UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

BUREAU OF COMPETITION

COMMISSION AUTHORIZED

April 20, 1989

The Honorable Marshall A. Rauch
North Carolina General Assembly
Senate Chamber
State Legislative Building
Raleigh, North Carolina 27602

Dear Mr. Rauch:

The staff of the Federal Trade Commission 1/ is pleased to respond to your invitation to comment on Senate Bill 378. The bill, if enacted, would prohibit distributors of household furniture from using a variety of distributional restraints in sales to North Carolina furniture dealers and apparently require furniture distributors who sell to North Carolina dealers to establish uniform nationwide retailing standards and wholesale prices. In addition, the bill would impose a *per se* prohibition on vertical price restraints in the State of North Carolina.

We recognize that low-cost and innovative marketing practices can provide significant benefits to consumers. Legislative restrictions on such practices are likely to harm consumers. We also recognize, however, that manufacturers and distributors often have legitimate concerns about the marketing of their products. Experience has shown that in many situations consumers can benefit from suppliers' placement of restrictions on retailing practices. Consequently, legislation that restricts the ability of manufacturers and distributors to control the distribution of their products is likely to harm consumers. We believe that S.B. 378 may unintentionally harm consumers by prohibiting practices designed to ensure that consumers receive important services.

I. Interest and Experience of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45. The Commission is one of the two federal agencies with principal responsibility for enforcing the antitrust laws. Under its statutory mandate, the Commission seeks to identify restrictions

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1/ These comments represent the views of the staff of the Federal Trade Commission's Bureau of Competition and do not necessarily represent the views of the Commission itself or any individual Commissioner.

that impede competition or increase costs without offering countervailing benefits to consumers. The Commission is interested in the development of sound policy respecting distributional restraints. The Commission has articulated its views on such restraints both through opinions in administrative cases 2/ and through testimony and comments to the United States Congress concerning proposed legislation. 3/ In addition, Commission staff has submitted comments, upon request, to state legislatures concerning various distributional practices. 4/

II. The Proposed Legislation

S.B. 378 contains three principal provisions. Section 2 of the bill would create a new provision, to be codified in N.C. Gen. Stat. § 75-5.1, that would prohibit suppliers of household furniture from using a variety of distributional methods that determine the manner in which their goods are resold by North Carolina retailers, particularly to consumers who buy furniture by telephone or mail order. 5/ Section 2 also appears to require furniture suppliers to impose uniform display requirements and

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2/ See, e.g., Beltone Electronics Corp., 100 F.T.C. 68 (1982).

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5/ Specifically, suppliers would be prohibited from (a) restricting the classes of consumers to whom any retailer may resell furniture, (b) limiting any retailer's sales to persons who have visited the retailer's showroom, (c) limiting the geographic areas in which any retailer may advertise or solicit sales, (d) limiting any retailer's communications with consumers to any communication medium, or (e) preventing any retailer from "advertis[ing] the availability of a particular communications medium . . . ." S.B. 378 Proposed § 75-5.1(a)(1)(a)-(e). The bill would also prohibit suppliers from effectuating the foregoing prohibited restrictions by terminating, refusing to sell, delaying deliveries, or threatening to terminate, refuse to sell, or delay delivery to any retailer. Id., Proposed Section 75-5.1(b)(2)(a)-(e).

other "retailing standards" on their retailers and to charge uniform wholesale prices wherever they do business. Finally, section 1 of the bill would amend N.C. Gen. Stat. § 75-5(b) to prohibit any person from setting or limiting the prices at which goods may be resold in North Carolina.

III. Analysis of the Proposed Legislation

(a) Prohibition of Certain Distributional Restraints

Section 2 of S.B. 378 appears to be designed to prevent manufacturers and distributors of household furniture from using certain distributional methods in selling their furniture to consumers. Thus, the bill would prohibit suppliers from employing certain practices, even if these practices would be the best means of distributing their products. Under the bill, suppliers would be prohibited from restricting the classes of consumers to whom any retailer may resell furniture, limiting any retailer's sales to persons who have visited the retailer's showroom, limiting the geographic areas in which any retailer may advertise or solicit sales, or limiting any retailer's communications with consumers to any communication medium.

Section 2 addresses nonprice vertical (or distributional) restraints, which suppliers may impose to facilitate the delivery of pre-sale and other retailing services to consumers. Many antitrust and economics scholars share the view that vertical restraints often serve procompetitive purposes. 6/ In many cases, suppliers may determine that they must have dealers who inform consumers fully about their product in order to sell it. Acquiring the necessary expertise and conveying the desired information to consumers can be costly, and some dealers may not be willing to incur these costs and provide the services if consumers can receive these services from one dealer and then buy the product from another dealer. In the absence of vertical restraints, dealers who do not provide retailing services may be able to "free ride" on those who do. By failing to provide services, free riders can enjoy lower costs than their full service competitors and, therefore, to underprice them. Consumers may then take advantage of the services provided by the higher price dealers but buy the product from the discounting free riders. This effect may discourage dealers from providing the desired services.

6/ See, e.g., Hovenkamp, Vertical Restrictions and Monopoly Power, 64 Boston U. L. Rev. 521 (1984); Posner, The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality, 48 U. Chi. L. Rev. 6 (1981).

Suppliers may use vertical restraints to deter free riding and thereby preserve dealer incentives to furnish services that consumers value. 7/ This use of vertical restraints to overcome the "free rider" effect was recognized by the Supreme Court more than ten years ago in Continental T.V., Inc. v. GTE Sylvania, Inc., 8/ where the Court overruled a broad rule of *per se* illegality for vertical nonprice restraints and applied a rule of reason standard to such restraints. S.B. 378 would prohibit certain restraints outright, and thus would forbid their use even when they enhance efficient distribution.

Vertical restraints may also prevent free riding on promotional services. Suppliers who need point-of-sale and other marketing efforts by dealers to compete with other suppliers may impose vertical restraints to prevent free riding by dealers who fail to furnish promotional services. Such promotional services may include in-store displays or more intangible services. For example, the types of outlets that carry apparel, cosmetics, or furniture brands may signal to consumers useful fashion or quality information. Department stores or high quality furniture dealers may convey such a message, and thereby provide a service to the manufacturer, simply by carrying a product. 9/ In such cases, vertical restraints may be the most efficient way for a supplier to preserve dealers' incentives to continue providing promotional efforts that foster inter-brand competition.

As these examples indicate, suppliers may impose the types of restrictions addressed by the proposed legislation in order to prevent free riding. For example, consumers who purchase furniture by telephone or mail order may examine the same furniture at a local full service dealer. In so doing, consumers are likely to consult with sales personnel and physically examine and compare different furniture models, thereby imposing costs on the dealership. Not surprisingly, a mail order dealer does not incur such costs and may therefore be able to underprice the full service retailer. Because mail order customers who first use the services of full service dealers impose costs on those dealers, many full service dealers may not wish to do business with suppliers who sell to low- or no-service discounters. Unless suppliers are able to prevent free riding, they could lose many

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7/ *See*, *e.g.*, Hovenkamp, *supra* note 6.

8/ 433 U.S. 36 (1977).

