TRADE REGULATION: VERTICAL TERRITORIAL RESTRICTIONS UPHELD BY SEVENTH CIRCUIT COURT OF APPEALS

FOR YEARS manufacturers have submitted without litigation to the Government's position that vertical territorial restrictions are illegal per se. In 1963, however, the Supreme Court refused to accept this per se doctrine.[1] That ruling was interpreted in *Snap-On Tools Corp. v. FTC*,[2] where the Court of Appeals for the Seventh Circuit upheld a system of vertical territorial restrictions.

A vertical territorial restriction generally consists of a promise by a dealer that he will sell the goods he buys from a manufacturer neither outside an area specified by the manufacturer nor to customers who reside or have their place of business outside that area.[3] It is usually connected with and strengthens an exclusive franchise.[4] Such restrictions help manufacturers to obtain capable dealers[5] and to discourage them from handling competing lines.[6] Moreover, the orderly distribution of goods and the determination of dealers' requirements in advance are facilitated.[7] In addition, dealers are required to develop the entire sales potential of their territory rather than go into another's territory.[8] On the other

[1] White Motor Co. v. United States, 372 U.S. 253 (1963).

[2] 321 F.2d 825 (7th Cir. 1963).

[3] A violation of this promise by the dealer, known as cross-selling, is penalized by a system of after-the-fact sanctions called profit pass-overs. The profit pass-over requires the dealer who sells to a customer from outside his territory to pay to the dealer from whose territory the customer came a certain sum of money fixed by the manufacturer. Note, 75 HARV. L. REV. 795, 809, 814 (1962). See generally Jordan, *Exclusive and Restricted Sales Areas Under the Antitrust Laws*, 9 U.C.L.A.L. REV. 111 (1962); Robinson, *Restraints on Trade and the Orderly Marketing of Goods*, 45 CORNELL L.Q. 254 (1960).

[4] "[T]he systematic granting of franchises with exclusive selling rights necessarily involves reciprocal restrictions on the grantor and the grantee of the franchise. The restriction on the freedom of the dealer to sell outside the assigned territory is necessary in order to make effective the granting of exclusive selling rights to others." Jordan, *supra* note 3, at 142.

[5] In order to persuade a desirable individual to make the investment and take the risk connected with a dealership, the manufacturer often must assure the dealer that he will be the exclusive dealer for the manufacturer's products within the granted territory. Note, *supra* note 3, at 805-09.

[6] See Jordan, *supra* note 3, at 122.

[7] See Note, *supra* note 3, at 805, 813.

[8] Businessmen say that without vertical territorial restrictions, a dealer would be tempted to encroach on the best of a neighboring dealer's customers rather than

hand, vertical territorial restrictions necessarily result in the elimination of intrabrand competition. Hence, the consumer is deprived of any competitive advantage, in prices or services, that he might gain if he were able to bargain with more than one dealer.[9]

Territorial restrictions were first considered by courts in horizontal form: the division of markets by competitors. Such horizontal division of territories has been held to be illegal per se both at common law and under section 1 of the Sherman Anti-Trust Act.[10] Because the anticompetitive intent in this device is clear, the courts have held possible economic justification to be irrelevant.[11] On the other hand, when vertical territorial restrictions first came before the courts they were upheld.[12] Nevertheless, in the past two decades, manufacturers, believing such restrictions to be illegal per se, have submitted to consent judgments whenever challenged.[13] A permissive provision in these consent judgments,

develop the more difficult customers in his own territory. This would result in considerably less total sales for the manufacturer. Note, *supra* note 3, at 811.

[9] White Motor Co. v. United States, 372 U.S. 253, 278 (1963) (dissenting opinion).

[10] 26 Stat. 209 (1890), as amended, 15 U.S.C. § 1 (1958). Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951) (agreement to divide territories by producers of antifriction bearings); United States v. Addyston Pipe & Steel Co., 85 Fed. 271 (6th Cir. 1898), *decree modified and judgment aff'd*, 175 U.S. 211 (1899) (agreement to divide territories by iron pipe manufacturers).

