[18] dual distribution systems[19] present a dilemma. On the one hand, because the manufacturer acts as a supplier to the independent distributor, the relationship is vertical. On the other hand, because the manufacturer, through its branch outlet,[20] competes on the same distribution level as the independent distributor, the relationship is also horizontal. Consequently, the legality of dual distributor imposed restraints is dependent on a court finding that a vertical relationship exists between the dual distributor and independent distributors.[21]

Prior to *Sylvania*, the courts uniformly advocated a horizontal analysis for determining the legality of dual distribution restraints.[22] The

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nia Court pointed out that courts are fully capable of balancing intrabrand and interbrand competition, it failed to clarify their relative importance. For a better insight into the rule of reason, see Zelek, Stern & Dunfee, *A Rule of Reason Decision Model After* Sylvania, 68 CALIF. L. REV. 13 (1980).

15. *See* note 11 *supra*.

16. *See* note 12 *supra*.

17. After *Sylvania*, courts must judge vertical restraints under the rule of reason, although they still treat horizontal restraints as per se illegal. If the court finds a particular restraint is horizontal, then it simply stops the inquiry and invalidates the restraint. On the other hand, if the court finds that the restraint is vertical, it then must inquire into the reasonableness of the restraint.

18. The basic distribution system involves a manufacturer who distributes his goods solely through a series of independent distributors. Because the manufacturer operates on a different level than its distributors, the relationship with distributors is vertical.

19. For a definition of dual distribution, see note 1 *supra*.

20. The term "branch outlet" refers to the manufacturer's wholly-owned distributor.

21. Dual distribution alone is not a violation of the antitrust laws. The existence of such a system, however, will subject any accompanying restraint to careful scrutiny.

> Any action taken by a supplier engaged in dual distribution that affects the prices at which its customers resell its products, or inhibits the ability of those customers to compete with the supplier, has the potential of being judged as a violation of Section 1 of the Sherman Act, unless the supplier can convince the trier of fact that the decision was motivated solely by legitimate business reasons, and not by a desire on the part of the supplier to restrain competition.

Bondurant, *Legal Risks Posed By Sherman Act Section 1; Favoritism of Owner Outlets; And Strategic Pricing*, 48 ANTITRUST L.J. 1815, 1816 (1981). For a discussion of the legal risks of dual distribution under § 2 of the Sherman Act, see Brett, *Legal Risks For Dual Distribution Under Sherman Act Section 2*, 48 ANTITRUST L.J. 1820 (1981).

22. *See, e.g.*, Pitchford v. Pepi, Inc., 531 F.2d 92 (3d Cir.), *cert. denied*, 426 U.S. 935 (1976); American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3d Cir. 1975); Hobart Bros. Co. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir.), *cert. denied*, 412 U.S. 923 (1973); Interphoto Corp. v. Minolta Corp., 295 F. Supp. 711 (S.D.N.Y.), *aff'd per curiam*, 417 F.2d 621 (2d Cir. 1969).

early cases relied upon *United States v. Arnold Schwinn & Co.*,[23] in which both horizontal and vertical territorial and customer restrictions imposed by a manufacturer were per se violations of section 1.[24] The pre-*Sylvania* courts consequently approached the characterization problem rather simplistically, focusing solely on whether the restraint restricted competition between the independent distributor and the wholly-owned distributor.[25] Courts used this approach to invalidate national account programs,[26] area of primary responsibility clauses,[27] and exclusive dealing arrangements.[28]

Decisions since *Sylvania* have moved away from horizontal treatment of dual distribution restraints. Although the cases immediately following *Sylvania* did not expressly sanction a vertical approach, they

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But see United States v. Arnold Schwinn & Co., 388 U.S. 365 (1967). *See generally* Altschuler, Sylvania, *Vertical Restraints, and Dual Distribution*, 25 ANTITRUST BULL. 1, 64 (1980); Note, *supra* note 11.

23. 388 U.S. 365 (1967). Both courts and commentators consider *Schwinn* a departure from precedent. *Schwinn* was subsequently overruled in *Sylvania*. For an annotation of various *Schwinn* critics, see Stewart & Roberts, *supra* note 11, at 729 nn.13-14.

