Business Electronics Corp. v. Sharp Electronics Corp.

485 U.S. 717 (1988)

Justice SCALIA delivered the opinion of the Court.

Petitioner Business Electronics Corporation seeks review of a decision of the United States Court of Appeals for the Fifth Circuit holding that a vertical restraint is *per se* illegal under § 1 of the Sherman Act, only if there is an express or implied agreement to set resale prices at some level. . . . We granted certiorari to resolve a conflict in the Courts of Appeals regarding the proper dividing line between the rule that vertical price restraints are illegal *per se* and the rule that vertical nonprice restraints are to be judged under the rule of reason.

I

In 1968, petitioner became the exclusive retailer in the Houston, Texas, area of electronic calculators manufactured by respondent Sharp Electronics Corporation. In 1972, respondent appointed Gilbert Hartwell as a second retailer in the Houston area. During the relevant period, electronic calculators were primarily sold to business customers for prices up to $1,000.

[M]uch of the evidence in this case was conflicting—in particular, concerning whether petitioner was "free riding" on Hartwell's provision of presale educational and promotional services by providing inadequate services itself. [A] few facts are undisputed. Respondent published a list of suggested minimum retail prices, but its written dealership agreements with petitioner and Hartwell did not obligate either to observe them, or to charge any other specific price. Petitioner's retail prices were often below respondent's suggested retail prices and generally below Hartwell's retail prices, even though Hartwell too sometimes priced below respondent's suggested retail prices. Hartwell complained to respondent on a number of occasions about petitioner's prices. In June 1973, Hartwell gave respondent the ultimatum that Hartwell would terminate his dealership unless respondent ended its relationship with petitioner within 30 days. Respondent terminated petitioner's dealership in July 1973.

Petitioner brought suit . . ., alleging that respondent and Hartwell had conspired to terminate petitioner and that such conspiracy was illegal *per se* under § 1 of the Sherman Act. . . . The District Court instructed the jury . . . [that] "[t]he Sherman Act is violated when a seller enters into an agreement or understanding with one of its dealers to terminate another dealer because of the other dealer's price cutting. . . .

The Fifth Circuit reversed, holding that the jury interrogatory and instructions were erroneous, and remanded for a new trial. [We granted certiorari].

II

A

Section 1 of the Sherman Act provides that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal." Since the earliest decisions of this Court interpreting this provision,

we have recognized that it was intended to prohibit only unreasonable restraints of trade. . . . Certain categories of agreements, however, have been held to be *per se* illegal, dispensing with the need for case-by-case evaluation. We have said that *per se* rules are appropriate only for "conduct that is manifestly anticompetitive," *Continental T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49-50 (1977), that is, conduct "that would always or almost always tend to restrict competition and decrease output," *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284, 289-290 (1985) (quoting *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1, 19-20 (1979)). . . .

Although vertical agreements on resale prices have been illegal *per se* since *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911), we have recognized that the scope of *per se* illegality should be narrow in the context of vertical restraints. In *GTE Sylvania*, we refused to extend *per se* illegality to vertical nonprice restraints, specifically to a manufacturer's termination of one dealer pursuant to an exclusive territory agreement with another. [We found that vertical restraints] had real potential to stimulate interbrand competition, "the primary concern of antitrust law":

> [N]ew 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.... 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. *GTE Sylvania*, 433 U.S. at 55.

Moreover, we observed that a rule of *per se* illegality for vertical nonprice restraints was not needed or effective to protect intra brand competition. First, so long as interbrand competition existed, that would provide a 'significant check' on any attempt to exploit intrabrand market power. In fact, in order to meet that interbrand competition, a manufacturer's dominant incentive is to lower resale prices. Second, the *per se* illegality of vertical restraints would create a perverse incentive for manufacturers to integrate vertically into distribution, an outcome hardly conducive to fostering the creation and maintenance of small businesses.

Finally, our opinion in *GTE Sylvania* noted a significant distinction between vertical nonprice and vertical price restraints. That is, there was support for the proposition that vertical price restraints reduce inter brand price competition because they "facilitate cartelizing." . . . The authorities cited by the Court suggested how vertical price agreements might assist horizontal price fixing at the manufacturer level (by reducing the manufacturer's incentive to cheat on a cartel, since its retailers could not pass on lower prices to consumers) or might be used to organize cartels at the retailer level. . . . Similar support for the cartel-facilitating effect of vertical nonprice restraints was and remains lacking.

. . . In *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 763 (1984), which addressed the evidentiary showing necessary to establish vertical concerted action, we expressed concern that "[i]f an inference of such an agreement may be drawn from highly ambiguous evidence, there is considerable danger that the doctrin[e] enunciated in *Sylvania* ... will be seriously eroded." We eschewed adoption of an evidentiary standard that "could deter or penalize perfectly legitimate conduct" or

"would create an irrational dislocation in the market" by preventing legitimate communication between a manufacturer and its distributors. *Id.*

Our approach to the question presented in the present case is guided by the premises of *GTE Sylvania* and *Monsanto*: that there is a presumption in favor of a rule-of-reason standard; that departure from that standard must be justified by demonstrable economic effect, such as the facilitation of cartelizing, rather than formalistic distinctions; that interbrand competition is the primary concern of the antitrust laws; and that rules in this area should be formulated with a view towards protecting the doctrine of GTE Sylvania. These premises lead us to conclude that the line drawn by the Fifth Circuit is the most appropriate one.

