The Vertical Restraints’ Paradox: Justifying the Different Legal Treatment of Price and Non-price Vertical Restraints

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Abstract

In a case currently pending before the U.S. Supreme Court the court has been urged to overrule the longstanding per se illegality rule presently applicable to minimum resale price maintenance, or RPM. Over the past fifty years antitrust theorists and economists have advanced several pro-competitive explanations for RPM. Additionally, scholars have argued that non-price vertical restraints (such as territorial exclusivity) and RPM have similar effects on price and quantity and should therefore be treated similarly by law. Nearly thirty years ago, the Supreme Court ruled that non-price vertical restraints should be subject to a rule of reason, acknowledging their pro-competitive potential. Since no explanation has been forwarded to justify treating RPM differently, there seems to be good reason to rectify the inconsistency and subject RPM to a rule of reason too. And indeed, the Court has recently granted Certiorari, signaling at least a willingness to reconsider its position. In the following I argue that legal policymakers’ current approach is economically justified. I show that all pro-competitive explanations for RPM suffer from a common flaw, the possibility of non-price competition, which challenges RPM’s ability to achieve any of the pro-competitive goals attributed to it. I then proceed to show that non-price vertical restraints are capable of achieving the pro-competitive goals which RPM is incapable of achieving. This justifies both applying a per se illegality rule to RPM and applying a different rule, namely a rule of reason, to other vertical restraints.

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Introduction

An upstream firm (normally a manufacturer) may impose certain restrictions on independent downstream firms (normally retailers) reselling its product. Such restrictions are generally referred to as ‘intra-brand restraints’, because they regulate distributors’ conduct with regard to a certain brand and do not affect the resale of other brands.¹

Intra-brand restraints can be further divided into two subgroups. One kind of intra-brand restraints is minimum resale price maintenance [RPM]. RPM is a practice whereby the manufacturer sets a minimum price below which retailers may not resell its product.² It is also referred to as ‘vertical price-fixing’.³ A second kind of intra-brand restraints a manufacturer may impose are restraints that do not directly regulate retail price. The manufacturer may, for example, confine each of the retailers selling the product to a specific territory. She may allow each retailer to sell only to a specified class of customers. These are known as territorial exclusivity and customer allocation, respectively. They are regularly referred to as non-price vertical restraints.⁴

The contemporary scholarly view is that RPM is pro-competitive because it achieves a host of pro-competitive goals. This has led scholars to generally advocate a lenient legal approach to RPM, arguing that it should be scrutinized under the rule of reason. Some scholars have even argued that RPM should be per se legal. That is, that it should never be prohibited by antitrust law.⁵ In the 2000 supplement of their treatise Areeda and Hovenkamp summarize the contemporary view as follows:

¹ See H. Hovenkamp, Federal Antitrust Policy, 2nd ed. (St. Paul: West Group, 1999) at 441.
² My argument does not apply to maximum RPM, which despite the similarity in name has very different competitive effects from minimum RPM. I hereinafter use RPM as shorthand for minimum RPM.
⁴ Hovenkamp, supra note 1 at 441.
“It now seems clear that nearly all instances of resale price maintenance are beneficial to consumers and cannot reasonably be construed as efforts to restrain trade or monopolize any product or service”.\(^6\)

Another line of argument, closely related to the first, is that RPM is no more harmful to competition than non-price vertical restraints. Scholars have pointed to the fact that the effects RPM has on price and quantity are similar to those of non-price vertical restraints.\(^7\) Some have even argued that since RPM eliminates only price competition whereas non-price vertical restraints eliminate all forms of competition, non-price restraints are more potentially harmful to competition than RPM.\(^8\)

The treatment of vertical restraints across jurisdictions sharply diverges from what is considered by the vast majority of scholars to be the appropriate treatment, at least with regard to RPM. RPM is generally illegal \textit{per se}. That is, it is condemned with no inquiry required into its actual effects on competition under the specific relevant market circumstances. With few exceptions for certain goods (most commonly books and newspapers), RPM is illegal \textit{per se} in the U.S.,\(^9\) Canada,\(^10\) the UK,\(^11\) the E.U.\(^12\) and Australia.\(^13\) In addition to


\(^7\) \textit{E.g.} R. Whish, \textit{Competition Law} 3\textsuperscript{rd} ed. (London: Butterworths, 1993) at 545; Easterbrook, \textit{supra} note 5.


\(^9\) \textit{Dr. Miles Medical Co. v. John D. Park & Sons Co.}, 220 U.S. 373 (1911) [\textit{Dr. Miles}]. For a survey of the developments and changes in the law see text accompanying \textit{infra} notes 27 - 40.

\(^10\) \textit{The Competition Act}, R.S.C. 1985, c. C-34


\(^12\) On the treatment of RPM by E.U. authorities see text accompanying \textit{infra} notes 41 - 53.

\(^13\) Articles 47 & 48 of the \textit{Trade Practices Act}, 1974 (CTH). Article 96(3) includes a list of practices which constitute resale price maintenance (by virtue of Article 96(1)), including termination of supplies to discounters (Art. 96(3)(a)). Article 97 permits recommending resale prices.
its general prohibition by E.U. authorities European countries such as Italy, Finland, Germany, Hungary, France, Spain, Norway, Sweden, and Ireland have also enacted explicit legislation prohibiting RPM. Non-price vertical restraints, by contrast, are treated more favorably and are generally subject to a rule of reason. However, none of the competition authorities upholding this different treatment has offered an economic justification for their treatment of RPM or for their different treatment of non-price vertical restraints. It is my purpose in this paper to offer such a justification and to contest the contemporary scholarly view. I argue that RPM cannot achieve any of the pro-competitive goals ascribed to it by scholars. I then show that non-price vertical restraints may achieve these same goals.

In a case currently pending before the U.S. Supreme Court the court has been urged to revisit its nearly century old condemnation of RPM. On December 7th 2006 the court decided to grant Certiorari and the issue will be dealt with in the upcoming session. Against the backdrop earlier described there would seem to be little reason, at least from a theoretical economic perspective, for the Supreme Court not to overrule its

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14 Article 2(2)(a) of Law No. 287 of October 10th 1990 Competition and Fair-Trading Act as translated by the Italian competition authority, online: Italian Competition Authority [http://www.agcm.it/eng/index.htm].
16 Act Against Restraints of Competition, as translated in OCDE/GD(97)229, ibid. at 65.
17 OCDE/GD(97)229, ibid. at 71.
18 Law 86-1243, article L 410 1 Code De Commerce, as translated in Holmes & Cerdan, supra note 11 at 14. Certain products are exempt, and the Government has the general power to control prices, after consulting the competition authority, in markets where price competition is limited by monopoly, long term supply problems, or regulation. See Holmes & Cerdan at 14.
19 Article 1(1)(a) of The Defence of Competition Law. Books and pharmaceuticals are exempt from the prohibition.
20 The Competition Act of 2004, Article 10(a), as translated to English by the Norwegian competition authority, online: [http://www.konkurransetilsynet.no/internett/index.asp?strUrl=1004939i].
21 Article 6(2)1 of the Swedish Competition Act, 1993 as translated to English by the Swedish competition authority, online: [http://www.kkv.se/eng/competition/competition_act_fulltext.shtml].
22 Competition Act, 2002, Article 4(1). For an interpretation of Art. 4(1) as prohibiting RPM see Case Com/98/02 Decision of the Competition Authority No. E/03/002, Agreements between Statoil Ireland Limited and motor fuels retailers allegedly fixing the retail price of motor fuels in Letterkenny online: [http://www.tca.ie/decisions/enforcement/e_03_002.pdf].
23 On the various exemptions see Whish, supra note 7 at 564. See also Marjorie Holmes & Clara Cerdan, supra note 11.
24 See text accompanying infra notes 27 - 53.
longstanding *per se* illegality rule. This paper can contribute to the debate (and hopefully the outcome) by offering a theoretical justification for the court’s current position.

The remainder of this paper is structured as follows: Section I reviews the state of the law with regard to vertical restraints in the U.S. and in the E.U. Section II reviews the anti-competitive effects that both RPM and other vertical restraints may have. Section III reviews the pro-competitive explanations for vertical restraints and explains why they fail to justify RPM but may well justify the employment of non-price vertical restraints. Section IV considers the appropriate rule of law for the different kinds of vertical restraints.
I. The State of the Law

1. RPM and Non-price Restraints in the U.S.

Section 1 of the Sherman Act\(^\text{27}\) prohibits “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce...”. The courts have interpreted the act to prohibit only unreasonable restraints of trade.\(^\text{28}\) The rule usually applied to business practices has become known as a rule of reason. According to this rule, the actual (or potential) competitive effects of a challenged practice under the relevant market circumstances are analyzed in order to make a decision regarding the legitimacy of the practice.\(^\text{29}\) Restraints found to be reasonable are not condemned, whereas unreasonable restraints of trade are. Certain practices, however, have been found to be inherently unreasonable.\(^\text{30}\) When such practices are concerned, no inquiry into their actual effect is required. They are illegal \textit{per se}.\(^\text{31}\) The \textit{per se} illegality rule is appropriate for such restraints of trade

“...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”.\(^\text{32}\)

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\(^{27}\) 15 U.S.C.A § 1 (1890).