[11] "[T]he range of restrictive agreements under consideration in this section covers just those antitrust offenses which are described as being illegal *per se* and in respect to which, in consequence, no evidence of economic justification is admissible. This situation is simply another reflection of the primacy of the political over the economic motivation of antitrust; agreements between competitors create economic power which may be abused, and this is thought undesirable even if it should also yield economic advantages. But it also reflects the fact that the courts themselves have always opposed the idea that they should attempt to assess the economic balance of advantage. Economic argument, even of the simplest kind, tends to be seen as a slippery slope on which the firm footing needed for a properly justiciable issue cannot be obtained. Once any such argument is admitted... there will be nothing to prevent the introduction of more and more subtle economic arguments. The strongest judicial tradition in antitrust is that which disclaims any competence in weighing these arguments and denies that any case-by-case assessment of the public interest in the light of them is or ought to be required by the law." NEALE, THE ANTITRUST LAWS OF THE UNITED STATES OF AMERICA 427-28 (1960). See also cases cited note 10 *supra*.

[12] See, *e.g.*, Phillips v. Iola Portland Cement Co., 125 Fed. 593 (8th Cir. 1903); Johnson v. Franklin Kirk Co., 83 Ind. App. 519, 148 N.E. 177 (1925). In the *Phillips* case a single vertical territorial restriction was upheld on the ground that its purpose was to promote the business of the manufacturer and its effect on competition was indirect and immaterial. In the *Johnson* case a system of vertical territorial restrictions was upheld on the ground that such agreements are not against public policy because a manufacturer has a right to control its output.

[13] See, *e.g.*, United States v. Lone Star Cadillac Co., TRADE REG. REP. (1963 Trade Cas.) ¶ 70739, at 77918 (N.D. Tex. May 10, 1963) (distributor of automobiles); United

however, has allowed the use of areas of primary responsibility.[14] Under this arrangement dealers are assigned an area which they must fully develop and service.

Recently, however, the White Motor Company refused to submit to such a consent judgment. This company is a manufacturer of trucks and truck parts and sells to dealers for resale. To effectuate its sales policy, the company enters into contracts with its dealers and distributors which require them to sell only to customers who live or whose place of business is in a specified area. White Motor Company contended that this was the only feasible system available which would enable it to compete against the larger companies in the field. Irrespective of this argument, both the trial court and the Court of Appeals held the territorial restrictions to be illegal per se. However, the Supreme Court, because not enough was known about the actual impact of this type of restriction, refused to set down an illegal per se rule.[15] Mr. Justice Douglas, speaking for the majority, rejected Government arguments analogizing vertical to horizontal territorial restrictions. He reasoned that it might be shown that the purpose and effect of vertical territorial restrictions are legitimate, as opposed to horizontal territorial restrictions which may never have any other purpose than the stifling of competition.[16] The rationale appears to be that vertical territorial restrictions may be upheld if circumstances necessitate their use.[17] The Court did not foreclose the possibility, however, that an illegal per se rule might be adopted as to these restrictions should they prove to have too great

States v. American Type Founders Co., TRADE REG. REP. (1958 Trade Cas.) ¶ 69065, at 74203 (D.N.J. June 20, 1958) (manufacturer of printing presses); United States v. J. P. Seeburg Corp., TRADE REG. REP. (1957 Trade Cas.) ¶ 68613, at 72476 (N.D. Ill. Jan. 31, 1957) (manufacturer of coin-operated phonograph machines).

The Department of Justice started its attack on vertical territorial restrictions in 1948, taking the position that such restrictions were illegal per se. It first applied pressure to the large automobile manufacturers and was able to convince them to remove voluntarily such restrictions from their dealer and distributor contracts. *Hearings Before the Subcommittee on Automobile Marketing Legislation of the House Committee on Interstate and Foreign Commerce*, 84th Cong., 2d Sess. 361-65 (1956).

[14] See cases cited note 13 *supra*.

[15] 372 U.S. at 261, 263.

[16] *Id.* at 263.

[17] Some of the inquiries that should be made in evaluating the impact and in determining the legality of the vertical territorial restriction are: what relationship does the restraint bear to the ultimate survival of the manufacturer, is the restraint more restrictive than necessary, and are there any adequate alternatives that would satisfy the manufacturer's needs? 372 U.S. at 268-72 (Brennan, J., concurring).

an effect on competition.[18] A strong dissent, rejecting any argument of business necessity, urged the adoption of an illegal per se rule.[19]