There has been no showing here that an agreement between a manufacturer and a dealer to terminate a "price cutter," without a further agreement on the price or price levels to be charged by the remaining dealer, almost always tends to restrict competition and reduce output. Any assistance to cartelizing that such an agreement might provide cannot be distinguished from the sort of minimal assistance that might be provided by vertical nonprice agreements like the exclusive territory agreement in *GTE Sylvania*, and is insufficient to justify a *per se* rule. Cartels are neither easy to form nor easy to maintain. Uncertainty over the terms of the cartel, particularly the prices to be charged in the future, obstructs both formation and adherence by making cheating easier. . . . Without an agreement with the remaining dealer on price, the manufacturer both retains its incentive to cheat on any manufacturer-level cartel (since lower prices can still be passed on to consumers) and cannot as easily be used to organize and hold together a retailer-level cartel.

The District Court's rule on the scope of *per se* illegality for vertical restraints would threaten to dismantle the doctrine of *GTE Sylvania.* Any agreement between a manufacturer and a dealer to terminate another dealer who happens to have charged lower prices can be alleged to have been directed against the terminated dealer's "price cutting." In the vast majority of cases, it will be extremely difficult for the manufacturer to convince a jury that its motivation was to ensure adequate services, since price cutting and some measure of service cutting usually go hand in hand. Accordingly, a manufacturer that agrees to give one dealer an exclusive territory and terminates another dealer pursuant to that agreement, or even a manufacturer that agrees with one dealer to terminate another for failure to provide contractually obligated services, exposes itself to the highly plausible claim that its real motivation was to terminate a price cutter. Moreover, even vertical restraints that do not result in dealer termination, such as the initial granting of an exclusive territory or the requirement that certain services be provided, can be attacked as designed to allow existing dealers to charge higher prices. Manufacturers would be likely to forgo legitimate and competitively useful conduct rather than risk treble damages and perhaps even criminal penalties.

We cannot avoid this difficulty by invalidating as illegal *per se* only those agreements imposing vertical restraints that contain the word "price," or that affect the "prices" charged by dealers. Such formalism was explicitly rejected in *GTE Sylvania.* As the above discussion indicates, all vertical restraints, including the exclusive territory agreement held not to be *per se* illegal in *GTE Sylvania,* have the potential to allow dealers to increase "prices" and can be characterized as intended to achieve just that. In fact, vertical nonprice restraints only accomplish the benefits identified in *GTE Sylvania* because they reduce intrabrand price competition to the point where the dealer's profit margin permits provision of the desired services. As we described it in *Monsanto:* "The manufacturer often will want to ensure that its distributors earn sufficient profit to pay for programs such as hiring and training additional salesmen or demonstrating the technical features of the product, and will want to see that 'free-riders' do not interfere." *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 762-63 (1984).

[T]he dissent's reasoning hinges upon its perception that the agreement between Sharp and Hartwell was a "naked" restraint-that is, it was not "ancillary" to any other agreement between Sharp and Hartwell. . . . But that is not true, unless one assumes, contrary to *GTE Sylvania* and *Monsanto*, and contrary to our earlier discussion, that it is not a quite plausible purpose of the restriction to enable Hartwell to provide better services under the sales franchise agreement. . . .

B

[W]e do not ignore common-law precedent concerning what constituted "restraint of trade" at the time the Sherman Act was adopted. But neither do we give that pre-1890 precedent the dispositive effect some would. The term "restraint of trade" in the statute, like the term at common law, refers not to a particular list of agreements, but to a particular economic consequence, which may be produced by quite different sorts of agreements in varying times and circumstances. The changing content of the term "restraint of trade" was well recognized at the time the Sherman Act was enacted. . . .

The Sherman Act adopted the term "restraint of trade" along with its dynamic potential. It invokes the common law itself, and not merely the static content that the common law had assigned to the term in 1890. . . . If it were otherwise, not only would the line of *per se* illegality have to be drawn today precisely where it was in 1890, but also case-by-case evaluation of legality (conducted where *per se* rules do not apply) would have to be governed by 19th-century notions of reasonableness. It would make no sense to create out of the single term "restraint of trade" a chronologically schizoid statute, in which a "rule of reason" evolves with new circumstances and new wisdom, but a line of *per se* illegality remains forever fixed where it was.

Of course, the common law, both in general and as embodied in the Sherman Act, does not lightly assume that the economic realities underlying earlier decisions have changed, or that earlier judicial perceptions of those realities were in error. . . .

Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911) . . . was an early Sherman Act case, [whose] holding that a resale price maintenance agreement was *per se* illegal was based largely on the perception that such an agreement was categorically impermissible at common law. . . . In the present case, of course, no agreement on resale price or price level, . . . so the common-law rationale of *Dr. Miles* does not apply. . . .

In sum, economic analysis supports the view, and no precedent opposes it, that a vertical restraint is not illegal *per se* unless it includes some agreement on price or price levels. Accordingly, the judgment of the Fifth Circuit is *Affirmed*.

Justice KENNEDY took no part in the consideration or decision of this case.

Justice STEVENS, with whom Justice WHITE joins, dissenting.

. . .