24. 388 U.S. 365, 372-73. Because the legality of the restraints in *Schwinn* did not turn on their classification as horizontal or vertical, subsequent cases prior to *Sylvania* did not make precise or accurate distinctions in classification. Pre-*Sylvania* decisions, consequently, are of dubious authority. *See* Altschuler, *supra* note 22, at 82; Note, *supra* note 11, at 1494.

Although *Schwinn*-era cases cited *Schwinn* as a mandate for horizontal classification of dual distribution restraints, the *Schwinn* Court classified one of the attacked restraints as vertical. *See* note 31 *infra* and accompanying text. The Court stressed that Schwinn's dual distribution system required the utmost cooperation between Schwinn and its distributors; therefore, the competitive element necessary to a horizontal restraint was absent.

Unlike most pre-*Sylvania* cases, the court in United States v. CIBA-Geigy Corp., [1976-1] Trade Cas. (CCH) ¶ 60,908 (D.N.J.), expressly denounced reliance on *Schwinn*'s broad per se rule and held that a dual distributional restraint was a horizontal market allocation. In finding the restraint per se illegal, the court stated that "where it is shown . . . that a vertically imposed restraint is intended to suppress horizontal competition, the court will treat the agreement as the equivalent of a horizontal restraint of trade." *Id.* at 68,959.

25. The Fifth Circuit's opinion in Hobart Bros. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir.), *cert. denied*, 412 U.S. 923 (1973), typifies the pre-*Sylvania* cases. *Hobart* involved a distribution system that restricted the manufacturer's distributors from selling to certain reserved markets and required distributors to concentrate their sales efforts in designated areas. Characterizing Hobart and its independent distributors as co-distributors, the court classified the distribution system as a horizontal agreement among competitors to eliminate competition. *Id.* at 899.

26. *E.g.*, Hobart Bros. Co. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir.), *cert. denied*, 412 U.S. 923 (1973); Interphoto Corp. v. Minolta Corp., 295 F. Supp. 711 (S.D.N.Y.), *aff'd per curiam*, 417 F.2d 621 (2d Cir. 1969). In a national account program the manufacturer reserves a specific market for his own servicing. Reserved markets often include major department store chains or government agencies. *See* United States v. White Motor Co., 372 U.S. 253 (1963).

27. *E.g.*, Pitchford v. Pepi, Inc., 531 F.2d 92 (3d Cir.), *cert. denied*, 426 U.S. 935 (1976).

28. American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3d Cir. 1975).

noticeably failed to mention the possibility of horizontal treatment.[29] One of the first cases to adopt expressly a vertical analysis for dual distribution restraints was *H & B Equipment Co. v. International Harvester Co.*[30] Relying on *Schwinn*, the Fifth Circuit in *H & B Equipment* determined that conspiracies are horizontal restraints only when they are carried out by a combination of distributors.[31] The court held that the conspiracy was vertical because the manufacturer and the wholly-owned distributor were the only parties involved.[32] Because the conspiracy did not involve any independent distributors, the possibility of a horizontal agreement to restrain trade was absent.

The *H & B Equipment* test resembles the simplistic approach of the pre-*Sylvania* era.[33] In contrast, the Federal District Court for the Central District of California in *Krehl v. Baskin-Robbins Ice Cream Co.*[34] adopted a more systematic approach. The court analyzed dual distribution restraints through a three part inquiry, focusing on the relative position of the manufacturer in the distribution chain, the purpose of the restraint, and the ability of the distributors to control marketing decisions.[35] Under the *Krehl* test, the restraint is vertical if the manu-

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29. *See* Martin Glauser Dodge Co. v. Chrysler Corp., 570 F.2d 72 (3d Cir. 1977), in which the Third Circuit, using rule of reason analysis, upheld a distribution system favoring Chrysler-owned dealers, but failed to mention the posssibility of horizontal treatment. *See also* Suburban Beverages, Inc. v. Pabst Brewing Co., 462 F. Supp. 1302 (E.D. Wis. 1978); Outboard Marine Corp. v. Pezetel, 461 F. Supp. 384 (D. Del. 1978); Altschuler, *supra* note 22, at 84, 92-93. *Cf.* Universal Lite Distribs., Inc. v. Northwest Indus., Inc., 452 F. Supp. 1206 (D. Md. 1978) (absence of actual or potential competition under a § 2 monopolization claim supporting a nonhorizontal relationship), *aff'd per curiam,* 602 F.2d 1173 (4th Cir. 1979).

