ANTITRUST
COMPETITION POLICY & TRUSTBUSTING

NOTE

GTE Sylvania marks a historical turning point in antitrust history, departing from undisciplined and intuitive analysis in favor of economic analysis. The case involved the right of a franchisor to impose restrictions on franchisees. In *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), the US Supreme Court imposed severe restrictions on this right, which practically outlawed common franchise business models.

A year before *Schwinn*, Donald Turner, then the head of the Department of Justice's Antitrust Division, criticized the antitrust jurisprudence of vertical restraints, calling it "inhospitality in the tradition of antitrust law." Then, like now, Turner was considered an antitrust giant. *Schwinn* took the inhospitality tradition one step further.

GTE Sylvania sharpened the distinction between horizontal and vertical arrangements. Horizontal arrangements—namely, economic relations among rivals—tend to raise antitrust concerns. In contrast, vertical arrangements—namely, economic ties between adjacent parties on a supply chain—tend to be procompetitive. The functioning of markets heavily depends on the existence of reliable supply chains.

In the decades that followed *GTE Sylvania*, the US Supreme Court replaced the sound rationale of the case with a bizarre ideological mantra stating that, because vertical arrangements tend to be procompetitive, they are unlikely to be anticompetitive. Dressed with economic terminology developed by scholars associated with the Chicago School, the adoption of this mantra undermined the ability of the federal government and private parties to prove that vertical arrangements unreasonably restrain competition.

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Continental T. V., Inc. v. GTE Sylvania Inc.

433 U.S. 36 (June 23, 1977)

Mr. Justice POWELL delivered the opinion of the Court.

Franchise agreements between manufacturers and retailers frequently include provisions barring the retailers from selling franchised products from locations other than those specified in the agreements. This case presents important questions concerning the appropriate antitrust analysis of these restrictions under § 1 of the Sherman Act and the Court's decision in *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).

I

Respondent GTE Sylvania Inc. (Sylvania) manufactures and sells television sets. Prior to 1962, like most other television manufacturers, Sylvania sold its televisions to independent or company-owned distributors who in turn resold to a large and diverse group of retailers. Prompted by a decline in its market share to a relatively insignificant 1% to 2% of national television sales,[1] Sylvania conducted an intensive reassessment of its marketing strategy, and in 1962 adopted the franchise plan challenged here. Sylvania phased out its wholesale distributors and began to sell its televisions directly to a smaller and more select group of franchised retailers. An acknowledged purpose of the change was to decrease the number of competing Sylvania retailers in the hope of attracting the more aggressive and competent retailers thought necessary to the improvement of the company's market position.[2] To this end, Sylvania limited the number of franchises granted for any given area and required each franchisee to sell his Sylvania products only from the location or locations at which he was franchised.[3] A franchise did not constitute an exclusive territory, and Sylvania retained sole discretion to increase the number of retailers in an area in light of the success or failure of existing retailers in developing their market. The revised marketing strategy appears to have been successful during the period at issue here, for by 1965 Sylvania's share of national television sales had increased to approximately 5%, and the company ranked as the Nation's eighth largest manufacturer of color television sets.

This suit is the result of the rupture of a franchiser-franchisee relationship that had previously prospered under the revised Sylvania plan. Dissatisfied with its sales in the city of San Francisco,[4] Sylvania decided in the spring of 1965 to franchise Young Brothers, an established San Francisco retailer of televisions, as an additional San Francisco retailer. The proposed location of the new franchise was approximately a mile from a retail outlet operated by petitioner Continental T. V., Inc. (Continental), one of the most successful Sylvania franchisees.[5] Continental protested that the location of the new franchise violated Sylvania's marketing policy, but Sylvania persisted in its plans. Continental then canceled a large Sylvania order and placed a large order with Phillips, one of Sylvania's competitors.

During this same period, Continental expressed a desire to open a store in Sacramento, Cal., a desire Sylvania attributed at least in part to Continental's displeasure over the Young Brothers decision. Sylvania believed that the Sacramento market was adequately served by the existing Sylvania retailers and denied the request.[6] In the face of this denial, Continental advised Sylvania in early September 1965, that it was in the process of moving Sylvania merchandise from its San Jose, Cal., warehouse to a new retail location that it had leased in Sacramento. Two weeks later, allegedly for unrelated reasons, Sylvania's credit department reduced Continental's credit line from $300,000 to

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[1] RCA at that time was the dominant firm with as much as 60% to 70% of national television sales in an industry with more than 100 manufacturers.

[2] The number of retailers selling Sylvania products declined significantly as a result of the change, but in 1965 there were at least two franchised Sylvania retailers in each metropolitan center of more than 100,000 population.