9/ *See* Marvel & McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J.L. & Econ. 363 (1985). *See also* Klein & Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J. Law & Econ. 265 (1988).

of their full-service dealers. 10/ As a consequence, the variety of products and services available to consumers may diminish. 11/

(b) Requirement of Uniform "Retailing Standards" and Wholesale Prices

Proposed N.C. Gen. Stat. 75-5.1(b) reads in pertinent part:

> [A] person engaged in the distribution or selling of household furniture to retailers in this State is not prohibited from establishing and enforcing reasonable retailing standards, including reason-

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10/ As a general matter, suppliers have an interest in seeing their products sold at lower prices, since sales are likely to be higher when prices are lower. Suppliers are likely to impose restraints that may result in higher prices in order to ensure that services that enhance the value of their product to consumers are in fact delivered to consumers.

11/ The drafters of the proposed legislation recognized the existence of the free riding problem and attempted to address it through proposed section 75-5.1(b). That provision would permit suppliers to establish and enforce "reasonable retailing standards, including reasonable showroom display requirements . . . ." Although this provision attempts to remedy the free riding problem, it is likely to be insufficient to enable suppliers to address the problem effectively. First, the provision does not mitigate the problem of free riding by mail order customers. Second, it limits suppliers to a single mechanism for ensuring the delivery of retailing services to consumers, namely explicit contract provisions specifying service levels. While such a mechanism may be adequate in theory for some suppliers, it is more difficult to police and thus costlier than other distributional restraints. Some scholars have argued, moreover, that explicit enforceable contracts requiring dealers to supply a desired level of services are not always economically feasible, and that vertical restraints may be necessary to enable suppliers to secure the desired level of dealer services. See Klein & Murphy, note 9, supra. Third, since the bill does not define "reasonable" showroom display requirements, it may invite further disputes concerning the appropriate level of services for the products in question. Finally, this section would permit the imposition of "retailing standards" only if they are "imposed and enforced uniformly and consistently upon all retailers with whom a person deals." This limitation would prevent suppliers from imposing different standards in different markets, with variations reflecting local retailing customs, retailing costs, or consumer demand characteristics. See Part III(b), infra.

> able showroom display requirements or reasonable advertising format restrictions, or from changing wholesale prices to retailers, provided that such standards, requirements and wholesale prices are imposed and enforced uniformly and consistently upon all retailers with whom the person deals.

This provision appears to require suppliers who wish to impose retailing standards, such as showroom display requirements, to impose uniform nationwide standards. 12/ It also appears to require suppliers to charge a uniform nationwide wholesale price.

A requirement that suppliers establish uniform retailing standards may further curtail suppliers' ability to ensure that the appropriate level of pre- and post-sale retailing services is delivered to consumers. Suppliers may require flexibility to accommodate regional variations in showroom displays and, more importantly, regional differences in the cost of retail services or consumer demand for such services. Without this flexibility, some suppliers may be forced to adopt standards (and consequently prices) that are less efficient than those they would adopt in the absence of the legislation.

A requirement that suppliers establish uniform wholesale prices may significantly limit the ability of suppliers to compete. Such a requirement could prevent a supplier from passing on cost-justified savings to retailers or from cutting prices to meet competition in markets in which the supplier faces strong competition. Without the ability to meet its competitors' prices, a supplier may have to withdraw from or lose market share in markets in which a price cut may be needed to meet the competition. Consequently, the supplier's ability to be an effective competitor may be impaired.

In addition, suppliers may desire the flexibility to reward successful dealers. By rewarding successful dealers, suppliers are able to foster long term relations with dealers. Such long

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12/ By its terms, the proposed legislation would require that a supplier impose uniform retailing standards upon and charge a uniform price to "<u>all</u> retailers with whom [it] deals," whether or not they are located in North Carolina. S.B. 378, Proposed § 75-5.1(b) (emphasis added). Consequently, the legislation would appear to govern suppliers' retailing standards and prices outside North Carolina, at least insofar as they differ from those within the state. Even if the provision were limited to North Carolina, however, it would be likely to harm consumer welfare, although any harm would be limited in reach to North Carolina consumers.

term relations may benefit consumers in reducing their search costs for complementary goods and enhance the ability of manufacturers to plan their business affairs. 13/

Federal law already prohibits price discrimination that may have anticompetitive effects. 14/ An absolute ban on all price differences is likely to harm competition, just as a legislative ban on discounting would harm competition.

(c) Vertical Price Restraints

Section 1 of S.B. 378 would codify a *per se* prohibition of vertical price restraints. The bill would prohibit not only agreements to set resale prices but also unilateral actions by suppliers to enforce suggested retail prices. Many antitrust and economics scholars have concluded, however, that vertical price restraints, like all distributional restraints, are often used for the procompetitive purpose of encouraging dealers to provide services to consumers. 15/ Suppliers generally benefit from price competition among their dealers, because lower retail prices generally lead to higher sales by the suppliers. Consequently, suppliers are likely to use vertical price restraints where the consumer benefits of additional services outweigh the loss to consumers attributable to higher retail prices. 16/

13/ For example, both the manufacturer and the consumer benefit if a consumer who purchased a dining set from a particular dealer is able to return to the dealer some years later to buy the same manufacturer's matching hutch.

14/ *See* 15 U.S.C. § 13 (Robinson-Patman Act).

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16/ In many cases, suppliers will find that they do not need to use any type of distributional restraint to ensure that consumers receive adequate services, either because the products they sell do not require such services or because dealers have the incentive to provide the services in the absence of restraints. In other cases, however, suppliers may find a need to use such restraints to ensure the delivery of services. The bill would deprive suppliers of the freedom to choose the method of distribution best suited to their products.

Vertical price restraints can promote consumer welfare, just as nonprice distributional restraints do. 17/ Commission economists have prepared two empirical studies on the effects of vertical price restraints. A study by former Commission economist Thomas Overstreet found that the majority of observed uses of vertical price restraints occur in relatively unconcentrated markets and that the practice is often used by small firms with no market power and no ability to harm consumer welfare. 18/ Because the ability to raise prices above the competitive level usually requires a highly concentrated market structure, this evidence suggests that vertical price restraints are commonly used to benefit consumers. A more recent study by Commission economist Pauline Ippolito concluded that approximately 70 percent of litigated cases of vertical price restraints are consistent with attempts to prevent free riding or other erosion of dealer services and that only 15 percent of litigated cases had any anticompetitive potential. 19/

We recognize, of course, that resale price maintenance may be an instrument for anticompetitive practices, such as when the practice is used to facilitate or police collusion at the manufacturer or dealer level. 20/ For this reason, vertical price agreements, but not nonprice restraints, are *per se* illegal under federal law. 21/ *Per se* treatment is limited, however, to agreements between suppliers and dealers to set resale prices. Suppliers' terminations of discounting dealers in response to

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17/ *See* note 15, *supra*.

18/ T. Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence* (Federal Trade Commission Staff Report 1983). *See also* Caves, *Vertical Restraints in Manufacturer-Distributor Relations: Incidence and Economic Effects* in R. Grieson, *Antitrust and Regulation* 29, 41-42 (1984).

