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THE RESURGENCE OF THE EXCLUSIVE TERRITORIAL DISTRIBUTORSHIP AS AN ANTITRUST PROBLEM

Rising to the surface as a problem in the restraint of trade field under antitrust law is the method of wholesale and retail distribution known as the exclusive territorial distributorship. The essential characteristics of an exclusive territorial distributorship are first, the setting of a limited area within which a retailer or wholesaler will confine his sales efforts; second, a covenant by the manufacturer, or whoever may supply the seller, that the manufacturer will not sell to anyone else within that same area; and third, an agreement that the manufacturer or supplier will exact similar covenants from other wholesalers or retailers that they will also confine their sales efforts to their allotted territories. Separation of selling outlets in this manner is usually used by sellers of goods sold under brand name where purchase is dependent upon brand differentiation. One can readily see that spacial separation of sellers eliminates competition in the price of each territorially distributed brand to the extent that the areas allotted are large enough to discourage purchasers from traveling to sellers in adjacent selling areas. On the other hand, the brand so handled is still in competition with other brands and is, therefore, not completely free to command a monopolistically high price. Hence, the problem becomes: do territorial distributorships restrain competition or monopolize trade in the type of goods concerned to the extent that they violate the antitrust laws?

A distinction must be recognized between an exclusive territorial distributorship contract and an exclusive dealing contract. Under the latter a retailer promises to deal exclusively in one manufacturer's goods. If exclusive dealing contracts are overly restrictive, they are subject to explicit prohibition under section 3 of the Clayton Act, but there is no federal statute which deals expressly with the territorial distributorship. The statutory provisions by which the legality of the territorial distributorship would be measured would undoubtedly be either section 1 of the Sherman Act prohibiting "every contract, combination . . . , or conspiracy, in
restraint of trade . . ."; section 2 of the Sherman Act which makes a misdemeanor of "every person who shall monopolize, . . . or combine or conspire with any other person . . . to monopolize any part of the trade or commerce among the several States . . ."; or section 5 of the Federal Trade Commission Act which declares illegal all "unfair methods of competition," and "unfair or deceptive acts or practices in commerce. . ." Of these, section 1 of the Sherman Act is the most likely to be used, since there is nothing inherently monopolistic or deceptive about the exclusive agency. When one reads into section 1 of the Sherman Act the rule of reason announced in Standard Oil Co. v. United States, the question posed, as it would apply to territorial distributorships is: does an exclusive territorial distributorship unreasonably restrain competition?

At present there is disagreement whether the exclusive agency unduly restrains competition. The Federal Trade Commission has procured several consent decrees requiring the abandonment of this distributing system. These decrees, however, must be considered with a view not only toward the expense in defending such protracted litigation, but also toward the significance of the fact that the entry of a consent judgment lessens the probability of suit by private parties. Writers in the field have expressed their conviction that the exclusive territorial distributorship would probably be declared illegal, but they have by no means been unopposed. The Attorney General's National Committee to Study the Antitrust Laws has declared that these distribution systems should be allowed if they are created to serve valid business purposes and if there is no attempt to monopolize the field. Indeed, two recent

8. 221 U.S. 1, 60 (1911).
10. Section 5 of the Clayton Act, 38 Stat. 731 (1914), 15 U.S.C. § 16 (1952) provides that consent judgments in criminal suits for antitrust violations are excepted from the usual rule that a decree against an antitrust defendant will be prima facie evidence against him in subsequent civil actions for treble damages brought by private parties. Since the private claimant against one who has submitted to a consent judgment will have a more difficult task of proving the antitrust violation without aid of presumption, he will be reluctant to bring suit in most cases.
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federal district court cases on territorial distributorships have disclosed conflicting attitudes toward the validity of these selling devices. After the case treatment and various suggested analyses of this problem have been studied, this Note will attempt to analyze the legality of the territorial distributorship by examining its tendency to restrain trade unreasonably by lessening competition in the product market in which it operates.