30. 577 F.2d 239 (5th Cir. 1978).

31. Courts have interpreted *Schwinn* as holding that "[c]onspiracies between a manufacturer and its distributors are only treated as horizontal . . . when the source of the conspiracy is a combination of distributors." *Id.* at 245. Although *Schwinn*'s per se rule was overruled by *Sylvania, see* note 23 *supra*, this aspect of *Schwinn* remains intact. *See, e.g.,* Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15 (4th Cir.), *cert. denied,* 102 S. Ct. 324 (1981); Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001 (5th Cir.), *cert. denied,* 102 S.Ct. 119 (1981); Westpoint Pepperrell, Inc. v. Rea, [1980-2] Trade Cas. (CCH) ¶ 63,341 (N.D. Cal.); Krehl v. Baskin Robbins Ice Cream Co., [1979-2] Trade Cas. (CCH) ¶ 62,806 (C.D. Cal.).

32. According to the court, "the asserted originator of the plan to eliminate H & B was the manufacturer, which allegedly established the company store for that purpose. Consequently, antitrust law treats the conspiracy as a vertical restraint, and those restrictions are now judged under the rule of reason." 577 F.2d at 245-46.

33. *See* notes 22-28 *supra* and accompanying text.

34. [1979-2] Trade Cas. (CCH) ¶ 62,806 (C.D. Cal.).

35. In finding a vertical relationship, the Court in *Krehl* stated:

> On the facts, the Baskin-Robbins arrangement differs decidedly from other arrangements proclaimed horizontal. . . . In all instances, the evidence shows that the appoint-

facturer can unilaterally dictate marketing decisions[36] and the restraint is designed to improve interbrand competition.[37]

In *Westpoint Pepperrell, Inc. v. Rea*[38] the Federal District Court for the Northern District of California took an approach similar to *Krehl*, focused on the manufacturer's behavior, and stated that it would not treat a manufacturer like a competitor as long as the manufacturer did not act like one.[39] *Westpoint Pepperrell* signifies that in the post-*Sylvania* era the courts are inclined to treat dual distribution restraints as vertical restraints.[40] Pre-*Sylvania* courts found horizontal relationships when the restraint merely restricted competition between the manufacturer and its distributor.[41] The *Westpoint Pepperrell* decision suggests, however, that a vertical relationship exists unless the restraint com-

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> ment of a new area manufacturer and the designation of the territory it was to service came from a Baskin-Robbins entity acting "from the top"; that is, acting not as a competitor to the new area franchiser, but rather as an entity at the apex of the market structure concerned with expanding the market for the Baskin-Robbins product. Such a purpose is "vertical" in nature . . . . At no time did any of the existing manufacturers have any voice in who a new area franchiser would be, or a veto over an applicant . . . [and further,] the independent area franchisers do not own or control Baskin-Robbins.

Id. at 78,703. One commentator has interpreted *Krehl* as adopting a two part test that focused on "the licensor's purpose in imposing the restraints, and its freedom from control by its licensees." Altschuler, *supra* note 22, at 99.

36. The *Krehl* court was concerned with the situation presented in United States v. Topco Assoc., 405 U.S. 596 (1972), in which a group of grocery store owners formed an association to buy products at lower prices. In *Topco* the true owners or manufacturers were not the association "acting from the top" but the individual grocers acting together as competitors in a horizontal relationship. *Accord,* United States v. Sealy, Inc., 388 U.S. 350 (1967).

37. In *Krehl* the Court reasoned that a per se violation of § 1 is justifiable only if the questioned restraint has an adverse effect on interbrand competition. If the restraint improves interbrand competition, it has no anticompetitive effect and therefore is not a violation. [1979-2] Trade Cas. (CCH) ¶ 62,806, at 78,705 (C.D. Cal.).

