

The Law of Vertical Integration and the Business Firm: 1880–1960

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ABSTRACT: Vertical integration occurs when a firm does something for itself that it could otherwise procure on the market. For example, a manufacturer that opens its own stores is said to be vertically integrated into distribution. One irony of history is that both classical political economy and marginalist economics saw vertical integration and vertical contractual arrangements as much less threatening to competition than cartels or other horizontal arrangements. Nevertheless, vertical integration has produced by far the greater amount of legislation at both federal and state levels and has motivated many more political action groups. Two things explain this phenomenon. First, while economists prior to the 1930s rarely saw a threat, neither did they understand why firms integrate or enter into long-term contracts, except for fairly obvious savings in production costs. Second, vertical integration led to many bankruptcies of small family businesses unable or unwilling to take on the costs and associated risks of integrating vertically themselves. When that happened, politics inevitably triumphed over economics.

Both the common law and classical economists tended to view vertical integration favorably. The principal limitation on vertical integration by contract was common-law rules limiting restraints on alienation. The managerial revolution in the United States in the nineteenth century occasioned the rise of significant vertical integration. At the same time, however, marginalist, or neoclassical, economics first began to see significant competitive problems. The emergent legal policy toward vertical control by contract was developed first in intellectual-property law's first-sale doctrine, and later on in antitrust policy.

In his 1937 article, The Nature of the Firm, Ronald H. Coase formulated a purely marginalist theory of vertical integration, but it was ignored by both economists and legal policymakers for nearly half a century. Economists continued to wrestle with theories that were far more myopic,

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and as a result much less satisfactory. The result was that vertical integration became much more vulnerable to special-interest legislation than did competition policy generally. By the mid-twentieth century a set of aggressive antitrust policies had emerged that dealt harshly with both vertical integration by contract and ownership vertical integration.

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I. INTRODUCTION

Vertical integration occurs whenever a business firm does something for itself that it might otherwise have obtained on the market.¹ The very concept is artificial because production and distribution processes can be divided up arbitrarily. For example, the village cobbler who maintains his own shop, makes three pair of shoes per week by hand, and sells them directly to consumers is vertically integrated “upstream” into shoe-making machinery and “downstream” into shoe retailing.² Nevertheless, his firm is very small. With the rise of machine manufacture, the cobbler’s individual business functions gradually became vertically *dis*-integrated. For example, the formation of United Shoe Machinery Company in 1899 created a firm that made only shoe-manufacturing equipment and leased it to shoe manufacturers, who in turn sold the shoes to distributors or perhaps directly to department stores for resale.³ What had once been the work of a single firm now became that of at least three or four.⁴ By the 1960s, the Supreme Court even found competitive harm in a shoe manufacturer’s acquisition of its own retail stores.⁵ The combined making and selling of one’s own product—an inherent feature in the history of shoemaking as well as most other businesses—had become contrary to the public interest.

Vertical integration could occur by three different legal devices. First, a firm could simply begin doing something for itself, rather than purchasing that thing on the market or selling to an intermediary retailer—such as the cobbler who merely started selling his own shoes directly to customers. This type of “de novo” vertical integration, or integration by new entry into the vertically related market, was typically regarded as the least damaging to competition, although

1. See MARTIN RICKETTS, *THE ECONOMICS OF BUSINESS ENTERPRISE: AN INTRODUCTION TO ECONOMIC ORGANIZATION AND THE THEORY OF THE FIRM* 217–18 (3d ed. 2002) (noting that vertical integration occurs where a single firm develops or acquires the intermediate stages required for production of final output). For a definition from the earlier part of the twentieth century, when U.S. economists were first discussing the problem, see Lawrence K. Frank, *The Significance of Industrial Integration*, 33 J. POL. ECON. 179, 179 (1925) (defining vertical integration as “the functional coordination of one or more units in each of the several successive stages of production, so that they are all operated as a single, unified industrial process”).

2. “Upstream” vertical integration is toward a source of supply; “downstream” vertical integration is toward consumers.