19/ P. Ippolito, *Resale Price Maintenance: Economic Evidence from Litigation* (Federal Trade Commission Staff Report 1988).

20/ *See* Posner, *Antitrust Analysis and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 Colum. L. Rev. 282, 294 (1975); H. Hovenkamp, *Economics and Federal Antitrust Law* 252 (1985).

21/ *Compare* *Monsanto Co. v. Spray-Rite Corp.*, 465 U.S. 752 (1984), with *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

complaints from other dealers and unilateral actions to enforce suggested retail prices are not unlawful. 22/

This legal treatment embodies a seven-decade legal tradition, recently reaffirmed by the Supreme Court, that a seller acting alone is free to "exercise his own independent discretion as to parties with whom he will deal." 23/ It also reflects a growing recognition that suppliers may terminate price cutters in order to prevent an erosion in the services provided to consumers by other dealers. 24/ We urge you to consider the desirability of penalizing unilateral conduct that is commonly designed to ensure the delivery of valuable retailing services to consumers.

IV. Conclusion

S.B. 378 would prohibit manufacturers and distributors from imposing distributional restrictions that could be used to ensure that consumers receive desired retailing services. In addition, the proposed legislation is likely to restrict the ability of suppliers to compete effectively by requiring them to impose uniform retailing standards and to charge uniform wholesale prices. For these reasons, you may wish to consider whether enactment of the proposed legislation would benefit consumers.

We appreciate the opportunity to comment on this bill. We would be happy to provide additional information if we can be of further assistance.

Sincerely,

Barbara A. Clark, Acting
for Jeffrey I. Zuckerman
Director

22/ See Monsanto Co. v. Spray-Rite Corp.; Business Electronics Corp. v. Sharp Electronics Corp., 108 S. Ct. 1515 (1988).

23/ United States v. Colgate & Co., 250 U.S. 300, 307 (1919).

24/ See Business Electronics Corp. v. Sharp Electronics, 108 U.S. at 1521.

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UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

BUREAU OF COMPETITION

COMMISSION AUTHORIZED

April 20, 1989

The Honorable George S. Robinson
North Carolina General Assembly
House of Representatives
Legislative Office Building
Raleigh, North Carolina 27611

Dear Mr. Robinson:

The staff of the Federal Trade Commission 1/ is pleased to respond to your invitation to comment on House Bill 520. The bill, if enacted, would prohibit distributors of household furniture from using a variety of distributional restraints in sales to North Carolina furniture dealers and apparently require furniture distributors who sell to North Carolina dealers to establish uniform nationwide retailing standards and wholesale prices. In addition, the bill would impose a per se prohibition on vertical price restraints in the State of North Carolina.

We recognize that low-cost and innovative marketing practices can provide significant benefits to consumers. Legislative restrictions on such practices are likely to harm consumers. We also recognize, however, that manufacturers and distributors often have legitimate concerns about the marketing of their products. Experience has shown that in many situations consumers can benefit from suppliers' placement of restrictions on retailing practices. Consequently, legislation that restricts the ability of manufacturers and distributors to control the distribution of their products is likely to harm consumers. We believe that H.B. 520 may unintentionally harm consumers by prohibiting practices designed to ensure that consumers receive important services.

I. Interest and Experience of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45. The Commission is one of the two federal agencies with principal responsibility for enforcing the antitrust laws. Under its statutory mandate, the Commission seeks to identify restrictions

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that impede competition or increase costs without offering countervailing benefits to consumers. The Commission is interested in the development of sound policy respecting distributional restraints. The Commission has articulated its views on such restraints both through opinions in administrative cases 2/ and through testimony and comments to the United States Congress concerning proposed legislation. 3/ In addition, Commission staff has submitted comments, upon request, to state legislatures concerning various distributional practices. 4/

II. The Proposed Legislation

H.B. 520 contains three principal provisions. Section 2 of the bill would create a new provision, to be codified in N.C. Gen. Stat. § 75-5.1, that would prohibit suppliers of household furniture from using a variety of distributional methods that determine the manner in which their goods are resold by North Carolina retailers, particularly to consumers who buy furniture by telephone or mail order. 5/ Section 2 also appears to require furniture suppliers to impose uniform display requirements and

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other "retailing standards" on their retailers and to charge uniform wholesale prices wherever they do business. Finally, section 1 of the bill would amend N.C. Gen. Stat. § 75-5(b) to prohibit any person from setting or limiting the prices at which goods may be resold in North Carolina.

III. Analysis of the Proposed Legislation

(a) Prohibition of Certain Distributional Restraints

Section 2 of H.B. 520 appears to be designed to prevent manufacturers and distributors of household furniture from using certain distributional methods in selling their furniture to consumers. Thus, the bill would prohibit suppliers from employing certain practices, even if these practices would be the best means of distributing their products. Under the bill, suppliers would be prohibited from restricting the classes of consumers to whom any retailer may resell furniture, limiting any retailer's sales to persons who have visited the retailer's showroom, limiting the geographic areas in which any retailer may advertise or solicit sales, or limiting any retailer's communications with consumers to any communication medium.

Section 2 addresses nonprice vertical (or distributional) restraints, which suppliers may impose to facilitate the delivery of pre-sale and other retailing services to consumers. Many antitrust and economics scholars share the view that vertical restraints often serve procompetitive purposes. 6/ In many cases, suppliers may determine that they must have dealers who inform consumers fully about their product in order to sell it. Acquiring the necessary expertise and conveying the desired information to consumers can be costly, and some dealers may not be willing to incur these costs and provide the services if consumers can receive these services from one dealer and then buy the product from another dealer. In the absence of vertical restraints, dealers who do not provide retailing services may be able to "free ride" on those who do. By failing to provide services, free riders can enjoy lower costs than their full service competitors and, therefore, to underprice them. Consumers may then take advantage of the services provided by the higher price dealers but buy the product from the discounting free riders. This effect may discourage dealers from providing the desired services.

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Suppliers may use vertical restraints to deter free riding and thereby preserve dealer incentives to furnish services that consumers value. 7/ This use of vertical restraints to overcome the "free rider" effect was recognized by the Supreme Court more than ten years ago in Continental T.V., Inc. v. GTE Sylvania, Inc., 8/ where the Court overruled a broad rule of *per se* illegality for vertical nonprice restraints and applied a rule of reason standard to such restraints. H.B. 520 would prohibit certain restraints outright, and thus would forbid their use even when they enhance efficient distribution.

Vertical restraints may also prevent free riding on promotional services. Suppliers who need point-of-sale and other marketing efforts by dealers to compete with other suppliers may impose vertical restraints to prevent free riding by dealers who fail to furnish promotional services. Such promotional services may include in-store displays or more intangible services. For example, the types of outlets that carry apparel, cosmetics, or furniture brands may signal to consumers useful fashion or quality information. Department stores or high quality furniture dealers may convey such a message, and thereby provide a service to the manufacturer, simply by carrying a product. 9/ In such cases, vertical restraints may be the most efficient way for a supplier to preserve dealers' incentives to continue providing promotional efforts that foster inter-brand competition.