COURT TREATMENT OF THE PROBLEM

Early state cases which had occasion to test the validity of the exclusive territorial distributorship under state law were almost unanimous in granting their approval to the system. Some courts strained the words of state statutes permitting the appointment of a single distributing agent to mean that many individual sellers operating exclusively in their territory were also allowed. Others resorted to a test of restraint of trade applicable to other types of cases. Thus, it is generally recognized that the validity of a contract to refrain from competing in an area, as a covenant accompanying the sale of a business, is measured by the reasonableness of the area within which the seller is prohibited from competing as well as the extent of the prohibitions in the covenant in relation to the protection necessary to the business sold. Some courts have used these same criteria to find the exclusive territorial distribution system valid, but they did not even consider the competitive state of the market in which the goods were sold. The few cases that have examined economic policy in making their decisions show consideration of the mutual advantages enjoyed by the retailers or the fact that exclusive agencies facilitate wider distribution of the product to the maker's advantage and work no restraint of competition. In one case the advantage to the manufacturer was said to be one of the factors validating the device despite the recognition that the territorial distributorship, as used by the particular manu-

15. 5 Williston, Contracts § 1641 (rev. ed. 1937).
facturer, allowed him a certain measure of control over the price to the consumer; thus working some restraint to competition.

On the other hand, the Texas courts have always invalidated exclusive territorial distributorships under the command of the state antitrust statutes. The only case outside of Texas that has held the contract invalid arose in California in 1922. In striking down an exclusive sales agency over a three state area, the court noted that the commodity involved had only one practical source of supply, of which the contracting parties assumed they had control, and that the prime intent was to give the distributor monopoly power over sales to consumers in his area. A later California case upheld the device, distinguishing the adverse precedent on the basis that there were in the later case both a competitive market among the manufacturers of the product and a lack of intent to monopolize the whole market.

Although the earliest federal case concerning the exclusive territorial distributorship held it legal, in time there developed some opposition to this form of marketing as evidenced by untested jury instructions intimating that a territorial distributorship would be illegal if used as a means of eliminating price competition between dealers, and by a dissent to a dismissal of an antitrust prosecution which expressed the opinion that the very division of territory by one manufacturer was illegal in itself, since it eliminated competition among distributors to such an extent that the distributors would be free to set any price they wished. In the most significant federal case, nevertheless, the system was upheld. A new and used car dealer brought an action against the manufacturers of Chevrolet automobiles for restraint of trade in refusing the retail dealer the privilege of setting up additional used car sales and repair facilities outside the dealer's original zone of influence in down-

town Brooklyn. The district court dismissed the complaint on the two bases that plaintiff had not shown that interstate commerce was involved, and that in both the new and used car sales operations, Chevrolet allowed the dealer to use its trade mark, in return for which Chevrolet had the right to protect its good will by restraining harmful competition among its dealers. The Court of Appeals for the Second Circuit affirmed the district court's findings and approved its reasoning. Upon a petition for rehearing the Court of Appeals interpreted the contract to mean that the dealer could compete beyond the bounds of his zone of influence, but could not create additional facilities outside. In addition the court found that there was ample evidence of competition in the low cost class of automobiles.

Since this case in 1942, several cases dealing with exclusive territorial distributorships have culminated in consent decrees. In evaluating the significance of these decrees one must take account of the fact that all of these cases were brought against leading producers in their field and were coupled with an alleged attempt to monopolize or fix resale prices illegally. Two recent cases have approached the problem of exclusive agency with divergent views. In the first case Packard Automobile Company had been induced by one of its distributors in Baltimore to deny further franchising to the two other Packard distributors in that city so that the first distributor might operate at a profit. In the treble damage action by one of the disfranchised dealers, the jury was left with the question, whether Packard’s actions at the request of the remaining distributor amounted to an unreasonable agreement in restraint of trade. The jury found for the plaintiff and awarded him damages. On a post-trial motion for judgment notwithstanding the verdict or for a new trial, Judge Holtzoff of the Federal District Court for the District of Columbia held that the jury had sufficient evidence upon which to decide that the agreement between the manufacturer and remaining dealer was an unreasonable restraint of trade, since it diminished competition in servicing and selling of Packard automobiles. Although Judge Holtzoff said that Packard would normally have the right to choose the number of dealers it wished to

28. Boro Hall Corp. v. General Motors Corp., 124 F. 2d 822 (2d Cir. 1942).
29. Boro Hall Corp. v. General Motors Corp., 130 F. 2d 196 (2d Cir. 1942), cert. denied, 317 U. S. 695 (1943).
30. See note 9 supra.
maintain, it could not reduce the number of dealers by conspiracy with another party.\footnote{33}{Id. at 8.}