3. See *United States v. Winslow*, 227 U.S. 202, 217 (1913) (approving the 1899 merger that created the United Shoe Machinery Company); CARL KAYSEN, *UNITED STATES V. UNITED SHOE MACHINERY CORPORATION: AN ECONOMIC ANALYSIS OF AN ANTI-TRUST CASE 2–3* (1956) (describing the merger and subsequent expansion).

4. For a description of the shoe market, see *Brown Shoe Co. v. United States*, 370 U.S. 294, 297 (1962), and *Witherell & Dobbins Co. v. United Shoe Machinery Co.*, 267 F. 950, 951 (1st Cir. 1920). See also KAYSEN, *supra* note 3, at 3–4 (describing the complexities of manufacturing both the machinery necessary to produce shoes and the shoes themselves).

5. *Brown Shoe*, 370 U.S. at 346.

U.S. legal policy in the 1930s and after became hostile.⁶ Second, a firm might acquire a different firm in a vertically related market, such as when Brown Shoe, a manufacturer, acquired Kinney Shoe's chain of retail stores in 1956.⁷

The third type of vertical integration was achieved by a long-term, or "relational," contract between two vertically related firms that maintained legally separate ownership. The rapid rise of franchising and independent dealer networks in the 1920s and after indicates just how important this type of vertical integration was to become. Indeed, today many firms incorporate for no other reason than to function as a kind of contractually controlled "subsidiary" to a parent firm. This includes car dealerships, fast-food franchises, and many other consumer businesses. While contracts generally produced the loosest forms of vertical integration, they also invoke the angriest controversy and some of the most aggressive special-interest legislation. Legal policymakers viewed such arrangements as uniting two sets of "independent" businesspersons, each of whom had legal prerogatives worthy of protection. The independent dealer had a legal status that the mere employee or agent did not. The origin of United States policy toward contractual vertical integration lay in intellectual-property law, although in the early twentieth century that role largely became the province of antitrust law.⁸

Few areas of economic law have experienced more fumbling, experimentation, and interest-group activity than the law of vertical integration during the marginalist revolution in economics. Marginalism, later to be called neoclassicism, substituted the forward-looking concepts of marginal utility, marginal revenue, and marginal cost in the place of the historical averages that classical political economists previously used to explain economic activity.⁹ While classical economists tended to assess behavior by looking at historical experience, marginalists believed that people's anticipation of the future determined their choices. This fact made marginalism a powerful tool for assessing preference, but it also injected significant uncertainty into the calculus of value. Value for classicists depended on the law of past averages, while neoclassicists relied on rational expectations. The change in perspective had a dramatic influence on the legal attitude toward business conduct.

Marginalism abruptly halted a period of relatively stable and largely benign economic and legal thinking about competition and business firms.

6. See discussion *infra* text accompanying notes 72–73 (noting that both the Justice Department and the Supreme Court launched aggressive campaigns against vertical mergers in the wake of the 1950 amendment to the Clayton Act).

7. *Brown Shoe*, 370 U.S. at 296. For the district court's opinion describing the 1956 merger, see *United States v. Brown Shoe Co.*, 179 F. Supp. 721, 724–27 (D. Mo. 1959).

8. See discussion *infra* text accompanying notes 111–14 (noting the incorporation of antitrust principles into vertical-integration analysis).

9. On the rise of marginalist economics, see MARK BLAUG, *ECONOMIC THEORY IN RETROSPECT*, chs. 8–11, 15 (5th ed., Cambridge Univ. Press 1996), and Herbert Hovenkamp, *The Marginalist Revolution in Legal Thought*, 46 VAND. L. REV. 305, 314–18 (1993) (discussing the relationship between Darwinism and the rise of marginalism).