[3] Sylvania imposed no restrictions on the right of the franchisee to sell the products of competing manufacturers.

[4] Sylvania's market share in San Francisco was approximately 2.5% half its national and northern California average.

[5] There are in fact four corporate petitioners: Continental T. V., Inc., A & G Sales, Sylpac, Inc., and S. A. M. Industries, Inc. All are owned in large part by the same individual, and all conducted business under the trade style of "Continental T. V." We adopt the convention used by the court below of referring to petitioners collectively as "Continental."

[6] Sylvania had achieved exceptional results in Sacramento, where its market share exceeded 15% in 1965.

$50,000. In response to the reduction in credit and the generally deteriorating relations with Sylvania, Continental withheld all payments owed to John P. Maguire & Co., Inc. (Maguire), the finance company that handled the credit arrangements between Sylvania and its retailers. Shortly thereafter, Sylvania terminated Continental's franchises, and Maguire filed this . . . action in the United States District Court for the Northern District of California seeking recovery of money owed and of secured merchandise held by Continental.

[Continental argues] that Sylvania had violated § 1 of the Sherman Act by entering into and enforcing franchise agreements that prohibited the sale of Sylvania products other than from specified locations. At the close of evidence in the jury trial of Continental's claims, Sylvania requested the District Court to instruct the jury that its location restriction was illegal only if it unreasonably restrained or suppressed competition. Relying on this Court's decision in *United States v. Arnold, Schwinn & Co.*, the District Court rejected the proffered instruction in favor of the following one:

> "Therefore, if you find by a preponderance of the evidence that Sylvania entered into a contract, combination or conspiracy with one or more of its dealers pursuant to which Sylvania exercised dominion or control over the products sold to the dealer, after having parted with title and risk to the products, you must find any effort thereafter to restrict outlets or store locations from which its dealers resold the merchandise which they had purchased from Sylvania to be a violation of Section 1 of the Sherman Act, regardless of the reasonableness of the location restrictions."

[T]the jury found that Sylvania had engaged "in a contract, combination or conspiracy in restraint of trade in violation of the antitrust laws with respect to location restrictions alone," and assessed Continental's damages at $591,505, which was trebled . . . to produce an award of $1,774,515.

[T]he Court of Appeals for the Ninth Circuit . . . reversed by a divided vote, [concluding] that *Schwinn* was distinguishable on several grounds. We granted Continental's petition for certiorari to resolve this important question of antitrust law.

II

A

[In *Schwinn*, this Court articulated] the following "bright line" *per se* rule of illegality for vertical restrictions: "Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it." But the Court expressly stated that the rule of reason governs when "the manufacturer retains title, dominion, and risk with respect to the product and the position and function of the dealer in question are, in fact, indistinguishable from those of an agent or salesman of the manufacturer." . . .

B

. . . Both Schwinn and Sylvania sought to reduce but not to eliminate competition among their respective retailers through the adoption of a franchise system. . . . These restrictions allowed Schwinn and Sylvania to regulate the amount of competition among their retailers by preventing a franchisee from selling franchised products from outlets other than the one covered by the franchise agreement. To exactly the same end, the Schwinn franchise plan included a companion restriction, apparently not found in the Sylvania plan, that prohibited franchised retailers from selling Schwinn products to non-franchised retailers. In *Schwinn* the Court expressly held that this restriction was impermissible. In intent and competitive impact, the retail-customer restriction in *Schwinn* is indistinguishable from the location restriction in the present case. In both cases the restrictions limited the freedom of the retailer to dispose of the purchased products as he desired. The fact that one restriction was addressed to territory and the other to customers is irrelevant to functional antitrust analysis. . . . As Mr. Chief Justice Hughes stated in *Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 360, 377 (1933): "Realities must dominate the judgment. . . . The Anti-Trust Act aims at substance."

III

Sylvania argues that, if *Schwinn* cannot be distinguished, it should be reconsidered. Although *Schwinn* is supported by the principle of *stare decisis*, we are convinced that the need for clarification of the law in this area justifies reconsideration. *Schwinn* itself was an abrupt and largely unexplained departure from *White Motor Co. v. United States*, 372 U.S. 253 (1963), where only four years earlier the Court had refused to endorse a *per se* rule for vertical restrictions. Since its announcement, *Schwinn* has been the subject of continuing controversy and confusion, both in the scholarly journals and in the federal courts. . . . In our view, the experience of the past 10 years should be brought to bear on this subject of considerable commercial importance.