As these examples indicate, suppliers may impose the types of restrictions addressed by the proposed legislation in order to prevent free riding. For example, consumers who purchase furniture by telephone or mail order may examine the same furniture at a local full service dealer. In so doing, consumers are likely to consult with sales personnel and physically examine and compare different furniture models, thereby imposing costs on the dealership. Not surprisingly, a mail order dealer does not incur such costs and may therefore be able to underprice the full service retailer. Because mail order customers who first use the services of full service dealers impose costs on those dealers, many full service dealers may not wish to do business with suppliers who sell to low- or no-service discounters. Unless suppliers are able to prevent free riding, they could lose many

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of their full-service dealers. 10/ As a consequence, the variety of products and services available to consumers may diminish. 11/

(b) Requirement of Uniform "Retailing Standards" and Wholesale Prices

Proposed N.C. Gen. Stat. 75-5.1(b) reads in pertinent part:

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10/ As a general matter, suppliers have an interest in seeing their products sold at lower prices, since sales are likely to be higher when prices are lower. Suppliers are likely to impose restraints that may result in higher prices in order to ensure that services that enhance the value of their product to consumers are in fact delivered to consumers.

11/ The drafters of the proposed legislation recognized the existence of the free riding problem and attempted to address it through proposed section 75-5.1(b). That provision would permit suppliers to establish and enforce "reasonable retailing standards, including reasonable showroom display requirements . . . ." Although this provision attempts to remedy the free riding problem, it is likely to be insufficient to enable suppliers to address the problem effectively. First, the provision does not mitigate the problem of free riding by mail order customers. Second, it limits suppliers to a single mechanism for ensuring the delivery of retailing services to consumers, namely explicit contract provisions specifying service levels. While such a mechanism may be adequate in theory for some suppliers, it is more difficult to police and thus costlier than other distributional restraints. Some scholars have argued, moreover, that explicit enforceable contracts requiring dealers to supply a desired level of services are not always economically feasible, and that vertical restraints may be necessary to enable suppliers to secure the desired level of dealer services. *See* Klein & Murphy, note 9, *supra*. Third, since the bill does not define "reasonable" showroom display requirements, it may invite further disputes concerning the appropriate level of services for the products in question. Finally, this section would permit the imposition of "retailing standards" only if they are "imposed and enforced uniformly and consistently upon all retailers with whom a person deals." This limitation would prevent suppliers from imposing different standards in different markets, with variations reflecting local retailing customs, retailing costs, or consumer demand characteristics. *See* Part III(b), *infra*.

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This provision appears to require suppliers who wish to impose retailing standards, such as showroom display requirements, to impose uniform nationwide standards. 12/ It also appears to require suppliers to charge a uniform nationwide wholesale price.

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A requirement that suppliers establish uniform wholesale prices may significantly limit the ability of suppliers to compete. Such a requirement could prevent a supplier from passing on cost-justified savings to retailers or from cutting prices to meet competition in markets in which the supplier faces strong competition. Without the ability to meet its competitors' prices, a supplier may have to withdraw from or lose market share in markets in which a price cut may be needed to meet the competition. Consequently, the supplier's ability to be an effective competitor may be impaired.

In addition, suppliers may desire the flexibility to reward successful dealers. By rewarding successful dealers, suppliers are able to foster long term relations with dealers. Such long

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12/ By its terms, the proposed legislation would require that a supplier impose uniform retailing standards upon and charge a uniform price to "all retailers with whom [it] deals," whether or not they are located in North Carolina. H.B. 520, Proposed § 75-5.1(b) (emphasis added). Consequently, the legislation would appear to govern suppliers' retailing standards and prices outside North Carolina, at least insofar as they differ from those within the state. Even if the provision were limited to North Carolina, however, it would be likely to harm consumer welfare, although any harm would be limited in reach to North Carolina consumers.

term relations may benefit consumers in reducing their search costs for complementary goods and enhance the ability of manufacturers to plan their business affairs. 13/

Federal law already prohibits price discrimination that may have anticompetitive effects. 14/ An absolute ban on all price differences is likely to harm competition, just as a legislative ban on discounting would harm competition.

(c) Vertical Price Restraints

Section 1 of H.B. 520 would codify a *per se* prohibition of vertical price restraints. The bill would prohibit not only agreements to set resale prices but also unilateral actions by suppliers to enforce suggested retail prices. Many antitrust and economics scholars have concluded, however, that vertical price restraints, like all distributional restraints, are often used for the procompetitive purpose of encouraging dealers to provide services to consumers. 15/ Suppliers generally benefit from price competition among their dealers, because lower retail prices generally lead to higher sales by the suppliers. Consequently, suppliers are likely to use vertical price restraints where the consumer benefits of additional services outweigh the loss to consumers attributable to higher retail prices. 16/

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16/ In many cases, suppliers will find that they do not need to use any type of distributional restraint to ensure that consumers receive adequate services, either because the products they sell do not require such services or because dealers have the incentive to provide the services in the absence of restraints. In other cases, however, suppliers may find a need to use such restraints to ensure the delivery of services. The bill would deprive suppliers of the freedom to choose the method of distribution best suited to their products.

complaints from other dealers and unilateral actions to enforce suggested retail prices are not unlawful. 22/

This legal treatment embodies a seven-decade legal tradition, recently reaffirmed by the Supreme Court, that a seller acting alone is free to "exercise his own independent discretion as to parties with whom he will deal." 23/ It also reflects a growing recognition that suppliers may terminate price cutters in order to prevent an erosion in the services provided to consumers by other dealers. 24/ We urge you to consider the desirability of penalizing unilateral conduct that is commonly designed to ensure the delivery of valuable retailing services to consumers.

IV. Conclusion

H.B. 520 would prohibit manufacturers and distributors from imposing distributional restrictions that could be used to ensure that consumers receive desired retailing services. In addition, the proposed legislation is likely to restrict the ability of suppliers to compete effectively by requiring them to impose uniform retailing standards and to charge uniform wholesale prices. For these reasons, you may wish to consider whether enactment of the proposed legislation would benefit consumers.

We appreciate the opportunity to comment on this bill. We would be happy to provide additional information if we can be of further assistance.

Sincerely,

Barbara A. Clark, Acting
for Jeffrey I. Zuckerman
Director

22/ See Monsanto Co. v. Spray-Rite Corp.; Business Electronics Corp. v. Sharp Electronics Corp., 108 S. Ct. 1515 (1988).

23/ United States v. Colgate & Co., 250 U.S. 300, 307 (1919).

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UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

BUREAU OF COMPETITION

COMMISSION AUTHORIZED

V890058

April 20, 1989

The Honorable Ann Q. Duncan
North Carolina General Assembly
House of Representatives
Legislative Office Building
Raleigh, North Carolina 27611

Dear Ms. Duncan:

The staff of the Federal Trade Commission 1/ is pleased to respond to your invitation to comment on House Bill 520. The bill, if enacted, would prohibit distributors of household furniture from using a variety of distributional restraints in sales to North Carolina furniture dealers and apparently require furniture distributors who sell to North Carolina dealers to establish uniform nationwide retailing standards and wholesale prices. In addition, the bill would impose a per se prohibition on vertical price restraints in the State of North Carolina.