\(^{29}\) \textit{Standard Oil Co. v. United States} 221 U.S. 1 at 59-62 (1911) [\textit{Standard Oil}]. While the rule of reason was articulated in \textit{Standard Oil} the use of the phrase “rule of reason” in the context of the legitimacy of restraints of trade was first used by Justice White in his dissenting opinion in \textit{United States v. Trans-Missouri Freight Association} 166 U.S. 290 at 355 (1897) [\textit{Trans-Missouri}]. It has been argued, however, that this was a mere “unfortunate choice of words”. See Robert H. Bork, \textit{The Antitrust Paradox} (New York: The Free Press, 1978) at 24.


\(^{31}\) The articulation of an explicit \textit{per se} rule was only achieved in \textit{United States v. Socony-Vacuum Oil Co.}, 310 U.S. 150 (1940) [\textit{Socony-Vacuum}]. However, The foundations of the \textit{per se} illegality rule were actually laid down in \textit{Standard Oil, supra} note 29 at 65, where Justice White reconciled the court’s rule of reason with the previous opinions that had focused on the character of the restraint rather than on its effect by saying that the agreements addressed in those cases were of the kind that created a conclusive presumption of an injury to competition, and thus “resort to [the rule of reason] was not permissible in order to allow that to be done which the statute prohibited”. The opinion of the majority \textit{Trans-Missouri supra} note 29, does in fact too create a \textit{per se} rule. For a survey of the development of the \textit{per se} rule in the years between \textit{Standard Oil} and \textit{Socony-Vacuum} see “The Rule of Reason”, \textit{supra} note 28 at 45-53.

In 1911, in its *Dr. Miles* ruling, the U.S. Supreme court subjected RPM to the *per se* illegality rule.\(^{33}\) Non-price vertical restraints, by contrast, were ultimately subjected to a rule of reason.\(^{34}\) Although U.S. authorities have generally maintained the *per se* illegality rule for RPM, there have been several deviations from the *per se* illegality rule during this time. The most significant of these deviations occurred in 1937 when Congress enacted fair trade laws which essentially legalized RPM across the U.S.\(^ {35}\) These laws were repealed nearly forty years later, in 1975.\(^ {36}\) In addition, there have been several Judiciary deviations from the *per se* illegality rule, some of which rely on the pro-competitive justifications for RPM.\(^ {37}\) The Department of Justice too was persuaded by the pro-competitive explanations, and in 1977 it filed an *Amicus* brief in a civil suite, urging

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\(^{33}\) *Dr. Miles*, *supra* note 9. As Gordon notes in J.S. Gordon, “horizontal and vertical restraints of trade: the legality of motion picture splits under the antitrust laws” (1965) 75 Yale L.J. 239, the *Dr. Miles* court did not use the *per se* terminology. However, this should not lead to the conclusion that the *Dr. Miles* court intended to subject RPM to a rule of reason analysis. First, as mentioned, the terminology of *per se* illegality did not exist at the time the court delivered the *Dr. Miles* judgment. It was only introduced in *Socony-Vacuum*, *supra* note 31 (at 218), nearly thirty years later. Second, the court’s reasoning, even if it is to be treated as laying down a rule of reason, leaves virtually no circumstances under which RPM can be found legitimate (see Roger D. Blair, & David L. Kaserman, *Law and Economics of Vertical Integration and Control* (New York: Academic Press, Inc., 1983) at 158). More importantly, the court’s true intention is of little importance if legal doctrine has understood the rule laid down by it to be a *rule of per se* illegality. For almost 100 years courts and scholars have interpreted *Dr. Miles* to be the milestone of the *per se* illegality rule of RPM, as have commentators. See Robert Pitofsky, “In Defense of Discounters: The No-Frills Case for a *Per Se* Rule Against Vertical Price Fixing” (1983) 71 Georgetown L.J. 1487, n. 3, Richard A. Posner, “The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision” (1977) 45 U. Chicago L.R. 1, Robert H. Bork, “Vertical Restraints: Schwinn Overruled” 1977 Sup. Ct. Rev. 171 at 179, Phillip E. Areeda, *Antitrust Law* (Boston: Little, Brown, & Company, 1989) vol. 8, Comanor, *supra* note 8 at 984. Therefore, even if the original intention of the court was not to set a *per se* rule – the *per se* illegality of RPM is well established.

\(^{34}\) *Continental T.V. v. GTE Sylvania*, 433 U.S. 36 (1977) [*Sylvania*]. This overruled what was then a 10-year old judgment finding such restraints to be *per se* illegal: *United States v. Arnold, Schwinn and Co.*, 388 U.S. 365 (1967).

\(^{35}\) In 1937 Congress enacted the Miller-Tydings Act [50 Stat. 693 (1937)], later supplemented by the McGuire Act [66 Stat. 632 (1952), 15 U.S.C.A § 45 (Supp., 1953)], both of which complemented widespread state legislation by legalizing RPM on a federal level when it was permitted by state law. By 1951 all but two states (Texas and Missouri) and the District of Columbia had fair trade laws in place. The *de facto* effect of the state fair trade laws coupled with the federal fair trade laws was to legalize RPM throughout the U.S. for almost forty years. See Comments, “Resale Price Maintenance and the Anti-trust Laws” (1951) 18 University of Chicago L.R. 369 at 373.

\(^{36}\) In 1975 Congress repealed the fair trade laws through the enactment of the Consumer Goods Pricing Act [89 Stat. 801 (1975)].

\(^{37}\) The most important of these Judiciary deviations is *United States v. Colgate & Co.*, 250 U.S. 300 (1919). *Colgate* was not influenced by the pro-competitive explanations, which did not exist at the time it was decided. However, subsequent judgments upholding *Colgate* do rely on some of these explanations. *Broxmeyer v. Polikoff*, 39 Pa.D.&C. 224 (1940) is one such example. For a survey of some of these decisions see Warren-Boulton, “Resale Price Maintenance Reexamined: *Monsanto v. Spray-Rite*” in J. Kwoka Jr. & L. White, eds. *The Antitrust Revolution* (Glenview: Scott, Foresman and Company, 1989) 375.
the Supreme Court to overrule the per se illegality rule and equate the treatment of RPM with that of non-price vertical restraints. Ultimately, the Supreme Court upheld the per se illegality rule for RPM, but it did slightly weaken it.\textsuperscript{38} The Legislature, the Judiciary, and the Department of Justice have all, at different times, questioned the justifiability of the per se illegality rule.\textsuperscript{39} Although the current state of the law is that RPM is per se illegal whereas non-price vertical restraints are subject to a rule of reason, the influence of the pro-competitive explanations is certainly felt among U.S. authorities. As Areeda and Hovenkamp state:

\begin{quote}
“While it is nominally illegal per se, the courts have construed this per se rule in an extraordinary narrow way by distinguishing between unilateral and collaborative conduct, and with a very narrow definition of ‘price’”.\textsuperscript{40}
\end{quote}

2. RPM and Non-price Vertical Restraints in the E.U.

Article 81 (formerly article 85) of the Treaty of Rome\textsuperscript{41} condemns agreements between undertakings which have as their object or effect the prevention, restriction, or distortion of competition. The E.U. thus embraces a distinction similar to the one applied in the U.S. Practices that have as their objective the restriction, distortion, or prevention of competition are condemned regardless of their actual effect, whereas other practices are condemned only if their effect is to restrict, distort or prevent competition.\textsuperscript{42} In the early Grundig case the European Court of Justice rejected the proposition that article 81 does not apply to vertical agreements.\textsuperscript{43} It ruled that article 81

\begin{quote}
“refers in a general way to all agreements which distort competition within the Common Market and does not establish any distinction between those agreements as to whether or not
\end{quote}

\textsuperscript{38} Monsanto Co. v. Spray-Rite Service Co. 465 U.S. 752 (1984). While upholding the per se illegality rule, Monsanto required the plaintiff to provide evidence of an agreement or a joint understanding between the manufacturer and the terminated dealer’s competitors. For accounts of how Monsanto undermined the per se illegality rule see Charles J. Goetz & Fred S. McChesney, Antitrust Law: Interpretation And Implementation 2nd ed. (Newark: LexisNexis, 2002) at 526-527, R.J. Roberts, Roberts on Competition/Antitrust: Canada and The United States 2nd ed. (Toronto: Butterworths, 1992) at 185 ch. 9 n 1.

\textsuperscript{39} Monsanto itself refused to overrule the per se illegality rule because it was well established for over 70 years, not because the court found it justifiable (465 U.S. 769). And, as mentioned, it placed a more difficult burden of proof on the plaintiff.

\textsuperscript{40} Areeda & Hovenkamp, supra note 6 at 504.


they were made between operators competing at the same stage or between non-competing operators placed at different stages”.

It also clarified that

“[f]or the purpose of applying Article [81(1)], it is superfluous to take account of the concrete effects of an agreement once it appears that it has as its objective the prevention, restriction, or distortion of competition”.

The standard according to which non-price vertical restraints are assessed is a rule of reason. They are examined in their economic context in order to assess their actual effect on competition. RPM, by contrast, has been persistently held as a practice that has as its objective the elimination of competition, by both the European Commission and the European Court of Justice. Therefore, unlike non-price vertical restraints, it is subject to a per se illegality rule and is condemned regardless of its actual or potential competitive effects.