Snap-On Tools is the first consideration of a vertical territorial restriction in the light of *White Motor Co.*[20] Snap-On is a large manufacturer of a complete line of hand tools and related equipment. It does most of its business through independent dealers who work out of mobile walk-in trucks and who regularly call on and service mechanics, automotive service, and industrial establishments. The dealers have an exclusive franchise subject to Snap-On's right to sell to certain industrial customers. Snap-On requires its dealers to enter into a standard form contract which includes territorial restrictions, resale price provisions, customer limitations, and restrictions on the right of the dealer to compete after ceasing to be a dealer.[21] After hearing the evidence, the hearing examiner dismissed the complaint against Snap-On.[22] The Federal Trade Commission reversed on the ground that Snap-On's over-all distribution plan was an unfair method of competition in violation of section 5

[18] "We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a 'pernicious effect on competition and lack ... any redeeming virtue' ... and therefore should be classified as *per se* violations of the Sherman Act." 372 U.S. at 263.

[19] An explicit agreement to limit competition has never been justified by the existence of interbrand competition. If dealers could not agree among themselves to divide territories, a manufacturer should not fare any better with a plan to achieve the same result. 372 U.S. at 278-80 (Clark, J., dissenting).

[20] The Supreme Court in *White Motor Co.* reversed the summary judgment granted the Government by the district court but did not intimate any view on the merits. The case was remanded for a trial on the merits to determine the legality of the vertical territorial restrictions therein, in accord with the reasoning of the Court. 372 U.S. at 264.

[21] The "Dealer Agreement" contained among others the following agreements and conditions:

1. The dealer agrees that he will not sell any of the products purchased from Snap-On at a price varying from the retail price fixed by Snap-On.

2. The dealer will sell Snap-On's products only within the geographical limits of the territory described in his agreement.

3. The dealer will not sell Snap-On's products to the certain persons or firms specified by name in his agreement.

4. The "Dealer Agreement" may be terminated by the company at any time, and at the termination of the agreement, whether by the dealer or by Snap-On, the dealer agrees that he will not engage in a similar business within the state in which he had been selling Snap-On's products for one year after the termination of the "Dealer Agreement." 321 F.2d at 827 n.2.

[22] The hearing examiner when he first heard the evidence considered separately the legality of the restrictive provisions of Snap-On's dealer contract. He dismissed the complaint as to the vertical territorial restrictions and the customer limitations. The Federal Trade Commission vacated this order and ordered the hearing examiner to consider whether the over-all distribution plan constituted an unlawful restraint

of the Federal Trade Commission Act.[23] The Court of Appeals, in reversing the Commission, held that the restrictive provisions of the contract should not be considered as a unitary device to restrain competition, but that each restraint should be considered individually. Consequently, the court found there to be no substantial basis for the Commission's finding that the restraints were illegal.[24] Furthermore, relying on *White Motor Co.*, the court reasoned that as the vertical territorial restrictions promoted broad meaningful interbrand competition, a minimal curtailment of intrabrand competition was justified.[25] Moreover, the court rejected areas of primary responsibility as an adequate alternative to the vertical territorial restrictions reasoning that, because Snap-On permitted the dealers to sell to any customer as long as the customer bought within the dealer's territory, there was but a difference in words between the two.[26]

Superficially, this reasoning complies with the principles set down by the Supreme Court in *White Motor Co.* However, its conclusion should be examined in terms of the attendant economic and business circumstances. The court stressed the fact that Snap-On allowed its dealers to sell to customers from any territory, as long as the sale was made within the territory of the dealer. In some businesses, such as that of White Motor, this would be an important limitation on vertical territorial restrictions, but in Snap-

on competition. Upon again hearing the evidence, the hearing examiner made findings of fact and dismissed the complaint. 321 F.2d at 828.

[23] "Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful." 52 Stat. 111 (1938), 15 U.S.C. § 45 (a) (1) (1958).

[24] As to the price restriction, the court found that Snap-On was attempting in good faith to comply with the law and that its activity should not be struck down as illegal on the basis of a technical and literal interpretation of the contract. 321 F.2d at 833-35.

The court found that the customer restrictions, at most, amounted to a de minimus restraint on competition. *Id.* at 835-36.

The court said that the restrictions on the dealer after termination of the "Dealer Agreement" might be unreasonable as to the size of the territory involved but as this provision was very rarely enforced and has since been deleted from the "Dealer Agreement" there was no need for a cease and desist order. *Id.* at 836-37.