We recognize that low-cost and innovative marketing practices can provide significant benefits to consumers. Legislative restrictions on such practices are likely to harm consumers. We also recognize, however, that manufacturers and distributors often have legitimate concerns about the marketing of their products. Experience has shown that in many situations consumers can benefit from suppliers' placement of restrictions on retailing practices. Consequently, legislation that restricts the ability of manufacturers and distributors to control the distribution of their products is likely to harm consumers. We believe that H.B. 520 may unintentionally harm consumers by prohibiting practices designed to ensure that consumers receive important services.

I. Interest and Experience of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45. The Commission is one of the two federal agencies with principal responsibility for enforcing the antitrust laws. Under its statutory mandate, the Commission seeks to identify restrictions

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1/ These comments represent the views of the staff of the Federal Trade Commission's Bureau of Competition and do not necessarily represent the views of the Commission itself or any individual Commissioner.

that impede competition or increase costs without offering countervailing benefits to consumers. The Commission is interested in the development of sound policy respecting distributional restraints. The Commission has articulated its views on such restraints both through opinions in administrative cases 2/ and through testimony and comments to the United States Congress concerning proposed legislation. 3/ In addition, Commission staff has submitted comments, upon request, to state legislatures concerning various distributional practices. 4/

II. The Proposed Legislation

H.B. 520 contains three principal provisions. Section 2 of the bill would create a new provision, to be codified in N.C. Gen. Stat. § 75-5.1, that would prohibit suppliers of household furniture from using a variety of distributional methods that determine the manner in which their goods are resold by North Carolina retailers, particularly to consumers who buy furniture by telephone or mail order. 5/ Section 2 also appears to require furniture suppliers to impose uniform display requirements and

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2/ See, e.g., Beltone Electronics Corp., 100 F.T.C. 68 (1982).

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5/ Specifically, suppliers would be prohibited from (a) restricting the classes of consumers to whom any retailer may resell furniture, (b) limiting any retailer's sales to persons who have visited the retailer's showroom, (c) limiting the geographic areas in which any retailer may advertise or solicit sales, (d) limiting any retailer's communications with consumers to any communication medium, or (e) preventing any retailer from "advertis[ing] the availability of a particular communications medium . . . ." H.B. 520, Proposed § 75-5.1(a)(1)(a)-(e). The bill would also prohibit suppliers from effectuating the foregoing prohibited restrictions by terminating, refusing to sell, delaying deliveries, or threatening to terminate, refuse to sell, or delay delivery to any retailer. Id., Proposed Section 75-5.1(b)(2)(a)-(e).

other "retailing standards" on their retailers and to charge uniform wholesale prices wherever they do business. Finally, section 1 of the bill would amend N.C. Gen. Stat. § 75-5(b) to prohibit any person from setting or limiting the prices at which goods may be resold in North Carolina.

III. Analysis of the Proposed Legislation

(a) Prohibition of Certain Distributional Restraints

Section 2 of H.B. 520 appears to be designed to prevent manufacturers and distributors of household furniture from using certain distributional methods in selling their furniture to consumers. Thus, the bill would prohibit suppliers from employing certain practices, even if these practices would be the best means of distributing their products. Under the bill, suppliers would be prohibited from restricting the classes of consumers to whom any retailer may resell furniture, limiting any retailer's sales to persons who have visited the retailer's showroom, limiting the geographic areas in which any retailer may advertise or solicit sales, or limiting any retailer's communications with consumers to any communication medium.

Section 2 addresses nonprice vertical (or distributional) restraints, which suppliers may impose to facilitate the delivery of pre-sale and other retailing services to consumers. Many antitrust and economics scholars share the view that vertical restraints often serve procompetitive purposes. 6/ In many cases, suppliers may determine that they must have dealers who inform consumers fully about their product in order to sell it. Acquiring the necessary expertise and conveying the desired information to consumers can be costly, and some dealers may not be willing to incur these costs and provide the services if consumers can receive these services from one dealer and then buy the product from another dealer. In the absence of vertical restraints, dealers who do not provide retailing services may be able to "free ride" on those who do. By failing to provide services, free riders can enjoy lower costs than their full service competitors and, therefore, to underprice them. Consumers may then take advantage of the services provided by the higher price dealers but buy the product from the discounting free riders. This effect may discourage dealers from providing the desired services.

6/ See, e.g., Hovenkamp, Vertical Restrictions and Monopoly Power, 64 Boston U. L. Rev. 521 (1984); Posner, The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality, 48 U. Chi. L. Rev. 6 (1981).

Suppliers may use vertical restraints to deter free riding and thereby preserve dealer incentives to furnish services that consumers value. 7/ This use of vertical restraints to overcome the "free rider" effect was recognized by the Supreme Court more than ten years ago in Continental T.V., Inc. v. GTE Sylvania, Inc., 8/ where the Court overruled a broad rule of *per se* illegality for vertical nonprice restraints and applied a rule of reason standard to such restraints. H.B. 520 would prohibit certain restraints outright, and thus would forbid their use even when they enhance efficient distribution.

Vertical restraints may also prevent free riding on promotional services. Suppliers who need point-of-sale and other marketing efforts by dealers to compete with other suppliers may impose vertical restraints to prevent free riding by dealers who fail to furnish promotional services. Such promotional services may include in-store displays or more intangible services. For example, the types of outlets that carry apparel, cosmetics, or furniture brands may signal to consumers useful fashion or quality information. Department stores or high quality furniture dealers may convey such a message, and thereby provide a service to the manufacturer, simply by carrying a product. 9/ In such cases, vertical restraints may be the most efficient way for a supplier to preserve dealers' incentives to continue providing promotional efforts that foster inter-brand competition.

As these examples indicate, suppliers may impose the types of restrictions addressed by the proposed legislation in order to prevent free riding. For example, consumers who purchase furniture by telephone or mail order may examine the same furniture at a local full service dealer. In so doing, consumers are likely to consult with sales personnel and physically examine and compare different furniture models, thereby imposing costs on the dealership. Not surprisingly, a mail order dealer does not incur such costs and may therefore be able to underprice the full service retailer. Because mail order customers who first use the services of full service dealers impose costs on those dealers, many full service dealers may not wish to do business with suppliers who sell to low- or no-service discounters. Unless suppliers are able to prevent free riding, they could lose many

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9/ *See* Marvel & McCafferty, The Welfare Effects of Resale Price Maintenance, 28 J.L. & Econ. 363 (1985). *See also* Klein & Murphy, Vertical Restraints as Contract Enforcement Mechanisms, 31 J. Law & Econ. 265 (1988).

of their full-service dealers. 10/ As a consequence, the variety of products and services available to consumers may diminish. 11/

(b) Requirement of Uniform "Retailing Standards" and Wholesale Prices

Proposed N.C. Gen. Stat. 75-5.1(b) reads in pertinent part:

> [A] person engaged in the distribution or selling of household furniture to retailers in this State is not prohibited from establishing and enforcing reasonable retailing standards, including reason-

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10/ As a general matter, suppliers have an interest in seeing their products sold at lower prices, since sales are likely to be higher when prices are lower. Suppliers are likely to impose restraints that may result in higher prices in order to ensure that services that enhance the value of their product to consumers are in fact delivered to consumers.