Moreover, the European Commission has recently introduced a Block Exemption Rule for vertical agreements [BER] followed by an official set of guidelines published in October 2002, which exempts vertical restraints – under certain conditions - from the application of article 81(1) in accordance with article 81(3). Article 4(a) of the BER as well as section 47 of the guidelines blacklist vertical price restraints, clarifying that an otherwise permissible vertical restraint will lose its exemption if it is accompanied by a price restriction. RPM was also blacklisted by the predecessors of the current BER, as well as by the

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44 Ibid. at 470.
45 Grundig, supra note 43 at 473.
47 Whish, supra note 42 at 596.
51 Neither of the BER’s predecessors, Regulations 1983/83 (OJ 1983 L173/1) and 67/67 (OJ 57, 1967, 849/1, extended by virtue of reg. 2591/72 and 3577/82) applied to agreements including RPM. See Art. 2(2) of Reg. 1983/83 and Art. 2(1)(a) of Reg. 67/67.
European Court of Justice, which held that an agreement containing RPM cannot enjoy an exemption under article 81(3) even on an *ad hoc* basis. The numerous arguments for the legalization of RPM have not persuaded E.U. authorities in the past and do not seem to be persuasive at present. E.U. authorities are not expected to change their position in the near future.


53 *Whish, supra* note 7 at 563.
II. Anti-Competitive Effects of Vertical Restraints

1. Retail-level Cartels

The first anti-competitive use of vertical restraints is as an enforcement mechanism for a retail-level cartel. Every cartel is, by its nature, unstable. Once a dimension of competition has been restricted, each cartel member has an incentive to compete along that dimension and hope that others adhere to the agreement. In the context of a price-fixing cartel, each cartel member has an immediate incentive to offer the product for a price that is slightly below the cartel price. If all other members of the cartel adhere to the agreement, the defecting member will enjoy both a supra-competitive return and an increase in market share at the other members’ expense.\(^54\) Each cartel member is therefore better off if others price at the agreed cartel price and he himself does not. Since each of the cartel members faces the same set of incentives each will try to under-price the other cartel members, and price will return to the competitive level. Therefore, cartels generally require an enforcement mechanism.\(^55\) A common distributor is frequently used by cartels as an enforcement measure. The common distributor is in a good position to both detect cheating attempts and prevent such cheating (by refusing to distribute the increased quantities of the cheating member).\(^56\) A mutual supplier may work very similarly as an enforcer. The cheating member will naturally need a larger quantity of the product to meet the excessive demand stimulated by the price cut. The supplier of the product will know relatively quickly not only that a cartel member is cheating, but also which cartel member is cheating. And the common supplier is in a good position to prevent and punish the defecting retailer by withholding supplies, so cheating becomes less attractive thus stabilizing the cartel.\(^57\)

Rather than agree on price, retailers may agree to divide the market between them. For example, they may agree that each retailer will be assigned a group of customers to which no other retailer is allowed to make a

\(^{54}\) In the theoretical setting of perfect competition the cheating cartel member will accrue all of the sales.

\(^{55}\) See Easterbrook, supra note 5 at 141.

\(^{56}\) Hovenkamp, supra note 8 at 87.

\(^{57}\) The use of a mutual supplier and not a common distributor is especially attractive when the cartel is a dealers’ cartel as opposed to any other cartel. First, retailers are by definition the final link in the chain of production. They are therefore technically prevented from using a common distributor because they simply do not have distributors. Second, for other cartels a common distributor may be preferable to a common supplier as an enforcer because a common distributor receives the final output from cartel members and is consequently in a good position to monitor and control their output. Suppliers, by contrast, supply an input used by the cartel members in the production of the final good. Cheating cartel members may alter their production process and substitute other inputs for the enforcing supplier’s product or change the proportions of the supplier’s product they use to produce their final good, making cheating again possible. Other cartels may consequently find that a common supplier is not a full-proof enforcement tool. In the case of retailers who simply resell a product manipulation of this kind is impossible. Cartel members simply cannot cheat by selling a different quantity using the same inputs.
sale (customer allocation). This gives each retailer (artificial) market power vis-à-vis his assigned customers, and allows the retailer to charge these customers a supra-competitive price. Similarly, retailers may assign exclusive territories to each retailer, allowing each retailer to charge consumers within the territory supra-competitive prices.\(^5^8\) The dimension of competition cartel members choose to eliminate will vary according to the nature of competition and the relevant features of the product, the geographical market, and consumers. For example, exclusive territories may be more lucrative than price-fixing under certain circumstances because they allow each retailer to price-discriminate within the territory and enlarge his own surplus.\(^5^9\) On the other hand, price-fixing may be preferable when moving between territories is easy and inexpensive so that consumers will generally be willing to travel between territories to purchase the product for a cheaper price, making territorial division impractical.\(^6^0\) But the essence of both kinds of horizontal agreements is the same: eliminating a dimension of competition so that cartel members are able to make supra-competitive returns.\(^6^1\)

Both RPM and non-price vertical restraints may be used as an enforcement mechanism for a retail-level cartel. RPM will be used to enforce a price-fixing cartel, whereas territorial restraints and customer allocation may be used to enforce a market division cartel. Each kind of vertical restraint may therefore have an anti-competitive effect when used to enforce a dealers’ cartel. By having an upstream firm ‘impose’ vertical restrictions on them, the downstream-level cartel members sustain their cartel.\(^6^2\)

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\(^5^8\) Hovenkamp, *supra* note 8 at 88 – 89 (see also p. 70 – 74 for a discussion on the geographic market). For a real-life example of price increase brought about by a horizontal territorial market division see *Jay Palmer et al. v. BRG of Georgia, Inc. et al.* 498 U.S. 46 (1990).

\(^5^9\) Another potential advantage of market division compared to price-fixing is that market division eliminates all forms of competition and not only price competition. Therefore, cheating on the cartel through a host of non-price avenues – an option I elaborate on later (see *infra* notes 76 - 81 and accompanying text) - is prevented. However, in the context of a price-fixing cartel non-price dimensions of competition may not be very harmful to the stability of the cartel because they are less lucrative than price competition. That is, consumers find free gifts, for example, less attractive than a price discount equal to the value of the gift. If that were not the case, price fixing cartels would not be in any way profitable and would not exist. See W.S. Bowman, “The Prerequisites and Effects of Resale Price Maintenance” (1955) 22 U.Ch.L.R. 825 at n. 29.

\(^6^0\) Or if circumstances, such as the low transportation costs associated with shipping the product or the inability of each member to perfectly monitor what happens within that member’s territory, make it easy to for cartel members to cheat by making sales outside their respective territories. See Hovenkamp, *supra* note 8 at 89.

\(^6^1\) It is for this reason that horizontal market division has been ruled illegal *per se*. See *United States v. Topco Associates, Inc.*, 405 U.S. 596 (1972) and *United States v. Sealy, Inc.*, 388 U.S. 350.

\(^6^2\) The enforcing supplier should generally be reluctant to impose such restraints because the supplier is harmed by the cartel in much the same way that consumers are. A smaller quantity is cleared by the market due to the cartel and therefore total revenue
2. Manufacturers’ Cartel

A second anti-competitive use of vertical restraints may be as a stabilizing tool for a manufacturing-level cartel. An upstream-level cartel may employ RPM as an incentive management tool or as an information tool.  

As an incentive management tool RPM may be used by members of a manufacturers’ cartel who have fixed wholesale prices to reduce each of the members’ incentive to cheat on the cartel. If retail prices are fixed, a cheating manufacturer cannot hope that a reduction in wholesale prices will result in lower retail prices. Consequently, the manufacturer cannot hope to increase volume by cheating on the cartel, and the fixed wholesale price is secured. Simply restricting retail price reductions will not, however, eliminate the cartel members’ incentive to cheat on the agreement. Lowering wholesale prices by a single manufacturer will still increase volume and therefore be profitable, because retailers will buy for the lowest price they can even if they cannot pass the concession on to consumers. Although RPM prevents them from increasing volume, retailers will buy more of their desired quantity from the cheating manufacturer. In order to ensure that RPM indeed sustains their cartel manufacturers need to eliminate each of the cartel members’ possibility of increasing output at other members’ expense by luring retailers away from other cartel members. RPM as an incentive management tool therefore requires a complementary measure – assigning exclusive dealers to each manufacturer and effectively preventing cartel members from selling through any other outlet, whether it is a new retailer or a retailer who has been ‘stolen’ from another manufacturer.  

Another use of RPM as a facilitating tool for a manufacturers’ cartel is as an information tool. When an RPM system is employed and retail prices are fixed, any reduction in the quantity sold by one manufacturer means that another cartel member has lowered wholesale prices to retailers. Of course, RPM is insufficient to conclusively implicate a cheating manufacturer. If quantities bought from a specific cartel member fall, that decreases. This, however, simply means that retailers must offer some inducement, namely a share of the supra-competitive rents, to the manufacturer.

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63 Iacobucci, supra note 5 at 94.
66 Telser, ibid. at 97, Blair & Kaserman, ibid. at 355; Ornstein, ibid. at 407 & 414, Areeda, supra note 33 at 99.
manufacturer cannot know if this is a result of another cartel member lowering prices or of a raise in retail costs. So further inquiry is required, and RPM can only signal that cheating may be occurring, not that it necessarily is. But even this information may well be valuable.

The upshot of this analysis is that RPM may be a tool used by a manufacturers’ cartel to stabilize the cartel. Despite some scholars’ argument that RPM as a facilitating tool for a manufacturers’ cartel is implausible, it is quite plausible as a theoretical possibility and empirically RPM has in fact been used in the past to sustain long-lasting manufacturers’ cartels.