A similar action was brought against the Hudson Sales Corporation in the Federal District Court for the District of Maryland. The disfranchised dealers complained that Hudson had cancelled their dealership contracts at the instance of the third Hudson dealer in metropolitan Baltimore, so that the only competition left came from two suburban Hudson dealers. Plaintiffs alleged and the court admitted that the one dealer remaining in the city had a virtual monopoly over the sale of Hudsons in the city of Baltimore. Plaintiffs further alleged a large drop in the sale of Hudson automobiles in Baltimore as a result of the cancellation of their dealership, and they sought damages suffered from Hudson’s actions. Judge Thomsen dismissed the complaints on the ground that they failed to show an unreasonable restraint of trade.\footnote{34}{Schwing Motor Co. v. Hudson Sales Corp., 138 F. Supp. 890 (1) Md. 1956).}

It was held that though Hudson left the last dealer with a virtual monopoly in Hudsons, this was insufficient to show a restraint of trade, since there was still competition with other makes of automobiles. In addition, even though there was a significant drop in the sale of Hudsons, this was not enough to show a substantial restraint of trade, since Hudson’s share of the market was not large enough to affect the market as a whole. The court criticized the Packard case for its failure to hold that in order for a contract to eliminate competitors to be illegal, it must be between competitors at the same stage of production, or it must be made by a dominant producer. The court also found fault with the Packard case because it drew a distinction between a manufacturer’s decision to eliminate dealers subsequent to negotiations with other dealers and that same decision made without discussion. The court decided that that distinction was specious, since all such decisions are made only after full discussion of the matter with the various parties to be affected. This distinction, Judge Thomsen felt, would make it virtually impossible for Hudson to cut down its number of dealers.\footnote{35}{Id. at 906.}

Although this latter criticism seems valid, Judge Holtzoff’s decision in the Packard case is probably sounder in its conclusion that elimination of all dealers in one make of automobile can be a substantial restraint of trade. When a customer’s choice has narrowed down to one type of car, the only protection he has against monopoly power at the retail level is the competition between dealers in that automobile not only over
prices but also over the amount of free services offered, the length of warranty on parts, and similar by-product features.

A recent comment on the validity of the territorial distributorship has expressed the opinion that illegality may be found in the very division of territory insofar as it promotes price-fixing, which is illegal per se. As a cornerstone for the division of territory analysis, the commentator points to the case of Addyston Pipe & Steel Co. v. United States which held that the geographical division of the market into individually controlled segments by a number of leading producers of cast iron pipe violated section 1 of the Sherman Act. The commentator also points out, however, that the Addyston case involved many manufacturers who together produced two thirds of the pipe sold in the United States and controlled three fourths of the total market area. When a single manufacturer allocates territory among his dealers, price-fixing does not result automatically as it does in situations where, as in the Addyston case, the majority of producers conspire together to eliminate competition by dividing territory. The territorial distributorship is, of course, illegal when used with an organized price-fixing system, even though only a single producer uses this marketing device, for a producer has no right to control the price of his goods after he has once sold them. In order, however, to condemn the territorial distributorship as a price-fixing scheme without a finding of a separate price-fixing agreement, it is necessary to establish that selling to but one dealer in each of several districts necessarily leads to a means of fixing prices. A manufacturer who separates his retailers need not set a minimum resale price in order to avoid ruinous price competition in his brand of goods. His dealers may price the commodity in its best competitive position in relation to rival products. The extent to which the producer will be able to set his price in relation to all competing goods by isolating his sellers will depend on the number of substitute products and the competitive nature of the market in which he is selling. Except to the extent that a dealer is relieved of price competition from other dealers in the same brand of goods, it cannot be decided whether price-fixing necessarily results from use of the territorial distributorship, until the product market in which the goods are sold has been studied.

38. 175 U. S. 211 (1899).
The exclusive agency may also be attacked on the ground that it involves the same price maintenance vices promoted by refusals to sell. The courts have invalidated distribution systems containing refusals to sell either when the system incorporates a method of enforcing fixed prices or when the refusal to sell is the result of a conspiracy. It has been argued above that the exclusive agency does not necessarily lead to price-fixing, and the opinion was also expressed that the manufacturer should be able to consult his distributors when deciding what number of outlets he will maintain. Therefore it seems that a refusal-to-sell attack is inapplicable to the exclusive territorial distributorship.