11/ The drafters of the proposed legislation recognized the existence of the free riding problem and attempted to address it through proposed section 75-5.1(b). That provision would permit suppliers to establish and enforce "reasonable retailing standards, including reasonable showroom display requirements . . . ." Although this provision attempts to remedy the free riding problem, it is likely to be insufficient to enable suppliers to address the problem effectively. First, the provision does not mitigate the problem of free riding by mail order customers. Second, it limits suppliers to a single mechanism for ensuring the delivery of retailing services to consumers, namely explicit contract provisions specifying service levels. While such a mechanism may be adequate in theory for some suppliers, it is more difficult to police and thus costlier than other distributional restraints. Some scholars have argued, moreover, that explicit enforceable contracts requiring dealers to supply a desired level of services are not always economically feasible, and that vertical restraints may be necessary to enable suppliers to secure the desired level of dealer services. See Klein & Murphy, note 9, supra. Third, since the bill does not define "reasonable" showroom display requirements, it may invite further disputes concerning the appropriate level of services for the products in question. Finally, this section would permit the imposition of "retailing standards" only if they are "imposed and enforced uniformly and consistently upon all retailers with whom a person deals." This limitation would prevent suppliers from imposing different standards in different markets, with variations reflecting local retailing customs, retailing costs, or consumer demand characteristics. See Part III(b), infra.

> able showroom display requirements or reasonable advertising format restrictions, or from changing wholesale prices to retailers, provided that such standards, requirements and wholesale prices are imposed and enforced uniformly and consistently upon all retailers with whom the person deals.

This provision appears to require suppliers who wish to impose retailing standards, such as showroom display requirements, to impose uniform nationwide standards. 12/ It also appears to require suppliers to charge a uniform nationwide wholesale price.

A requirement that suppliers establish uniform retailing standards may further curtail suppliers' ability to ensure that the appropriate level of pre- and post-sale retailing services is delivered to consumers. Suppliers may require flexibility to accommodate regional variations in showroom displays and, more importantly, regional differences in the cost of retail services or consumer demand for such services. Without this flexibility, some suppliers may be forced to adopt standards (and consequently prices) that are less efficient than those they would adopt in the absence of the legislation.

A requirement that suppliers establish uniform wholesale prices may significantly limit the ability of suppliers to compete. Such a requirement could prevent a supplier from passing on cost-justified savings to retailers or from cutting prices to meet competition in markets in which the supplier faces strong competition. Without the ability to meet its competitors' prices, a supplier may have to withdraw from or lose market share in markets in which a price cut may be needed to meet the competition. Consequently, the supplier's ability to be an effective competitor may be impaired.

In addition, suppliers may desire the flexibility to reward successful dealers. By rewarding successful dealers, suppliers are able to foster long term relations with dealers. Such long

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12/ By its terms, the proposed legislation would require that a supplier impose uniform retailing standards upon and charge a uniform price to "all retailers with whom [it] deals," whether or not they are located in North Carolina. H.B. 520, Proposed § 75-5.1(b) (emphasis added). Consequently, the legislation would appear to govern suppliers' retailing standards and prices outside North Carolina, at least insofar as they differ from those within the state. Even if the provision were limited to North Carolina, however, it would be likely to harm consumer welfare, although any harm would be limited in reach to North Carolina consumers.

term relations may benefit consumers in reducing their search costs for complementary goods and enhance the ability of manufacturers to plan their business affairs. 13/

Federal law already prohibits price discrimination that may have anticompetitive effects. 14/ An absolute ban on all price differences is likely to harm competition, just as a legislative ban on discounting would harm competition.

(c) Vertical Price Restraints

Section 1 of H.B. 520 would codify a *per se* prohibition of vertical price restraints. The bill would prohibit not only agreements to set resale prices but also unilateral actions by suppliers to enforce suggested retail prices. Many antitrust and economics scholars have concluded, however, that vertical price restraints, like all distributional restraints, are often used for the procompetitive purpose of encouraging dealers to provide services to consumers. 15/ Suppliers generally benefit from price competition among their dealers, because lower retail prices generally lead to higher sales by the suppliers. Consequently, suppliers are likely to use vertical price restraints where the consumer benefits of additional services outweigh the loss to consumers attributable to higher retail prices. 16/

13/ For example, both the manufacturer and the consumer benefit if a consumer who purchased a dining set from a particular dealer is able to return to the dealer some years later to buy the same manufacturer's matching hutch.

14/ *See* 15 U.S.C. § 13 (Robinson-Patman Act).

15/ *See, e.g.*, Hovenkamp, *supra* note 6, at 522-27; ; R. Bork, *The Antitrust Paradox* 280-98 (1978); Posner, *The Rule of Reason and the Economic Approach: Reflections on the* Sylvania *Decision*, 45 U. Chi. L. Rev. 1, 6-10 (1977); Posner, *supra* note 6; Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. Law & Econ. 86 (1960).

16/ In many cases, suppliers will find that they do not need to use any type of distributional restraint to ensure that consumers receive adequate services, either because the products they sell do not require such services or because dealers have the incentive to provide the services in the absence of restraints. In other cases, however, suppliers may find a need to use such restraints to ensure the delivery of services. The bill would deprive suppliers of the freedom to choose the method of distribution best suited to their products.

Vertical price restraints can promote consumer welfare, just as nonprice distributional restraints do. 17/ Commission economists have prepared two empirical studies on the effects of vertical price restraints. A study by former Commission economist Thomas Overstreet found that the majority of observed uses of vertical price restraints occur in relatively unconcentrated markets and that the practice is often used by small firms with no market power and no ability to harm consumer welfare. 18/ Because the ability to raise prices above the competitive level usually requires a highly concentrated market structure, this evidence suggests that vertical price restraints are commonly used to benefit consumers. A more recent study by Commission economist Pauline Ippolito concluded that approximately 70 percent of litigated cases of vertical price restraints are consistent with attempts to prevent free riding or other erosion of dealer services and that only 15 percent of litigated cases had any anticompetitive potential. 19/

We recognize, of course, that resale price maintenance may be an instrument for anticompetitive practices, such as when the practice is used to facilitate or police collusion at the manufacturer or dealer level. 20/ For this reason, vertical price agreements, but not nonprice restraints, are *per se* illegal under federal law. 21/ *Per se* treatment is limited, however, to agreements between suppliers and dealers to set resale prices. Suppliers' terminations of discounting dealers in response to

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17/ *See* note 15, *supra*.

18/ T. Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence* (Federal Trade Commission Staff Report 1983). *See also* Caves, *Vertical Restraints in Manufacturer-Distributor Relations: Incidence and Economic Effects* in R. Grieson, *Antitrust and Regulation* 29, 41-42 (1984).

19/ P. Ippolito, *Resale Price Maintenance: Economic Evidence from Litigation* (Federal Trade Commission Staff Report 1988).

20/ *See* Posner, *Antitrust Analysis and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 Colum. L. Rev. 282, 294 (1975); H. Hovenkamp, *Economics and Federal Antitrust Law* 252 (1985).