Much like RPM, non-price vertical restraints may be used as a facilitating device for an upstream cartel. For example, vertical non-price restrictions may be used as an information tool, making monitoring of the cartel easier. By limiting the number of retail outlets that carry the product within a given territory, manufacturers make it easier for each other to detect cartel cheating. A manufacturer observing a drop in market share


needs to explore the reasons for this across fewer outlets than she otherwise would have. So non-price vertical restraints too may be used anti-competitively to sustain upstream level cartels.

As a sustaining measure for upstream cartels, vertical non-price restraints require an additional measure designed to overcome the double marginalization problem. When RPM is used as an enforcement mechanism, manufacturers can rely on competition between retailers to keep prices down to the RPM level. When non-price vertical restraints are used, by contrast, each retailer is given market power vis-à-vis that retailers’ consumers and is effectively turned into a local monopoly. Each retailer will regard the (cartelistic) wholesale price as given and, being a monopoly, will equate marginal cost to marginal revenue, restricting output to a suboptimal level from the supplying manufacturer’s perspective.\footnote{For a formal illustration of the double marginalization problem (although it is not labeled ‘double marginalization’) see Joseph J. Spengler, “Vertical Integration and Antitrust Policy” (1950) 58 J. Pol. Econ. 347.} In order to overcome the double marginalization problem, a manufacturers’ cartel using non-price vertical restraints to sustain the cartel, must supplement the restraints with a measure preventing retailers from raising retail prices further than mandated by the upstream cartelistic price. One such measure may be to impose a price ceiling, or maximum RPM.\footnote{On the use of maximum RPM to overcome the double marginalization problem see Jean Tirole, \textit{The Theory of Industrial Organization} (Cambridge: The M.I.T. Press, 1988) at 177 - 178.} Another such measure may be to charge retailers a per-unit competitive price, allow them to sell the product for a monopoly markup, and charge them a fixed franchise fee equal to the total monopoly gains.\footnote{See \textit{ibid.} at 176 – 177.} But regardless of the precise measure chosen, the double marginalization problem must be addressed if non-price vertical restraints are the chosen facilitating practice. This is not a significant qualification to the use of non-price vertical restraints as a stabilizing tool for a manufacturers’ cartel. Each cartel member needs to implement a vertical restraint system with that cartel-member’s retailers. Adding a price cap to the agreement with retailers is probably not a very heavy burden. On the other hand, it might require some negotiations with retailers which in turn implies incurring additional transaction costs. So non-price vertical restraints may be slightly less attractive as a facilitating device for a manufacturers’ cartel than RPM. But both kinds of vertical restraints may nonetheless be used anti-competitively in such a manner.

### 3. Summary: Anti-competitive Uses of Vertical Restraints

Both RPM and non-price vertical restraints may be used as an enforcement mechanism for a dealers’ cartel. RPM is more suitable for price-fixing cartels whereas non-price vertical restraints are better-suited to sustain market-division cartels. Both kinds of vertical restraints may also be used as a stabilizing device for a manufacturers’ cartel. In the context of an upstream cartel, however, it would generally seem that RPM is
slightly advantageous in comparison to non-price vertical restraints as a stabilizing mechanism because the use of non-price restraints as a stabilizing mechanism requires a supplement that RPM does not. But this is only a minor advantage, and both kinds of vertical restraints may be used to achieve anti-competitive goals.
III. Pro-Competitive Explanations for Vertical Restraints

Over the past 50 years, several pro-competitive justifications have been offered for vertical restraints. These will be reviewed next. Generally, I show that the explanations fail to justify RPM but may well justify the use of non-price vertical restraints.

1. The Free-Rider Explanation

The free-rider explanation is the cornerstone of the pro-competitive explanations. It was originally developed in 1955 by Bowman and subsequently refined by Telser in 1960. The free-rider problem exists when retailers are in a position to offer product-specific point-of-sale services that increase the total sales of the product. The provision of these services has two effects. One effect is to raise the retail price of the product, because retailers must recover the additional cost of providing the services. The second effect is to stimulate additional demand for the product. From the manufacturer’s standpoint the provision of these services is desirable if the cost of providing the services is offset by consumers’ added willingness to pay for the product, in which case the overall effect of providing the services is to increase demand despite the increase in price. The example both Bowman and Telser give of such services are pre-sale demonstrations, which for some products may be the most effective way of familiarizing customers with the features of the product. Although these services entail an additional cost of educating sales personnel, placing several products on display, and so on, these costs are offset by the increased demand for the product that they stimulate. Normally, there would be no need for the manufacturer’s intervention. Since consumers’ responsiveness to these services is such that the benefits from the services exceed their cost, retailers will provide the services simply because it is profitable to do so. The problem arises when these services create a positive horizontal externality. That is, once the services are provided by one retailer other retailers can refrain from providing the services and nonetheless benefit from the provision of these services by their competitor. Pre-sale demonstrations are a good example of services that create such an externality. Once they have been provided by one retailer, another retailer who has not incurred the cost of providing the services can offer the educated customer the same product for a lower price. Despite the fact that retailers as a whole (as well as the manufacturer) are better off if the services are provided, each of the retailers prefers to shirk on providing the services and have others provide them. None of the retailers will find it profitable to incur the cost of providing the services only to allow others to free ride on these services and under-price the service dealer.

73 Bowman, supra note 59.
74 Telser, supra note 65 at 89 & n. 4.
75 See Telser, ibid. at 91, Bowman supra note 59 at 841 - 842.
Consequently, the services will not be provided by any of the retailers. According to Bowman and Telser, RPM may be imposed by the manufacturer to overcome the free rider problem. RPM’s effect is twofold. First, the danger of those dealers providing the services (the service dealers) being under-pricing is removed. Second, since retailers cannot compete with each other on price they are forced to compete with each other on the provision of services. Once prices are uniform across retail establishments, consumers will have no incentive to buy the product from a non-service dealer and will purchase it from service dealers. Dealers will therefore invest the difference between wholesale price and the maintained resale price in providing the desired point-of-sale services. The excessive margin between wholesale price and retail price created by RPM will be competed away by retailers, who will all become service dealers.

RPM, according to this explanation, increases not only the manufacturer’s surplus but total welfare as well. The costs of providing the services, which consumers bear by paying higher prices for the product, are offset by the aggregate value that consumers place on the services.

The problem with the hypothesis is that it is susceptible to the non-price competition caveat. Retailers’ incentive to free ride on other retailers’ efforts is not curtailed by the introduction of RPM. What is curtailed, according to the hypothesis, is their ability to free ride. This implicitly assumes that there are only two possible dimensions of competition at the retail level: price competition (which RPM prevents) and providing the special services the manufacturer desires. But if retailers can free ride on the services when these are provided by other retailers (otherwise there is no need for RPM), there is nothing to prevent them from using the payment offered through RPM to finance other forms of non-price competition that will lure consumers away from the service dealers. Instead of pre-sale demonstrations retailers will offer free or discounted supplements to the product, attractive credit terms (for purchase of the product), free or discounted delivery of the product, warranties, wrapping, or any other service they find will appeal to consumers.\textsuperscript{76} The non-price dimension of competition need not be the most effective form of competition available; it need not even be a more effective form than providing the services the manufacturer desires. Since the special services sought by the manufacturer are by assumption such that create a positive horizontal externality, retailers can take advantage of the special services once they are provided by competing retailers and avoid the cost of providing the services. These cost savings can be used to finance other services. And since the dealer who provides the desired special services cannot save the costs, those dealers who free ride on the services have an inherent advantage over the retailer who does. If there is an alternative form of non-price competition that has any appeal to consumers at all, free riders are better off

\textsuperscript{76} B. Klein and K.M. Murphy, “Vertical Restraints as Contract Enforcement Mechanisms” (1988) 31(2) J. L&E 265 at 266. See also p. 267 & 295.
than the retailer providing the services sought by the manufacturer. Therefore, if the manufacturer cannot curtail all possible forms of non-price competition, even the relatively ineffective methods, the original free rider problem will persist despite the introduction of RPM.

Non-price competition is not merely a theoretical possibility. Examples of various forms of non-price competition jeopardizing actual price fixing schemes, vertical and horizontal, are plentiful as are attempts to contractually limit some of these forms. So are imaginative forms of non-price competition designed to circumvent price restrictions. In addition to free delivery, discounted supplements, and generous installment programs already mentioned, trading stamps and gift coupon campaigns (which consumers can redeem for more than their cost) have been used to under-price maintained resale prices in the U.S. when RPM was permissible. Similarly, a discount house attempting to sell a well known brand of vacuum cleaners for less than its maintained price allowed old brooms as trade-ins on the specific brand. The same discount house also sold other price maintained items at full price, but donated the discount it would otherwise have given to

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77 For example, giving away free alcoholic beverages, secret rebates, and paying advertising, display, and distribution allowances were prohibited in the beer trade (Ewald T. Grether, price control under fair trade legislation (New York: Oxford University Press, 1939) reprinted in Leon Stein advisory ed., Getting and Spending: The Consumer’s Dilemma (New York: Arno Press, 1976) at 138); book publishers prohibited both price cuts and refunds, discounts or commissions or gifts that directly or indirectly affect the fair trade price (Grether at 153); in the furniture industry “besides outright direct price reductions, trouble was experienced with indirect methods of reducing prices such as trade-in allowances, gifts, and combination sales. In the case of high-priced items a common practice for price cutters is to give a reduction on other merchandise if purchased” (Grether at 185); in the sale of stoves price setting was compromised by the lack of control of trade-in values, the practice of giving reductions on other merchandise. Installment selling were another complication, and in an attempt to standardize credit terms dealers were expected to add ½ per cent a month to the minimum price and give no discounts for cash (Grether at 192); in the plumbing industry price control was ineffective because plumbers offer a mixture of hardware and personal services which are intimately linked as well as because of direct-to-consumer services (Grether at 192); in Standard Sanitary, supra note 69 at 175 – 176 the possibility of shipping free (or discounted) goods with the product in an attempt to under-price the cartelistic price was limited by prohibiting cartel members as well as downstream jobbers to bill the product with other products, ship it uncrated, offer allowance for returned crates, and so on; in Hardie v. Chilton, supra note 69, a member of the trade association under-priced the RPMd price by selling for the set price, “but including in the consideration for it a full year’s tax…and some minor matters” (p. 311); in the tobacco industry “[o]ne standing complaint of retailers…is against the giving away of matches, which is termed an indirect way of cutting prices” (Edwin R. A. Seligman, Robert A. Love, Price Cutting and Price Maintenance: A Study in Economics (New York: Harper & Brothers Publishers, 1932) at 420).