38. [1980-2] Trade Cas. (CCH) ¶ 63,341 (N.D. Cal.).

39. *Id.* at 75,743. The court focused on whether the territorial restraints imposed by the manufacturer on the distributors insulated them from competition. Westpoint's pledge not to appoint another distributor in the area of primary responsibility of one of its distributors was the only possible source of insulation. The court reasoned that, under *Schwinn*, the pledge was not a horizontal restraint because it was a unilateral decision on the part of the manufacturer. *Id.*

40. *Compare* United States v. CIBA-Geigy Corp., [1976-1] Trade Cas. (CCH) ¶ 60,908 (D. N.J.) (pre-*Sylvania* case classifying restraint as horizontal) *with* Carter Wallace, Inc. v. Otte, [1978-1] Trade Cas. (CCH) ¶ 61,976 (E.D.N.Y.) (post-*Sylvania* case classifying restraint as vertical). *See* Altschuler, *supra* note 22, at 86.

41. *See, e.g.,* American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3d Cir. 1975); Hobart Bros. Co. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir.), *cert. denied,* 412 U.S. 923 (1973); Interphoto Corp. v. Minolta Corp., 295 F. Supp. 711 (S.D.N.Y.), *aff'd per curiam,* 417 F.2d 621 (2d Cir. 1969).

pletely eliminates competition in the market.[42]

Although many courts have accepted vertical treatment of dual distribution restraints, some courts[43] and commentators[44] have been reluctant to rule out horizontal treatment in certain situations. In *Donald B. Rice Tire Co. v. Michelin Tire Corp.*[45] the Fourth Circuit refused to adopt the lower court's[46] suggestion that *Schwinn* mandated per se vertical treatment for dual distribution restraints imposed by a manufacturer.[47] The court stated that proper characterization depended upon the restraint's purpose rather than its source.[48] Like the *Krehl* court, the *Rice Tire* court indicated that restraints imposed to improve interbrand competition are vertical; restraints imposed to promote price fixing, however, are horizontal.[49]

In *Red Diamond Supply, Inc. v. Liquid Carbonic Corp.*[50] the Fifth Circuit expanded the class of restraints subject to the rule of reason with its sweeping proposition that all restraints imposed by a dual dis-

42. [1980-2] Trade Cas. (CCH) ¶63,341, at 75,743.

43. *See, e.g.,* Sherman v. British Leyland Motors, Ltd., 601 F.2d 429 (9th Cir. 1979); Dougherty v. Continental Oil Co., 579 F.2d 954 (5th Cir. 1978), *vacated and dismissed by stipulation,* 591 F.2d 1206 (5th Cir. 1979).

44. One commentator has suggested that vertical restrictions imposed by a dual distributor who "retains an exclusive area or category of customers and prevents dealers from engaging in what otherwise would constitute substantial intra-brand competition with the manufacturer" are illegal per se or at least carry a strong presumption of illegality. Pitofsky, *supra* note 14, at 28. Pitofsky states that "where a supplier retains an area or class of customers exclusively for itself, it is in effect agreeing horizontally with distributors in adjacent territories that they will not compete." *Id.* at 32.

45. 638 F.2d 15 (4th Cir.), *cert. denied,* 102 S. Ct. 324 (1981).

46. 483 F. Supp. 750 (D. Md. 1980).

47. The Fourth Circuit said:

> We must reject, however, any implication arising from the district court's discussion of *Schwinn* that a restraint may always be regarded as vertical if it is imposed by the manufacturer. Although the Supreme Court did emphasize in *Schwinn* that the source of the restrictions in that case was the manufacturer, it went on to distinguish the restrictions under consideration from "horizontal restraints in which the actors are distributors with or without the manufacturer's participation." . . . [I]t is important to distinguish between a conspiracy among dealers and their supplying manufacturer for the purpose of retail price maintenance that would benefit the dealers and one involving the same parties but redounding primarily to the benefit of the manufacturer as a result of increased interbrand competition. A restraint imposed by the former conspiracy would be horizontal in nature and *per se* illegal, while one imposed by the latter would be vertical and analyzed under the rule of reason.