21/ *Compare* *Monsanto Co. v. Spray-Rite Corp.*, 465 U.S. 752 (1984), with *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

complaints from other dealers and unilateral actions to enforce suggested retail prices are not unlawful. 22/

This legal treatment embodies a seven-decade legal tradition, recently reaffirmed by the Supreme Court, that a seller acting alone is free to "exercise his own independent discretion as to parties with whom he will deal." 23/ It also reflects a growing recognition that suppliers may terminate price cutters in order to prevent an erosion in the services provided to consumers by other dealers. 24/ We urge you to consider the desirability of penalizing unilateral conduct that is commonly designed to ensure the delivery of valuable retailing services to consumers.

IV. Conclusion

H.B. 520 would prohibit manufacturers and distributors from imposing distributional restrictions that could be used to ensure that consumers receive desired retailing services. In addition, the proposed legislation is likely to restrict the ability of suppliers to compete effectively by requiring them to impose uniform retailing standards and to charge uniform wholesale prices. For these reasons, you may wish to consider whether enactment of the proposed legislation would benefit consumers.

We appreciate the opportunity to comment on this bill. We would be happy to provide additional information if we can be of further assistance.

Sincerely,

Barbara A. Clark, Acting
for Jeffrey I. Zuckerman
Director

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UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

BUREAU OF COMPETITION

COMMISSION AUTHORIZED

April 20, 1989

The Honorable Theresa H. Esposito
North Carolina General Assembly
House of Representatives
Legislative Office Building
Raleigh, North Carolina 27611

Dear Ms. Esposito:

The staff of the Federal Trade Commission 1/ is pleased to respond to your invitation to comment on House Bill 520. The bill, if enacted, would prohibit distributors of household furniture from using a variety of distributional restraints in sales to North Carolina furniture dealers and apparently require furniture distributors who sell to North Carolina dealers to establish uniform nationwide retailing standards and wholesale prices. In addition, the bill would impose a *per se* prohibition on vertical price restraints in the State of North Carolina.

We recognize that low-cost and innovative marketing practices can provide significant benefits to consumers. Legislative restrictions on such practices are likely to harm consumers. We also recognize, however, that manufacturers and distributors often have legitimate concerns about the marketing of their products. Experience has shown that in many situations consumers can benefit from suppliers' placement of restrictions on retailing practices. Consequently, legislation that restricts the ability of manufacturers and distributors to control the distribution of their products is likely to harm consumers. We believe that H.B. 520 may unintentionally harm consumers by prohibiting practices designed to ensure that consumers receive important services.

I. Interest and Experience of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45. The Commission is one of the two federal agencies with principal responsibility for enforcing the antitrust laws. Under its statutory mandate, the Commission seeks to identify restrictions

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that impede competition or increase costs without offering countervailing benefits to consumers. The Commission is interested in the development of sound policy respecting distributional restraints. The Commission has articulated its views on such restraints both through opinions in administrative cases 2/ and through testimony and comments to the United States Congress concerning proposed legislation. 3/ In addition, Commission staff has submitted comments, upon request, to state legislatures concerning various distributional practices. 4/

II. The Proposed Legislation

H.B. 520 contains three principal provisions. Section 2 of the bill would create a new provision, to be codified in N.C. Gen. Stat. § 75-5.1, that would prohibit suppliers of household furniture from using a variety of distributional methods that determine the manner in which their goods are resold by North Carolina retailers, particularly to consumers who buy furniture by telephone or mail order. 5/ Section 2 also appears to require furniture suppliers to impose uniform display requirements and

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5/ Specifically, suppliers would be prohibited from (a) restricting the classes of consumers to whom any retailer may resell furniture, (b) limiting any retailer's sales to persons who have visited the retailer's showroom, (c) limiting the geographic areas in which any retailer may advertise or solicit sales, (d) limiting any retailer's communications with consumers to any communication medium, or (e) preventing any retailer from "advertis[ing] the availability of a particular communications medium . . . ." H.B. 520, Proposed § 75-5.1(a)(1)(a)-(e). The bill would also prohibit suppliers from effectuating the foregoing prohibited restrictions by terminating, refusing to sell, delaying deliveries, or threatening to terminate, refuse to sell, or delay delivery to any retailer. Id., Proposed Section 75-5.1(b)(2)(a)-(e).

other "retailing standards" on their retailers and to charge uniform wholesale prices wherever they do business. Finally, section 1 of the bill would amend N.C. Gen. Stat. § 75-5(b) to prohibit any person from setting or limiting the prices at which goods may be resold in North Carolina.

III. Analysis of the Proposed Legislation

(a) Prohibition of Certain Distributional Restraints

Section 2 of H.B. 520 appears to be designed to prevent manufacturers and distributors of household furniture from using certain distributional methods in selling their furniture to consumers. Thus, the bill would prohibit suppliers from employing certain practices, even if these practices would be the best means of distributing their products. Under the bill, suppliers would be prohibited from restricting the classes of consumers to whom any retailer may resell furniture, limiting any retailer's sales to persons who have visited the retailer's showroom, limiting the geographic areas in which any retailer may advertise or solicit sales, or limiting any retailer's communications with consumers to any communication medium.

Section 2 addresses nonprice vertical (or distributional) restraints, which suppliers may impose to facilitate the delivery of pre-sale and other retailing services to consumers. Many antitrust and economics scholars share the view that vertical restraints often serve procompetitive purposes. 6/ In many cases, suppliers may determine that they must have dealers who inform consumers fully about their product in order to sell it. Acquiring the necessary expertise and conveying the desired information to consumers can be costly, and some dealers may not be willing to incur these costs and provide the services if consumers can receive these services from one dealer and then buy the product from another dealer. In the absence of vertical restraints, dealers who do not provide retailing services may be able to "free ride" on those who do. By failing to provide services, free riders can enjoy lower costs than their full service competitors and, therefore, to underprice them. Consumers may then take advantage of the services provided by the higher price dealers but buy the product from the discounting free riders. This effect may discourage dealers from providing the desired services.

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Suppliers may use vertical restraints to deter free riding and thereby preserve dealer incentives to furnish services that consumers value. 7/ This use of vertical restraints to overcome the "free rider" effect was recognized by the Supreme Court more than ten years ago in Continental T.V., Inc. v. GTE Sylvania, Inc., 8/ where the Court overruled a broad rule of *per se* illegality for vertical nonprice restraints and applied a rule of reason standard to such restraints. H.B. 520 would prohibit certain restraints outright, and thus would forbid their use even when they enhance efficient distribution.

Vertical restraints may also prevent free riding on promotional services. Suppliers who need point-of-sale and other marketing efforts by dealers to compete with other suppliers may impose vertical restraints to prevent free riding by dealers who fail to furnish promotional services. Such promotional services may include in-store displays or more intangible services. For example, the types of outlets that carry apparel, cosmetics, or furniture brands may signal to consumers useful fashion or quality information. Department stores or high quality furniture dealers may convey such a message, and thereby provide a service to the manufacturer, simply by carrying a product. 9/ In such cases, vertical restraints may be the most efficient way for a supplier to preserve dealers' incentives to continue providing promotional efforts that foster inter-brand competition.