78 Text accompanying supra note 76. For actual cases of such uses see Grether, ibid. at 185 & 192.

any charity the consumer named. When American Airlines attempted to ban discounts by firms that sold its tickets

“Under-the-table discounts, rebates by “captives” (travel subsidiaries of the firms whose employees [were] traveling), and tie-in sales (packages of air travel and other services such as hotels, with the price reduction on the air fare allocated for bookkeeping purposes to the hotel or car rental) [were] endemic”.

It is highly unrealistic to hope that the introduction of RPM will automatically cause retailers to provide the desired services, absent explicit contractual limitations on all forms of undesired non-price competition. Non-price vertical restraints, by contrast, are not susceptible to the non-price competition caveat. The reason is that non-price vertical restraints effectively eliminate all forms of competition and not just price competition. A good illustration of this is territorial exclusivity. If each retailer is assigned an exclusive territory, it is protected from free-riding within that territory. All possible forms of competition are eliminated (within the territory), relieving the retailer from any danger of free riding. The retailer will consequently use the funds at its disposal to focus on the most efficient way of increasing volume. If pre-sale demonstrations yield more revenue than they cost to provide, the retailer will find it profitable to provide the demonstrations. This is not to suggest that territorial exclusivity and customer allocation are always possible. There may be situations in which transportation costs are so insignificant that consumers are willing to travel to a different territory in order to obtain the product for a lower price. If that is the case then competition (and the free rider problem) cannot be suppressed by assigning exclusive territories. Similarly, customer allocation may be very costly to monitor and enforce or simply unfeasible due to an inability to adequately define each class. Additionally, even when such restraints are plausible, they require the manufacturer to address the double marginalization problem earlier mentioned. Since each retailer becomes a local monopoly by virtue of the vertical restraint, and since the retailer only makes a competitive return if he provides the desired services, for any given wholesale price each retailer will find it more profitable to charge a monopoly markup than to

80 Ibid. at 62.
81 Illinois Corporate Travel, Inc. v. American Airlines 889 F2d. 751 at 752 [American Airlines].
82 ‘Insignificant’ in this context implies that transportation costs are insignificant in relation to the utility consumers derive from the product and to the price they pay for it.
83 See text accompanying supra notes 70 - 71.
provide the services.\textsuperscript{84} No matter what wholesale price they are charged, retailers will regard this as part of their marginal cost and sell a quantity of the product for which marginal cost equals marginal revenue, reducing output to a suboptimal level from the manufacturer’s standpoint (as well as from the combined perspective of retailers and the manufacturer as a whole). Only if the per-unit markup is fixed and retailers cannot exert monopoly power will each retailer seek to increase volume in the most effective way, which by Telser’s assumption is to provide the desired services. But when feasible, non-price vertical restraints have the potential of inducing the performance of services, whereas RPM does not.

2. Preventing Retailers’ Focus on the Infra-marginal Consumers

A second explanation for RPM, developed by Winter,\textsuperscript{85} is that by disallowing price competition the manufacturer forces retailers to compete along a dimension which caters to consumers who are on the product margin. Very similarly to the free rider explanation, this explanation argues that absent RPM retailers will gravitate towards price competition, even when a different form of competition maximizes the joint profits of the manufacturer and the retailers. The reason for the divergence between the overall profit-maximizing strategy and the private profit-maximizing strategy of each of the retailers is not, however, the free-rider problem. The reason is the existence of a vertical discrepancy. The manufacturer is indifferent to which retail outlet makes the sale, so long as a sale is made. Retailers, by contrast, focus also on winning consumers away from each other. Retailers focus on consumers who are on the inter-retailer margin, whereas the manufacturer is concerned only with those consumers who are on the product margin.\textsuperscript{86} The manufacturer’s optimal mix of price and service is determined by those consumers who are on the fringe of buying the product. It is these consumers alone who determine the effect of a change in price and services from the manufacturer’s perspective.

One manifestation of the problem developed in length by Winter is the under-provision of services that reduce shopping time. Winter bases the explanation on three assumptions. The first is that retail services reduce the time it takes to purchase a product. The second is that shopping across stores takes time. The third is that consumers’ costs of time vary.\textsuperscript{87} The first assumption is relevant to a great number of services provided by retailers. Shorter cashier lines, convenient fitting rooms, well-organized inventory, prominent shelf space and informed staff are all good examples of services that indeed reduce the time it takes a

\textsuperscript{84} The competitive return implies no economic profit. See Trebilcock et al., \textit{The Law And Economics Of Canadian Competition Policy} (Toronto: University of Toronto Press, 2002) at 56.


\textsuperscript{86} \textit{Ibid.} at 63.

\textsuperscript{87} \textit{Ibid.}
consumer to buy the product. The second assumption, that is that shopping takes time, is undeniably true. The third assumption is also true. Different consumers have different opportunity costs of time. Some consumers get paid more than others for a given unit of time, some would use the time for things they place a large value on whereas others do not feel that the alternative use of their time would be very beneficial to them, and so on.

Based on these assumptions, Winter divides potential consumers of the product into two categories: consumers with high opportunity costs of time and consumers with low opportunity costs of time. As mentioned, retailers focus on consumers who are on the inter-retailer margin, whereas the manufacturer is concerned only with those consumers who are on the product margin. According to Winter, consumers who have low opportunity costs of time, that is consumers who are not time-sensitive, are over-represented on the inter-retailer margin. The reason for this is that those consumers who are inclined to move from one retail outlet to another to compare prices are by definition willing to spend a relatively significant amount of time searching for lower prices. They are less time-sensitive and more price-sensitive. On the product margin, however, there are consumers who are time-sensitive and will only purchase the product if the time they need to spend on buying it is reduced. The combined profits of the manufacturer and retailers are maximized if retailers focus on the time-sensitive consumers and provide time reducing services that appeal to consumers who will not buy the product otherwise. But retailers, who are in competition with each other, divert their attention to winning consumers away from other retailers and offer lower prices rather than more services. The consumers retailers are competing for do not value time-reducing services. These consumers are willing to spend time inside an establishment in return for lower prices in the same way they are willing to shop between retail outlets for better prices. Consequently, retailers provide ‘too much’ price competition and ‘too little’ service competition. By introducing RPM the manufacturer overcomes this inefficient gravitation to low prices. Retailers cannot compete for price-sensitive consumers who are on the inter-retailer margin, and are therefore forced to attract consumers on the product margin. The way to do this is to provide time-reducing services. By disallowing price reductions through RPM the manufacturer forces retailers to provide the profit maximizing mix of price and services.

Much like the original free rider explanation, this explanation is susceptible to the non-price competition caveat. Again, once RPM is introduced retailers can use the extra income to fund various forms of non-price competition. Gifts, free (or discounted) supplements to the RPMd product, free delivery, credit and the like are all possible ways to compete the margin created by RPM. As Iacobucci notes, Winter’s explanation is

88 Ibid. at 62.
89 Ibid. at 70.
especially vulnerable to this objection because by assumption it is the price-sensitive consumers that retailers are competing for. They will consequently prefer any of the infinite methods of effectively lowering prices (through non-price competition) to providing time-reducing services. The always optimistic assumption that retailers will automatically resort to a desired form of non-price competition if price competition is restricted is even more heroic under Winter’s assumptions.  

Non-price vertical restraints, by contrast, may achieve the desired result. In essence, non-price restraints eliminate the inter-retailer margin. Each retailer is turned into a local monopoly, and within its assigned territory (or class of consumers) faces the same demand curve as the manufacturer faces in the territory. The retailer will therefore focus on capturing those consumers who are on the product margin and provide the services that cater to these consumers. Once again, non-price vertical restraints may be unfeasible and will certainly require a supplemental mechanism for eliminating the double marginalization problem. But when feasible, and subject to overcoming the double marginalization issue, non-price restraints have the potential of achieving what RPM cannot. Winter acknowledges that

“[t]he mechanism through which vertical territorial division of the markets corrects the incentive distortion is simpler: this restraint eliminates the interretailer margin, and thus eliminates the distortion.”  

The reality, however, is that non-price vertical restraints are not a simpler way than RPM to correct the distortion. They are the only way to correct it.