The traditional framework of analysis under § 1 of the Sherman Act is familiar and does not require extended discussion. Section 1 prohibits "(e)very contract, combination . . ., or conspiracy, in restraint of trade or commerce." Since the early years of this century a judicial gloss on this statutory language has established the "rule of reason" as the prevailing standard of analysis. *Standard Oil Co. v. United States*, 221 U.S. 1 (1911). Under this rule, the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition. *Per se* rules of illegality are appropriate only when they relate to conduct that is manifestly anticompetitive. As the Court explained in *Northern Pacific Railway Co. v. United States*, 356 U.S. 1, 5 (1958), "there are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." . . .

The market impact of vertical restrictions[18] is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition.[19] Significantly, the Court in *Schwinn* did not distinguish among the challenged restrictions on the basis of their individual potential for intrabrand harm or interbrand benefit. Restrictions that completely eliminated intrabrand competition among Schwinn distributors were analyzed no differently from those that merely moderated intrabrand competition among retailers. . . .

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[18] As in *Schwinn*, we are concerned here only with nonprice vertical restrictions. The *per se* illegality of price restrictions has been established firmly for many years and involves significantly different questions of analysis and policy. . . . [S]ome commentators have argued that the manufacturer's motivation for imposing vertical price restrictions may be the same as for nonprice restrictions. There are, however, significant differences that could easily justify different treatment. . . . Unlike nonprice restrictions, resale price maintenance is not only designed to, but almost invariably does in fact, reduce price competition not only among sellers of the affected product, but quite as much between that product and competing brands. Professor Posner also recognized that "industry-wide resale price maintenance might facilitate cartelizing." . . .

[19] Interbrand competition is the competition among the manufacturers of the same generic product television sets in this case and is the primary concern of antitrust law. The extreme example of a deficiency of interbrand competition is monopoly, where there is only one manufacturer. In contrast, intrabrand competition is the competition between the distributors wholesale or retail of the product of a particular manufacturer. . . .

Vertical restrictions reduce intrabrand competition by limiting the number of sellers of a particular product competing for the business of a given group of buyers. Location restrictions have this effect because of practical constraints on the effective marketing area of retail outlets. Although intrabrand competition may be reduced, the ability of retailers to exploit the resulting market may be limited both by the ability of consumers to travel to other franchised locations and, perhaps more importantly, to purchase the competing products of other manufacturers. . . .

Vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. . . . For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. Service and repair are vital for many products, such as automobiles and major household appliances. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did. . . .

We conclude that the distinction drawn in *Schwinn* between sale and non-sale transactions is not sufficient to justify the application of a *per se* rule in one situation and a rule of reason in the other. The question remains whether the *per se* rule stated in *Schwinn* should be expanded to include non-sale transactions or abandoned in favor of a return to the rule of reason. We have found no persuasive support for expanding the *per se* rule. . . .

We revert to the standard articulated in *Northern Pacific Railway*, and reiterated in *White Motor*, for determining whether vertical restrictions must be "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." *Northern Pacific*, 356 U.S., at 5. [Non-price vertical restraints], in varying forms, are widely used in our free market economy. . . . [T]here is substantial scholarly and judicial authority supporting their economic utility. There is relatively little authority to the contrary.[28] . . . Accordingly, we conclude that the *per se* rule stated in *Schwinn* must be overruled.[30] In so holding we do not foreclose the possibility that particular applications of vertical restrictions might justify *per se* prohibition under *Northern Pacific Railway* But we do make clear that departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than as in *Schwinn* upon formalistic line drawing.

In sum, we conclude that the appropriate decision is to return to the rule of reason that governed vertical restrictions prior to *Schwinn*. When anticompetitive effects are shown to result from particular vertical restrictions they can be adequately policed under the rule of reason, the standard

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[28] There may be occasional problems in differentiating vertical restrictions from horizontal restrictions originating in agreements among the retailers. There is no doubt that restrictions in the latter category would be illegal per se, *see*, *e.g.*, *United States v. General Motors Corp.*, 384 U.S. 127 (1966); *United States v. Topco Associates, Inc.*, 405 U.S. 596 (1972), but we do not regard the problems of proof as sufficiently great to justify a *per se* rule.

[30] The importance of *stare decisis* is, of course, unquestioned, but as Mr. Justice Frankfurter stated in *Helvering v. Hallock*, 309 U.S. 106, 119 (1940), "*stare decisis* is a principle of policy and not a mechanical formula of adherence to the latest decision, however recent and questionable, when such adherence involves collision with a prior doctrine more embracing in its scope, intrinsically sounder, and verified by experience."

traditionally applied for the majority of anticompetitive practices challenged under § 1 of the Act. Accordingly, the decision of the Court of Appeals is *Affirmed*.

Mr. Justice BRENNAN with whom Mr. Justice MARSHALL joins, dissenting.

I would not overrule the *per se* rule stated in *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), and would therefore reverse the decision of the Court of Appeals for the Ninth Circuit.