[25] "[T]he trial examiner discussed the facts fully, and demonstrated by them to his satisfaction, and to ours, that there are certain advantages to a manufacturer, such as petitioner, in requiring an exclusive territorial arrangement with its dealers which promotes (rather than supresses) in a broad, meaningful way, competition between it and other manufacturers of similar products, and which therefore justify a minimal curtailment of intrabrand competition among its dealers." 321 F.2d at 831-32.

[26] *Id.* at 832.

On's situation this limitation is meaningless. There the customer does not call on the dealer; rather the dealer calls on and sells to the customer at the latter's place of business. Moreover, despite what the court said, there is more than a mere difference in words between the area of primary responsibility and the vertical territorial restrictions employed by Snap-On.[27] Under the former when a dealer has fully developed and serviced his territory he might solicit customers from outside his territory, whereas, under the latter, the dealer is never permitted to sell outside his territory.[28] Even though the court said that anything less than the particular vertical territorial restrictions employed would produce friction among the dealers,[29] this would seem to be no more than the normal friction that exists among competitors. It is this very friction that the antitrust laws require for the protection of the consumer.[30]

Although the effect on intrabrand competition is characterized by the court as minimal, realistically the net purpose and effect of the vertical restriction, in conjunction with the exclusive franchise, is to eliminate intrabrand competition.[31] On the other hand, the court places particular emphasis on the justification that this type of restriction promotes interbrand competition. Conspicuously lacking, however, is an examination of the resulting interbrand competition in the absence of such a restriction. In this context, an important consideration is how the ultimate survival of Snap-On, and others similarly situated, would be affected if vertical territorial restrictions were not permitted.[32]

General considerations would suggest that the ultimate survival of Snap-On would not be substantially affected by not permitting

[27] Mr. Justice Brennan (citing Snap-On Tools Corp., TRADE REG. REP. (1961-1963 Transfer Binder; FTC Complaints, Orders, Stipulations) ¶ 15546, at 20414 (FTC Docket No. 7116, Nov. 1, 1961) as support) suggested the area of primary responsibility as a less restrictive alternative and a lawful means of serving the legitimate needs of a manufacturer. 372 U.S. at 271 n.12.

[28] Actually, the dealer can sell outside his territory by breaching his agreement with the manufacturer and paying the profit pass-over penalty. Therefore, the real barrier is no greater than the profit pass-over, which may vary from business to business, as it is the manufacturer who sets the amount of the profit pass-over. Note, *supra* note 3, at 827-29.

[29] 321 F.2d at 832.

[30] "The general objective of the antitrust laws is promotion of competition in open markets." ATT'Y GEN. NAT'L COMM. ANTITRUST REP. 1 (1955).

[31] This was admitted to be the purpose and effect by counsel for Snap-On during the hearing. Brief for Respondent, pp. 21-23.

[32] See note 17 *supra*.

vertical territorial restrictions.[33] Initially it is important to consider that Snap-On is one of the larger competitors in the hand tool business.[34] Moreover, there was no finding by the court that the competitors of Snap-On were permitted to use, or did use, vertical territorial restrictions. Consequently, it does not seem likely that Snap-On would be submerged if put on an even footing with its competitors. A more plausible conclusion would be that Snap-On would continue as a strong competitor in its field and on a more equitable basis.

By making justification of vertical territorial restrictions relatively easy, *Snap-On Tools* extends *White Motor Co.* beyond its intended limits.[35] This non-discriminating analysis could lead to either of two undesirable extremes. It could be a basis for justifying almost all such restrictions, or it could lead the Supreme Court to lay down an illegal per se rule banning all vertical restrictions.[36] A stricter economic analysis is called for; vertical territorial restrictions should be justified only when it is shown that they are necessary for survival, that they promote interbrand competition, and that there are no adequate alternatives.

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[33] At any rate, Snap-On would be permitted to use the area of primary responsibility, and this, connected with an exclusive franchise, should prove efficient in the development and servicing of the assigned areas. Note, *supra* note 3, at 828-29.

[34] Snap-On has 50 branch offices in principal cities of the United States, Canada, Mexico, and Puerto Rico. Its net sales have increased from $16 million in 1951 to $24 million in 1957. Snap-On is among the six top tool firms in the country according to testimony of its sales vice president. Brief for Respondent, pp. 7-8.

[35] See text accompanying note 17 *supra*.

[36] See text accompanying note 18 *supra*.