3.  The Outlets Hypothesis

A third explanation for RPM is one developed by Gould and Preston. This explanation is based on the plausible assumption that the demand for a product is a function not only of the product’s price but also of the number of retail outlets carrying the product. If retailers are allowed to discount the product they will compete away any supra-competitive returns and the price will be driven down to the competitive point, leaving retailers with a trivial (competitive) per-unit return. Some retailers will be driven out of the market

90 Iacobucci, supra note 5 at 85.
91 Winter, supra note 85 at 68.
93 Gould & Preston assume a perfectly competitive retail market. The analysis is equally applicable to markets that are not perfectly competitive, as real markets are. The benchmark will be different. That is, the return each retailer makes when retailing the product will be greater than under perfect competition. But this return too may be insufficient to cover the average cost of the optimal number of retailers. For simplicity, Gould & Preston assume a perfectly competitive retail segment. See ibid, at 304 n. 1.
(or simply drop the product). The number of retailers that will ultimately stay in the market will be a number for which the average costs of production are exactly covered by the per-unit return. But this number may be sub-optimal from a social perspective. From a social perspective as well as from the manufacturer’s perspective it may be profitable to incur the added costs of sustaining more retail outlets because these costs are offset by the extra demand stimulated by the existence of the outlets. The problem is that the trivial-return insufficient number of outlets is an equilibrium point, so the market will not self-correct. Supply and demand intersect, and the existing (insufficient) number of outlets is one of long-run equilibrium. No potential retailer will find it profitable to enter the market given the prospective profit margin. The manufacturer can rectify the problem by setting retail prices so that the profits from retailing the product are capable of sustaining additional outlets. These additional outlets result in increased demand. This, in turn, results in a different equilibrium, which enhances total welfare.

Much like Winter’s model, the Gould and Perston model as a justification for RPM is extremely fragile due to the possibility of non-price competition. The assumption underlying the model is that absent RPM retailers are in equilibrium. Once RPM is introduced retailers suddenly make a supra-competitive return on sales. And since this margin is high enough to induce new retailers to incur the fixed costs of entry, which they will otherwise find unprofitable to incur, it must be a relatively large margin. But existing retailers are not expected by the manufacturer to provide additional services or otherwise incur any additional cost in return for this inflated margin. So there is absolutely no reason for them not to use the margin to compete with other retailers. It is highly unlikely that none of the existing retailers in a saturated market (which is by assumption in equilibrium) who suddenly receive a large windfall will not compete with others and try to attract consumers. As to the efficacy of non-price competition, as mentioned earlier, non-price competition need not be the most efficient form of competition. If retailers receive a windfall they will search for any possible way to use it to attract consumers. Gould and Perston are aware of this, and they acknowledge that their model

“assumes (1) that the manufacturer is fully successful in maintaining r.p.m., and (2) that the retailer believes that additional expenditures on his part will not increase his sales volume, even at the expense of other retailers”

Realizing that the second of these assumptions is unrealistic Gould and Perston suggest that some products are simply not candidates for non-price competition. They argue that circumstances under which retailers will find non-price competition unprofitable “might easily prevail in the retailing of convenience goods such
as cigarettes”. But there is no reason to think that non-price competition is inconceivable in convenience goods. A free box of matches, an ashtray, or a free sample of cigarettes are all a much more rational response on the part of retailers than doing nothing and waiting for existing competitors or new entrants to appropriate their patronage. In fact, free boxes of matches have actually been used to overcome price restrictions imposed by cigarette manufacturers.\textsuperscript{95} 

Non-price vertical restraints, by contrast, may once again achieve the ideal number of outlets. Moreover, under the Gould and Preston explanation non-price vertical restraints do not even raise the double marginalization issue. According to the model, the manufacturer introduces vertical restraints in order to ensure that retailers make a supra-competitive return, which in turn sustains additional outlets. Therefore, there is no need to prevent the retail-level markup which is precisely the goal of the system. Of course, the territory must be of size that adequately compensates retailers for the fixed costs of entry on one hand, but on the other it must not be too large so that the local monopoly markup does not result in an overall decrease in quantity. But within the borders of a properly bounded territory (or correctly defined class of consumers) the manufacturer should be content to allow each retailer to make a monopoly profit. Non-price vertical restraints therefore easily achieve what RPM cannot.

4. \textit{Quality and Fashion Certification}

Marvel and McCafferty offer what is in essence an extension of Telser’s explanation to intangible non-product-specific services. They suggest that dealers are more than merely a manufacturer’s agent providing a host of tangible services. Rather, retailers also perform the function of consumers’ agents. As such, they identify and choose high quality products. These services are susceptible to free riding, and it is this problem that RPM solves.\textsuperscript{96} 

Retailers select the products they carry from a wide variety of products. By stocking a certain product on its shelves, the retailer attests that the quality of the item in question is consistent with the retailer’s overall reputation. Retailers differ in their overall reputation. Some are more prestigious than others. By carrying the product the more prestigious retailers convey a message to consumers that the product meets their high standards. But consumers need not buy the product at a prestigious outlet in order to enjoy the certification it offers. The mere fact that the prestigious dealers carry the product is enough to signal quality. Consequently, some retailers may free ride on the quality certification provided by their more prestigious competitors. If consumers can obtain the certification offered by one retailer and buy the product at a different outlet, the

\textsuperscript{95} Seligman & Love, \textit{supra} note 77 at 420. 
less prestigious retailers will be able to under-price the high quality retailers. Consumers will purchase the product at the less prestigious outlets for lower prices. The prestigious retailers will not be compensated for their quality certifying services and will eventually be forced out of the market. In order to assure that such services are not under-provided the manufacturer disallows price competition among retailers, thereby guaranteeing prestigious retailers a sufficient margin in return for their services.

The explanation, according to Marvel and McCafferty, is not necessarily limited to quality. Fashion too is a candidate for certification services. Retailers may expend significant resources, and indeed sometimes do, on sophisticated buyers and other devices to sense fashion trends in the making. It is easy to see how in such a case the mere information that the retailer is stocking the product is enough. Consumers can easily buy the product elsewhere, taking advantage of the certification provided by the fashionable retailer.

As a justification for RPM, the certification hypothesis too is subject to the non-price competition pitfall. According to the explanation the less prestigious retailers, whose costs are (by Marvel and McCafferty’s assumption) lower than the more prestigious outlets’ costs, receive a windfall. They are making a supra-competitive return on each unit sold. Unlike other explanations, according to the Marvel and McCaffery’s explanation these retailers are not even expected to provide any kind of service in return for these rents. They are simply overpaid for services that are to be provided by their prestigious counterparts. It is therefore unclear why the less prestigious retailers would not use these extra funds to lure customers away from the more prestigious retailers. At the heart of the explanation is Marvel and McCaffery’s assumption that consumers are completely indifferent to where they buy the product, as long as it is carried by the prestigious outlet. The less prestigious retailers can thus easily attract consumers if they offer any inducement at all. And the means to do so are supplied by the manufacturer, according to the explanation. Once again, the chosen form of non-price competition (e.g. free sampling) need not be the most effective form of competition to undermine the hypothesis. It merely need be possible.

In contrast to RPM, Non-price vertical restraints have the potential of rectifying the free-rider problem. If retailers cannot free-ride on the services provided by the more prestigious retailers because they can only sell in different geographic markets, each will be forced to choose between being a prestigious outlet and being a

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97 Ibid. at 348.
98 Ibid. at 354.
99 Each of the first three explanations expects retailers to incur some cost in return for or as result of the supra-competitive return. According to the free rider explanation these costs are the costs of providing pre-sale demonstrations. According to Winter these are the costs of the time-reducing services. According to Gould & Preston retailers are not expected to directly provide a service to consumers, but the supra-competitive rents induce investment in fixed costs which would otherwise not have been justified.
100 Marvel & McCafferty, supra note 96 at 348 & 350.
non-prestigious outlet. If being a prestigious retailer is more lucrative than being a non-prestigious retailer, all retailers will become prestigious retailers. Once again, non-price vertical restraints will require addressing the double marginalization problem so that retailers do not markup the product to the manufacturer’s detriment. In addition, territorial exclusivity may not be a very plausible option under the Marvel & McCafferty setting, at least if certification requires customers to physically visit the prestigious outlet. As Marvel & McCafferty acknowledge, if consumers are required to visit the more prestigious outlet in order to obtain certification, the analysis is only consistent with settings in which travel costs are lower than the cost of providing certification. Otherwise, prestigious outlets could simply charge a premium equal to the travel cost to the next outlet and be adequately compensated for their services with no vertical restraints. So consumers’ absolute indifference to where they purchase the product and the ensuing free rider problem imply insignificant travel costs. If that is the case, exclusive territories may be inconceivable and the manufacturer will have to resort to customer allocation. But again, non-price vertical restraints have the potential of inducing certification.

5. **RPM as a Contract Enforcement Mechanism**

A fifth explanation according to which RPM is a pro-competitive device, offered by Klein and Murphy, seeks to explain RPM as a private enforcement mechanism that forces retailers to perform tasks they implicitly agree to undertake.