638 F.2d at 16.

48. *Id. See* note 47 *supra.*

49. 638 F.2d at 16. *See* notes 34-37 *supra* and accompanying text.

50. 637 F.2d 1001 (5th Cir.), *cert. denied,* 102 S. Ct. 119 (1981).

tributor are per se vertical.[51] Rejecting the lower court's horizontal characterization,[52] the Fifth Circuit relied on *Schwinn* and held that trade agreements between a manufacturer and its distributors are horizontal only when the agreements involve a combination of distributors.[53] The court interpreted *Schwinn* and *H & B Equipment* as mandating per se vertical treatment of all restraints imposed by a manufacturer on its distributors.[54] Consequently, Red Diamond's allegation that Liquid had imposed territorial and customer restraints upon its distributors required that the Fifth Circuit hold the restraint to be vertical.[55]

Citing *Schwinn* and *H & B Equipment*, the court specifically rejected Red Diamond's contention that Liquid's dual distributor status required a horizontal characterization.[56] The court reasoned that in a dual distribution system the distributors are not the manufacturer's competitors; rather, they act as its agents in pursuit of a common purpose, the efficient marketing of the manufacturer's product.[57] The Fifth Circuit warned that if the distributors own and control the supplying entity, their relationship, although it may appear vertical, is actually horizontal.[58]

In *Red Diamond*, the Fifth Circuit fell into the trap that the Fourth Circuit carefully avoided in *Rice Tire*.[59] Although the Fourth Circuit

51. *Id.* at 1004.

52. *See* note 6 *supra* and accompanying text.

53. 637 F.2d at 1004. *See* note 31 *supra*.

54. After reviewing *Schwinn*, *see* note 31 *supra*, the *Red Diamond* court quickly concluded that "when the manufacturer is the source, the conspiracy is vertical." 637 F.2d at 1004. *See* notes 30-32 *supra* and accompanying text.

55. 637 F.2d at 1004.

56. *Id.* The court distinguished its earlier decision in Hobart Bros. Co. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir. 1973), on the ground that Gilliland, a Hobart distributor, also manufactured its own products that directly competed with certain Hobart products, thereby making the competitive nature of their relationship more pronounced. *Id.* at 1005. The *Hobart* court, however, also declared that Hobart's relationship with its other dealers that did not manufacture competing products was horizontal. *Id.* at 899. Consequently, the Fifth Circuit's attempt to distinguish *Hobart* in *Red Diamond* is imprecise. *See* note 25 *supra* for further discussion of *Hobart*.

57. 637 F.2d at 1005.

58. Like the court in *Krehl*, the Fifth Circuit was concerned with the *Topco* situation. *See* note 36 *supra*.

After concluding that Liquid's relationship with its dealers was vertical, the court analyzed the agreements under the rule of reason. Because Red Diamond failed to prove any anticompetitive effect, the court found no violation. 637 F.2d at 1007.

59. *See* notes 45-49 *supra* and accompanying text.

correctly interpreted *Schwinn* as a purpose-oriented test,[60] the Fifth Circuit, misled by its earlier decision in *H & B Equipment*, failed to perceive *Schwinn*'s limitations.[61] Although the *H & B Equipment* court also relied on *Schwinn* for the proposition that restraints are horizontal only when imposed by a combination of distributors, it did not interpret *Schwinn* as mandating per se vertical treatment for manufacturer imposed restraints. Instead, the *H & B Equipment* decision proposed that unilateral marketing decisions carried out by a manufacturer without the involvement of its distributors are vertical restraints.[62] Because the restraints in *Red Diamond* involved both the manufacturer and distributors, the court's reliance on *H & B Equipment* was misplaced.[63]

The Fifth Circuit's perception of the distributors' role in a marketing system fails to recognize the realities of the market place.[64] Although distributors are concerned with efficient marketing of the manufacturer's product, they are concerned also with their own success. These two interests do not always coincide.[65] The courts in *Rice Tire*, *Westpoint Pepperrell*, *Krehl*, and *Schwinn* recognized that although certain arrangements between a manufacturer and distributor are nominally vertical, they are simply attempts by competitors to divide markets horizontally and fix prices.[66] In *Rice Tire* the Fourth Circuit recognized that although exclusive territorial restraints can improve interbrand competition, they also permit distributors to charge monopolistic prices.[67] Manufacturers attract distributors by offering exclusive

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60. *See* notes 47-48 *supra* and accompanying text.