As these examples indicate, suppliers may impose the types of restrictions addressed by the proposed legislation in order to prevent free riding. For example, consumers who purchase furniture by telephone or mail order may examine the same furniture at a local full service dealer. In so doing, consumers are likely to consult with sales personnel and physically examine and compare different furniture models, thereby imposing costs on the dealership. Not surprisingly, a mail order dealer does not incur such costs and may therefore be able to underprice the full service retailer. Because mail order customers who first use the services of full service dealers impose costs on those dealers, many full service dealers may not wish to do business with suppliers who sell to low- or no-service discounters. Unless suppliers are able to prevent free riding, they could lose many

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(b) Requirement of Uniform "Retailing Standards" and Wholesale Prices

Proposed N.C. Gen. Stat. 75-5.1(b) reads in pertinent part:

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11/ The drafters of the proposed legislation recognized the existence of the free riding problem and attempted to address it through proposed section 75-5.1(b). That provision would permit suppliers to establish and enforce "reasonable retailing standards, including reasonable showroom display requirements . . . ." Although this provision attempts to remedy the free riding problem, it is likely to be insufficient to enable suppliers to address the problem effectively. First, the provision does not mitigate the problem of free riding by mail order customers. Second, it limits suppliers to a single mechanism for ensuring the delivery of retailing services to consumers, namely explicit contract provisions specifying service levels. While such a mechanism may be adequate in theory for some suppliers, it is more difficult to police and thus costlier than other distributional restraints. Some scholars have argued, moreover, that explicit enforceable contracts requiring dealers to supply a desired level of services are not always economically feasible, and that vertical restraints may be necessary to enable suppliers to secure the desired level of dealer services. *See* Klein & Murphy, note 9, *supra*. Third, since the bill does not define "reasonable" showroom display requirements, it may invite further disputes concerning the appropriate level of services for the products in question. Finally, this section would permit the imposition of "retailing standards" only if they are "imposed and enforced uniformly and consistently upon all retailers with whom a person deals." This limitation would prevent suppliers from imposing different standards in different markets, with variations reflecting local retailing customs, retailing costs, or consumer demand characteristics. *See* Part III(b), *infra*.

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Section 1 of H.B. 520 would codify a *per se* prohibition of vertical price restraints. The bill would prohibit not only agreements to set resale prices but also unilateral actions by suppliers to enforce suggested retail prices. Many antitrust and economics scholars have concluded, however, that vertical price restraints, like all distributional restraints, are often used for the procompetitive purpose of encouraging dealers to provide services to consumers. 15/ Suppliers generally benefit from price competition among their dealers, because lower retail prices generally lead to higher sales by the suppliers. Consequently, suppliers are likely to use vertical price restraints where the consumer benefits of additional services outweigh the loss to consumers attributable to higher retail prices. 16/

13/ For example, both the manufacturer and the consumer benefit if a consumer who purchased a dining set from a particular dealer is able to return to the dealer some years later to buy the same manufacturer's matching hutch.

14/ *See* 15 U.S.C. § 13 (Robinson-Patman Act).

15/ *See*, *e.g.*, Hovenkamp, *supra* note 6, at 522-27; ; R. Bork, *The Antitrust Paradox* 280-98 (1978); Posner, *The Rule of Reason and the Economic Approach: Reflections on the* Sylvania *Decision*, 45 U. Chi. L. Rev. 1, 6-10 (1977); Posner, *supra* note 6; Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. Law & Econ. 86 (1960).

16/ In many cases, suppliers will find that they do not need to use any type of distributional restraint to ensure that consumers receive adequate services, either because the products they sell do not require such services or because dealers have the incentive to provide the services in the absence of restraints. In other cases, however, suppliers may find a need to use such restraints to ensure the delivery of services. The bill would deprive suppliers of the freedom to choose the method of distribution best suited to their products.

Vertical price restraints can promote consumer welfare, just as nonprice distributional restraints do. 17/ Commission economists have prepared two empirical studies on the effects of vertical price restraints. A study by former Commission economist Thomas Overstreet found that the majority of observed uses of vertical price restraints occur in relatively unconcentrated markets and that the practice is often used by small firms with no market power and no ability to harm consumer welfare. 18/ Because the ability to raise prices above the competitive level usually requires a highly concentrated market structure, this evidence suggests that vertical price restraints are commonly used to benefit consumers. A more recent study by Commission economist Pauline Ippolito concluded that approximately 70 percent of litigated cases of vertical price restraints are consistent with attempts to prevent free riding or other erosion of dealer services and that only 15 percent of litigated cases had any anticompetitive potential. 19/

We recognize, of course, that resale price maintenance may be an instrument for anticompetitive practices, such as when the practice is used to facilitate or police collusion at the manufacturer or dealer level. 20/ For this reason, vertical price agreements, but not nonprice restraints, are *per se* illegal under federal law. 21/ *Per se* treatment is limited, however, to agreements between suppliers and dealers to set resale prices. Suppliers' terminations of discounting dealers in response to

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17/ *See* note 15, *supra*.

18/ T. Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence* (Federal Trade Commission Staff Report 1983). *See also* Caves, *Vertical Restraints in Manufacturer-Distributor Relations: Incidence and Economic Effects* in R. Grieson, *Antitrust and Regulation* 29, 41-42 (1984).

19/ P. Ippolito, *Resale Price Maintenance: Economic Evidence from Litigation* (Federal Trade Commission Staff Report 1988).

20/ *See* Posner, *Antitrust Analysis and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 Colum. L. Rev. 282, 294 (1975); H. Hovenkamp, *Economics and Federal Antitrust Law* 252 (1985).

21/ *Compare* *Monsanto Co. v. Spray-Rite Corp.*, 465 U.S. 752 (1984), with *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

complaints from other dealers and unilateral actions to enforce suggested retail prices are not unlawful. 22/

This legal treatment embodies a seven-decade legal tradition, recently reaffirmed by the Supreme Court, that a seller acting alone is free to "exercise his own independent discretion as to parties with whom he will deal." 23/ It also reflects a growing recognition that suppliers may terminate price cutters in order to prevent an erosion in the services provided to consumers by other dealers. 24/ We urge you to consider the desirability of penalizing unilateral conduct that is commonly designed to ensure the delivery of valuable retailing services to consumers.

IV. Conclusion

H.B. 520 would prohibit manufacturers and distributors from imposing distributional restrictions that could be used to ensure that consumers receive desired retailing services. In addition, the proposed legislation is likely to restrict the ability of suppliers to compete effectively by requiring them to impose uniform retailing standards and to charge uniform wholesale prices. For these reasons, you may wish to consider whether enactment of the proposed legislation would benefit consumers.

We appreciate the opportunity to comment on this bill. We would be happy to provide additional information if we can be of further assistance.

Sincerely,

Barbara A. Clark, Acting

for Jeffrey I. Zuckerman
Director

22/ See Monsanto Co. v. Spray-Rite Corp.; Business Electronics Corp. v. Sharp Electronics Corp., 108 S. Ct. 1515 (1988).

23/ United States v. Colgate & Co., 250 U.S. 300, 307 (1919).

24/ See Business Electronics Corp. v. Sharp Electronics, 108 U.S. at 1521.