Klein and Murphy offer an alternative explanation based on the assumption that it is not economically feasible for a manufacturer to write an explicit enforceable contract with dealers for the supply of services, but that retailers’ conduct is observable. That is, while the manufacturer has specific services in mind and while the manufacturer can monitor the provision of these services, it is nonetheless prohibitively costly to specify dealer performance in a way that a contractual breach and the extent of damages can be satisfactorily proven in court if the services are not provided. Given this assumption, a manufacturer is forced to create a private enforcement mechanism. This is done, according to Klein and Murphy, by offering retailers a share of the manufacturer’s monopolistic rents. Through RPM a future stream of rents is created, resulting in a strong incentive for retailers to continue carrying the manufacturer’s product. The threat of termination of dealers who do not perform according to the manufacturer’s expectations is a strong incentive for retailers to provide the services. A future stream of rents is a more valuable asset the more competitive the retail market is. At the extreme, if retailers are in perfect competition, any supra-competitive rent is extremely attractive to

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101 Marvel & McCafferty, *ibid.* at 354. See also at n. 13.
102 Klein & Murphy, *supra* note 76 at 267 – 268.
RPM not only increases the future gains from carrying the product. It also decreases the short-run gains from shirking on the provision of services because retailers’ ability to expand output is limited due to the restriction on price reduction. Each of these effects of RPM, and certainly their combination, creates a disincentive for retailers to under-provide services they know the manufacturer values. Klein and Murphy suggest that the use of RPM is especially attractive under circumstances in which consumers cannot detect retail services that affect the quality of the product before purchase, such as the rotation of products with a limited shelf life. Once the product has been purchased the consumer will be able to ascertain its quality but the consumer will not know the exact reason for the deteriorated quality of the product and will attribute at least part of the poor quality to the manufacturer. Thus a negative vertical externality is created whereby retailers do not fully bear the consequence of their misconduct. Some of these consequences are borne by the manufacturer. RPM overcomes retailers’ tendency to shirk and prevents this vertical externality. Notwithstanding its appeal in cases where consumers cannot ascertain the product’s quality before purchase and incorrectly assign ‘blame’ for its deteriorated quality after purchase, the hypothesis can explain RPM in other circumstances as well. Klein and Murphy suggest that the hypothesis can be extended to product promotion services such as shelf space or product demonstrations. Generally, they argue, the hypothesis is applicable to any kind of services (sought by the manufacturer) when it is not economical for the manufacturer to write an explicit contract with his dealers regarding some aspect of desired dealer performance. However, although Klein and Murphy are fully aware of the non-price competition caveat and attempt to dodge it, on careful examination their explanation too is challenged by the non-price competition possibility. As mentioned, Klein and Murphy suggest that

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103 Ibid. at 268 – 269.
104 Ibid. at 267.
105 Ibid. at 281. Klein & Murphy also explain why it may be rational for the consumer to blame the manufacturer, at least partially, for the deteriorated quality. This is because there is some probability that the manufacturer is to blame for the deteriorated quality on one hand and it is irrational for a consumer to incur the full cost of investigating the exact reason for the low quality on the other. Consequently, consumers will rationally assign some ‘responsibility’ to the manufacturer and discount the product accordingly. See note 23.
106 Ibid. at 282 – 292.
107 Ibid. at 267.
108 Klein & Murphy, supra note 76 at 266. See also p. 267 & 295.
“the manufacturer uses vertical restraints to decrease the short-run gain to nonperforming dealers (by limiting their ability to expand output) and to increase the long-run gain to performing dealers (by creating a quasi-rent stream”).

RPM, however, is problematic with regard to both of these effects. First is the decrease in short-run gains from shirking. A retailer can increase her own short-run gains by engaging in non-price competition and expanding output despite the RPM system. RPM limits the ability to engage in direct price competition, not to expand output. Klein and Murphy acknowledge that the applicability of the analysis to RPM “implicitly assumes that, although a positive price-marginal cost gap exists, dealers cannot expand output through nonprice competition such as tie-in sales, discounts on other items, or giveaways”. They address this issue by introducing the concept of monopolistic competition, which in essence is a concept that explains why competition is never perfect, to non-price competition. They argue that when the unrealistic assumption of perfect competition is relaxed, dealers will not have an incentive to engage in a broad range of forms of non-price competition. This argument is illustrated in figure 1, which is a simplified version of the figure presented by Klein & Murphy.

109 Ibid. at 267.
110 Ibid. at 277.
111 The concept of monopolistic competition was originally developed in Edward Hastings Chamberlin, The Theory of Monopolistic Competition, 8th ed., (Cambridge: Harvard University Press, 1962). Chamberlin observed that no seller is an absolute price-takers or truly faces a perfectly horizontal demand curve. Put differently, no market is perfectly competitive. Different products and establishments are always differentiated and all consumers have some preference between products and sellers. In the context of retail outlets “[differentiation] may… exist with respect to conditioning surrounding [the product’s] sale. In retail trade … these conditions include such factors as the convenience of the seller’s location, the general tone or character of his establishment, his way of doing business, his reputation for fair dealing, courtesy, efficiency, and all the personal links which attach his customers either to himself or to those employed by him” (56). But regardless of the reason, consumers and sellers are not paired at absolute random as under perfect competition (56).

112 Klein & Murphy, supra note 76 at 277 – 278.
113 Ibid., figure 3.
In figure I D represents the individual retailer’s (less than perfectly elastic) demand curve. Mr is the corresponding marginal revenue curve, which the retailer will equate to S, its supply curve. The retailer will sell a quantity of q. D* represents the demand for the product given the retailer’s expenditures on services. This demand curve slopes exactly as D does in the segment AB. At B, however, D* turns less elastic than D, reflecting the relative ineffectiveness of non-price competition. Since a dollar spent on service generates less than a dollar ‘spent’ on price competition, that is less than a price reduction of $1, the demand curve given the elimination of price competition becomes less elastic at outputs greater than q.\textsuperscript{114} The marginal revenue curve corresponding to D* is Mr*, which is no different than Mr in the segment AC. At C, however, there is a discontinuity in Mr* which corresponds to the kink in D* at the minimum price. If the retailer’s marginal cost curve passes through this discontinuity, that is if marginal cost exceeds marginal revenue at any point beyond the kink, increases in sales through non-price competition are not profitable.\textsuperscript{115} Therefore, Klein and Murphy suggest that such non-price competition will not need to be monitored. But there are two major flaws in this analysis. First, the demand curve can only reflect consumers’ reservation price for one form of non-price competition. As mentioned earlier, the possibilities of non-price competition are infinite and examples of different forms of non-price competition are plentiful.\textsuperscript{116} The fact that some forms of non-price competition are unprofitable does not imply that no forms of non-price competition are. Second, it is unclear why the demand curve for the services considered as the non-price competitive channel suddenly changes its elasticity at the point of minimum retail price, which was set to assure a stream completely unrelated to this form of competition. The minimum price is arbitrary with regard to the demand curve for possible forms of non-price competition. It is set, according to the explanation, to assure a stream that covers the cost of providing unobservable services. But somehow, at the exact point that the price is set, the demand curve for non-price competition turns less elastic.\textsuperscript{117} A manufacturer considers the cost of rotating products with limited shelf life and concludes that the per-unit cost of rotation is x. She therefore sets a minimum price that is calculated to cover these costs. And somehow, at that exact price, consumers sharply decrease the value

\textsuperscript{114} Klein & Murphy offer an exact measurement of the relative elasticity. If α (α<1) represents the ineffectiveness of non-price competition, that is if $1 spent on non-price competition generates a benefit equal to α multiplied by the benefit generated by a $1 price reduction, then an effective price paid by consumers, Pr-αz, results in a larger decrease in the net price received by the retailer, Pr-z. The demand curve will slope at 1/α its original slope at outputs greater than q. See ibid. at 278 – 279.

\textsuperscript{115} Ibid. at 279.

\textsuperscript{116} Text accompanying supra notes 76 - 81.

\textsuperscript{117} The demand curve for the non-price form of competition must be thought to have changed its elasticity. Otherwise it would have laid above and to the right of the original demand curve at points that are to the left of the minimum retail price point, in which case retailers would have engaged in this form in the first place and not lowered the price to the minimum price allowed.
they place on free gifts and discounted supplements to the product. This would seem highly unlikely.\textsuperscript{118} So, RPM seems unlikely to reduce the short-run gains of shirking. It will still be profitable for retailers to search for a non-price competition channel, engage in it and increase volume. By doing so they will sell more units of the product and the payment they receive will be larger than they deserve. This results in RPM being an inadequate measure for inducing retailers to perform desired services.

As for assuring long run gains, once again the future rents guaranteed by RPM are subject to the danger of non-price competition. If any of the retailers decides to increase volume by engaging in non-price competition, each of the other retailers will lose some sales. And since the stream of rents is calculated on a per-unit basis, loss of sales results in the stream of rents being smaller than intended by the manufacturer. This reintroduces the prisoners’ dilemma that is common to horizontal price-fixing settings. Retailers as a whole are better off if all abide by their obligations and provide the services. However, each retailer is better off if other adhere to the agreement and he himself engages in non-price competition, increases volume, and is overcompensated for the services. As a direct consequence of the possibility of non-price competition the future stream of rents for retailers who do not engage in non-price competition may be dwindled, which will result in the system’s effectiveness being compromised.\textsuperscript{119}

Non-price restraints, by contrast, avoid the possibility of non-price competition. At first blush, it would seem that isolating retailers from competition with each other does not address the problem, because under the Klein & Murphy explanation the problem addressed is a \textit{vertical} externality, not a horizontal one. That is, the problem addressed is not that retailers take advantage of services performed by others, but rather that each retailer imposes a negative externality on the manufacturer. However, this does not change the analysis. If each retailer is a local monopoly its (private) profit-maximizing strategy is not to increase volume beyond the monopoly level. Consequently, it will not attempt to employ any non-price volume-increasing techniques. Its profit maximizing strategy is to exert the monopoly power vested in it by the manufacturer. It will therefore price at the monopoly level and refrain from effectively lowering prices. And since the only way to assure the preservation of the future stream of rents is to perform according to the manufacturer’s expectations, the incentive to shirk on the agreement is curtailed.