SUGGESTED ANALYSIS

The approach to the territorial distributorship problem which will probably prove most useful is suggested in the 1955 Report of the Attorney General's National Committee to Study the Antitrust Laws. There it was stated that as an ancillary agreement in the distribution of goods, and where it is not a part of an attempt to monopolize or restrain trade by itself, the territorial distributorship should be held valid, if it serves lawful business purposes and if it does not foreclose competition from the dealer's market. The essential element in preventing restraint of trade and one of the prime reasons for the passage of the antitrust legislation is the fostering of price competition as a mechanism of price making. If the manufacturers have an unqualified right in choosing their dealers, the pertinent consideration is whether enforced non-competition between dealers in one brand of goods is working a substantial prejudice to price competition in the relevant product market. The answer to this problem depends first on a determination of the market in which the producer is operating and second on the degree of competitiveness within that market.

In making a proper delimitation of the market, one must first determine the criteria for deciding which products are of a like nature. The prime limitations have been expressed in terms of func-

46. The scope of this Note does not include a case analysis on the question of determining the market. For a good discussion on this point, see Macdonald, Product Competition in the Relevant Market Under the Sherman Act, 53 Mich. L. Rev. 69 (1954).
tional interchangeability and reactive interchangeability. In order for product A to be functionally interchangeable with product B it must be adaptable to substantially all the uses of product B, with the same basic range of uses for both. For example, rubber fabrications may be substituted in many places normally calling for plastics, but rubber is not subject to many of the diverse uses of which plastic is capable and therefore is not functionally interchangeable with plastic. Further, if product A can accomplish only generally what product B can do, e.g., radio as contrasted to the newspaper, it is functionally non-interchangeable with product B, but this is of course a matter of degree. If it is determined that various products are functionally interchangeable, a second test, that of reactive interchangeability, must be applied in order to determine whether there are close substitutes within a market. This concept measures the willingness of consumers to switch from one brand to another in products which are functionally similar. Such factors as design, quality, packaging, advertising, and sales promotion sometimes separate seemingly competitive products. Under this differentiation the recording of a composition of music by a renowned performer or even by a quality recording company could put the record in a market apart from recordings of the same musical composition by performers of negligible renown or by minor record companies whose quality of recording is unknown. The measure of reactive and functional interchangeability has been stated in terms of cross-elasticity of demand. This means that if all other factors are held constant, lowering the price or raising the quality of one product will lower the demand for competing goods.

If, upon studying the character of the market, one finds that there is little cross-elasticity of demand, that is, very few close substitutes from which a product is receiving effective competition, the further elimination of competition through territorial distributorships should not be permitted. An example of such a market is that of the automobile. All cars are functionally interchangeable, but they have little reactive interchangeability because of extensive advertising, the buyer’s habit of purchasing one line of cars through the years, the dealer’s habit of giving higher trade-in allowances on used cars of the same make as the new car to be purchased, and

48. See id. at 586-88.
49. See ibid.
51. See Scitovskv. Welfare and Competition 396 (1951); Bain, op. cit. supra note 50, at 50-51; Macdonald, supra note 46, at 82-83.
other similar factors. In the final analysis most competition to individual buyers comes not from dealers in different makes of cars, but from different dealers in the same make. If a purchaser decides to buy one of the low- or even medium-priced cars of the big three producers, the chances are good that there is some competition from numerous dealers in that make of car who are within a reachable vicinity. If, however, the car chosen be one from a manufacturer other than the big three, the sources of competition in price are very likely to be severely limited. Indeed, the Packard case pointed out that the elimination of rival Packard dealers could cause the market for Packard automobiles to suffer a substantial diminution in competition over trade-in values, terms of sale, and efficiency of service. Thus the court recognized that reactive interchangeability was limited to the one brand of automobile and that elimination of Packard dealers in the area lessened competition over the price of Packards.

Conclusion

The exclusive territorial distributorship has a large hurdle to overcome before it should be permitted. Because it casts out one source of price competition, that between the dealers in the brand of goods concerned, it has been suggested that the exclusive agency be prohibited altogether. The cases from both state and federal courts show that there is no great tendency to strike down this method of distribution, unless it works a monopoly or tends to restrain trade in a particular type of goods. Under the recently developing standards of competition and market, the territorial distributorship should meet two basic requirements. There must first be a fairly large number of both functional and reactive interchangeables from which the product concerned can receive price competition. Secondly the market must be characterized by lack of collusion and independence of pricing and selling policies. If, but only if, these two conditions exist, there should be ample safety in allowing a manufacturer to choose the exclusive territorial distributorship as his means of distribution.