61. *See* notes 30-32 *supra* and accompanying text.

62. *See* note 32 *supra* and accompanying text.

63. Although the decision to eliminate the dealer in *H & B Equipment* required no cooperation between the manufacturer and other dealers, *see* note 32 *supra*, the vitality of the alleged restraints in *Red Diamond* did depend upon such cooperation. 637 F.2d at 1002. Therefore, unlike the manufacturer in *H & B Equipment*, Liquid was acting in concert with its independent distributors. This distinction indicates that restraints imposed by a manufacturer are not always unilateral conduct under *Schwinn*. *See* note 31 *supra* and accompanying text.

64. *See* note 57 *supra* and accompanying text.

65. A distributor is concerned with maximizing his profit. One method of increasing one's profit margin is inflating the price. Such activity, however, often results in less demand for the manufacturer's product.

66. *See* notes 34-49 *supra* and accompanying text.

67. *See* note 49 *supra* and accompanying text. Because exclusive distributorships eliminate intrabrand competition, distributors, absent intense interbrand competition, are free to maintain their prices at artificially high levels. *See generally* Schildkraut, *supra* note 13, at 342.

distributorships.[68] If the purpose of the exclusive distributorship is to facilitate price inflation, then such arrangements are horizontal restraints under *Rice Tire* and *Schwinn*.[69] The Fifth Circuit's test fails to accommodate the horizontal nature of these situations.[70]

The *Red Diamond* court's failure to require an inquiry into the purpose or effect of the restraint is a radical departure from previous case law. Such an inquiry is essential to proper characterization of dual distribution restraints. *Krehl*'s three part inquiry offers the most flexible approach because it focuses on the individual conditions of a manufacturer's marketing system.[71] In contrast, the *Red Diamond* per se approach is wholly inadequate.[72]

By adopting a per se approach to characterization in *Red Diamond*, the Fifth Circuit has intensified the conflict surrounding the legality of dual distribution restraints. In the wake of *Red Diamond* a host of divergent precedents remain, ranging from per se horizontal treatment to per se vertical treatment.[73] Until the Supreme Court addresses the issue, this conflict will persist.

B.S.M.

68. Manufacturers attract unwilling distributors to market their product by promising them the larger profit margins guaranteed by exclusive territories.

69. *See* notes 47-49 *supra* and accompanying text.

70. Although the Fifth Circuit recognized the horizontal aspects of the *Topco* situation, *see* note 58 *supra*, it failed to recognize that a manufacturer and an independent distributor as competitors can agree to restrain trade.

71. *See* notes 34-37 *supra* and accompanying text.

72. The Fifth Circuit per se vertical rule is as simplistic as the pre-*Sylvania* horizontal rule. *See* notes 22-26 *supra* and accompanying text.

73. The current case law includes Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15 (4th Cir.) (purpose oriented test), *cert. denied*, 102 S. Ct. 324 (1981); Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001 (5th Cir.) (per se vertical treatment), *cert. denied*, 102 S. Ct. 119 (1981); Martin B. Glauser Dodge Co. v. Chrysler Corp., 570 F.2d 72 (3d Cir. 1977) (nonclassification rule of reason approach); Hobart Bros. Co. v. Malcolm T. Gilliland, Inc., 471 F.2d 894 (5th Cir.) (per se horizontal analysis), *cert. denied*, 412 U.S. 923 (1973); Krehl v. Baskin-Robbins Ice Cream Co., [1979-2] Trade Cas. (CCH) ¶ 62,806 (C.D. Cal.) (three part inquiry into nature of relationship and purpose of restraint).