6. \textit{RPM and Demand Uncertainty}

\textsuperscript{118} It would only be likely that the demand for \textit{some} forms of non-price competition would coincidentally turn less elastic at the minimum point if the assumption that there are an infinite number of non-price venues was adopted, as it should. But if that is the case then, again, only some of very many possible forms of non-price competition are ‘naturally’ eliminated.

\textsuperscript{119} Klein & Murphy, \textit{supra} note 76 at 277.
A sixth pro-competitive explanation for RPM is one offered by Deneckere, Marvel and Peck. According to this explanation, RPM may be welfare enhancing if retailers must decide on the quantities of the product they purchase before demand for the product is fully known.  

Deneckere, Marvel & Peck illustrate their argument with a model in which retailers must decide what quantity of the product to purchase before demand uncertainty is resolved. It is known that demand for the product may ultimately turn out to be high or low. Retailers are in perfect competition with each other. The price they charge for the product will thus normally equal the wholesale price of the product plus the marginal costs of retailing. In the high-demand state the market will clear a certain quantity of the product at this price. In the low-demand state the market will clear a smaller quantity of the product at this price. Units of the product that are not purchased are valueless, or have insignificant scrap value. When deciding what quantity of the product to purchase retailers must account for both demand-states. This may cause them to purchase sub-optimal quantities of the product.

By introducing RPM the manufacturer essentially guarantees retailers that they will make enough profit in the low demand state to recover their costs of purchasing excessive quantities. This, in turn, induces retailers to purchase large enough quantities to meet demand in the high-demand state.

This hypothesis is extremely susceptible to the non-price competition caveat. According to the hypothesis, the need for RPM stems from the fact that “retailers are saddled with excessive inventories in the low-demand state”. By assumption, these inventories have no scrap value at the end of the demand period “so


121 Resulting in no economic profit at the retail level. For the distinction between economic profit and accounting profits see Trebilcock et al., supra note 84 at 56.

122 Deneckere, Marvel & Peck, supra note 120 at 622 and at n. 10.

123 Ibid. at 625.
that unsold inventories are, to [retailers], a sunk cost". Under such circumstances retailers should be willing to sell the excessive inventories at any price higher than zero (in the low-demand state). Not only is the market-price in the low-demand state higher than zero, it is artificially kept even higher (through RPM) than it would have normally been. The margin between the prevailing market-price and the value of the inventory to retailers is thus increased. And since under competition retailers will use the excessive margins to compete, enlarging the margin broadens the range of non-price competition avenues that retailers will find profitable. If RPM is introduced in the low-demand state it will cause retailers to engage in an even wider range of forms of non-price competition than they would have had retail prices been lower or had the scrap value of the product been higher.

Non-price competition does not directly harm the manufacturer, who has (by assumption) already received full consideration for the units. However, the object of RPM under the model is to ensure retailers ex ante, when they decide what quantities to purchase, that should the low-demand state materialize they will make a supra-competitive return. Realizing that this is unrealistic, and that in fact should the low-demand state materialize they will only be pushed to fund additional non-price competition channels, retailers will refrain from purchasing the desired quantities ex ante. Thus, non-price competition greatly undermines this explanation.

Once again, non-price vertical restraints may achieve what RPM cannot. By isolating each of the retailers from intra-brand competition, the manufacturer guarantees each retailer the ability to charge a monopoly markup, which – in the low demand state – will adequately compensate retailers for the costs associated with the excessive inventory. As in some of the previous hypotheses, the double marginalization problem arises. Although in the low-demand state the double marginalization is of no concern, because the retail-level monopoly markup is precisely what the manufacturer grants retailers in return for stocking the product, in the high-demand state the double marginalization problem may result in sub-optimal quantities of the product

\[\text{Ibid. at 622.}\]
being sold by retailers (and consequently purchased from the manufacturer). Therefore, the double marginalization problem must be addressed. But as discussed earlier, the problem can be solved by imposing price ceilings or charging franchise fees.\textsuperscript{125} Moreover, according to the demand uncertainty hypothesis the number of units of the product ultimately sold to consumers is of no concern to the manufacturer. By assumption, retailers purchase the product from the manufacturer before the demand period.\textsuperscript{126} The manufacturer thus receives full consideration regardless of the units retailers actually sell. The manufacturer’s sole concern in this context is that retailers will anticipate this scenario and realize that the optimal quantity from their perspective as local monopolies is smaller than the optimal quantity from the manufacturer’s perspective, which in turn will result in retailers purchasing smaller quantities of the product \textit{ex ante}. Therefore, simply making territorial exclusivity (or other non-price restraints) conditional on the purchase of the desired number of units will suffice. From the manufacturer’s perspective there is no need to truly curb double marginalization. If the manufacturer can compel retailers to purchase enough units, it should be happy to allow them to then charge a monopoly markup (in the high-demand state) if they find this course of action more profitable. The double marginalization is thus even easier to deal with under the demand uncertainty hypothesis.\textsuperscript{127}

\textsuperscript{125} Text accompanying \textit{supra} notes 70 - 72.

\textsuperscript{126} Deneckere, Marvel & Peck, \textit{supra} note 120 at 622.

\textsuperscript{127} Note, that this analysis does not imply that antitrust law should tolerate such a course of action. The manufacturer may be indifferent to the choice between franchise fees or price ceilings on the one hand and receiving consideration for the full quantity and allowing retailers to charge a monopoly markup on the other. But from a total welfare perspective the two are not equivalent. Franchise fees and price ceilings will result in only one monopoly markup, whereas forcing retailers to purchase the full quantity and then allowing them to price freely (as local monopolies) will result in a double markup, increasing the deadweight loss associated with market power. Consequently, antitrust law should tolerate franchise fees and price ceilings, which eliminate the double marginalization, and not the alternative which allows it. But from the manufacturer’s perspective non-price vertical restraints can achieve what RPM cannot.
IV. Conclusion

Both RPM and non-price vertical restraints may be used as an anti-competitive tool to facilitate collusion at either the upstream level or the downstream level. They are therefore potentially anti-competitive. The appropriate rule of law for their evaluation thus depends largely on their ability to achieve pro-competitive goals as well. If they have the potential of achieving such goals, they should be subject to a rule of reason. If not, they should be subject to a rule of per se illegality. The past half century has seen a plethora of pro-competitive justifications for vertical restraints. These generally argue that vertical restraints achieve a host of socially beneficial goals. I have shown that RPM is incapable of achieving any of the pro-competitive goals identified with it due to the possibility of non-price competition. Each of the pro-competitive explanations for RPM overlooks the fact that in response to the imposition of RPM retailers will seek any of the infinite forms of non-price competition which effectively achieve the same results as price competition rather than perform according to the manufacturer’s expectations. Each of the hypotheses explains why absent RPM retailers gravitate to price competition even when a more efficient form of competition exists. It is therefore hard to believe that blocking the possibility of directly reducing retail prices will automatically align retailers’ private incentives with those of the manufacturer. This justifies applying a per se illegality rule to RPM. It has anti-competitive effects on one hand, and no ‘redeeming virtue’, or no objective other than the restriction, distortion, or elimination of competition, on the other.

Paradoxically, non-price vertical restraints – which eliminate all possible forms of competition – are capable of achieving pro-competitive goals which RPM is not. By eliminating all forms of competition and turning each retailer into a mini-monopoly, non-price vertical restraints effectively overcome each of the retailers’ gravitation to inefficient competition and cause retailers to internalize the manufacturer’s incentives. This justifies applying a rule of reason to non-price vertical restraints. Although they may be used anti-competitively, they nonetheless have the potential of attaining a host of pro-competitive goals. To be sure, exclusive territories may not always be conceivable. The size of the territory necessary to compensate retailers for the cost of services may be so great that the harms of an exclusive territory system outweigh its benefits. For some products, dispersed retail outlets are a necessity for consumers to purchase the product.\textsuperscript{128} At the other extreme, if the cost of providing the services is trivial, the territory size necessary to compensate retailers may be so small that consumers within a territory cannot practically be prevented from purchasing outside the territory. Customer allocation may not be feasible because retailers cannot be prevented from selling to consumers assigned to other retailers. And even if they can, if the different class of customers

\textsuperscript{128} See Gould & Preston, supra note 92. For a general overview of the effectiveness of non-price vertical restraints see Phillip E. Areeda, supra note 33 at 15 – 16, 211 – 215, and 495 – 507.
allocated to each of the retailers is dispersed across all (or many) of the geographic areas in which the product is sold, each retailer will be forced to retail in all (or most) of these areas. The system is certainly wasteful if it forces retailers to duplicate each other’s efforts in the same areas, each for the sake of a different class of consumers. In such cases territorial exclusivity and other non-price vertical restraints may prove counter-productive. But the point is that unlike RPM these restraints may achieve the pro-competitive goals identified by scholars.

As the U.S. Supreme Court addresses the issue in its upcoming session, it is to be hoped that the ostensible similarity between the effects of non-price vertical restraints and RPM will be rejected by it as a compelling reason to overrule *Dr. Miles*. It may seem inconsistent to uphold a rule of reason to non-price restraints and at the same time uphold a harsher rule for RPM, but it is not. Although legal policymakers have not yet produced an economic explanation for the existing rules of law, such an explanation exists. And it suggests that the present rules of law are the economically justified ones with regard to both price and non-price vertical restraints. Economic justifications for a different policy are yet to be presented.