While the classical economists were somewhat preoccupied with monopoly in land, in manufacturing they tended to see either competition or monopoly, and monopoly was generally regarded as exceptional. The rise of marginalist economics in the 1870s threatened that vision by dividing markets into degrees of competitiveness. This further led to a search for the preconditions for perfectly competitive markets, and the developing intuition that such markets were quite rare. One result that quickly followed was the rise of modern, interventionist competition policy.¹⁰

The marginalist crisis in competition policy did not find a satisfactory solution until the middle of the twentieth century. Because markets are populated by firms, the principal actors in this crisis were business corporations. Economists in the first half of the twentieth century probed the firm's nature, structure, motives, and extent of operations at an unprecedented level. Competitive markets were impossible without competitive firms. In legal policy, the main sources of government intervention were, first, the common law and then later state corporate law. Antitrust did not emerge as an important regulator of firm structure until well into the twentieth century.

Much of the fumbling in the formulation of legal policy about vertical integration resulted from the fact that both economists and lawyers understood it so poorly. Today, it is all too easy to see the history of business regulation in the United States as little more than a series of interest-group clashes.¹¹ Many historians have seen regulation mainly as a political process in which well-organized, dominant interest groups obtain political advantage and protect their particular industry from competition, typically at the expense of consumers.¹²

10. See Herbert Hovenkamp, *United States Competition Policy in Crisis: 1890–1955*, 94 MINN. L. REV. 311, 322 (2009) (discussing the idea of “social control,” which tended to normalize and limit industrial excesses).

11. See, e.g., WILLIAM J. NOVAK, *THE PEOPLE'S WELFARE: LAW AND REGULATION IN NINETEENTH-CENTURY AMERICA* 83–84 (1996) (discussing a lack of separation between market and state in early U.S. history); Claudia Goldin & Gary D. Libecap, *Introduction to THE REGULATED ECONOMY: A HISTORICAL APPROACH TO POLITICAL ECONOMY I* (Claudia Goldin & Gary D. Libecap eds., 1994) (discussing the debatable relationship between government intervention and economic development); Herbert Hovenkamp, *Regulation History as Politics or Markets*, 12 YALE J. ON REG. 549 (1995) (reviewing *THE REGULATED ECONOMY: A HISTORICAL APPROACH TO POLITICAL ECONOMY* (Claudia Goldin & Gary D. Libecap eds., 1994)). On the history of competition policy and antitrust, see generally HERBERT HOVENKAMP, *THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION* ch. 2 (2005), *THE CAUSES AND CONSEQUENCES OF ANTITRUST: THE PUBLIC-CHOICE PERSPECTIVE* (Fred S. McChesney & William F. Shughart II eds., 1995), Thomas J. DiLorenzo, *The Origins of Antitrust: An Interest-Group Perspective*, 5 INT'L REV. L. & ECON. 73 (1985), Thomas W. Hazlett, *The Legislative History of the Sherman Act Re-Examined*, 30 ECON. INQUIRY 263, 267 (1992), and George J. Stigler, *The Origin of the Sherman Act*, 14 J. LEGAL STUD. 1 (1985).

12. See generally GABRIEL KOLKO, *RAILROADS AND REGULATION, 1877–1916* (1965) (revealing how railroad barons sought government regulation when competition forced them to underprice their services). On this theory of regulation, see Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 235–36 (1976), and Richard A. Posner, *The Social Cost of Monopoly and Regulation*, 83 J. POL. ECON. 807, 807 (1975).

But the reductionist impulse to explain regulation as nothing more than interest-group politics clearly overstates the case. For example, in our federalist system, many markets are governed by the individual states, each of which has its own legislative process. Nevertheless, in nearly every state, state-controlled, local monopolies deliver electricity and natural gas while groceries and clothing are sold in competitively structured markets. These results did not occur simply because interest groups backing the electricity and natural gas industries were better organized than were the purveyors of groceries, shoes or lumber. In fact, policy-making in these markets was heavily driven by theory. At the same time, interest-group pressures in a complex democracy cannot be ignored, particularly in a political regime like that which existed in the late nineteenth and early twentieth centuries, when fundamental changes in technology and corporate structure created much hardship for established small businesses that were crushed in the process. The period witnessed the dramatic rise of the large, multistate business firm, followed by significant but volatile economic growth, and culminated with the Great Depression and the rise of the welfare state.

When robust economic theory indicates that a particular regulatory regime is best for a particular industry, that theory weighs heavily in policy-making. Indeed, broadly accepted theory is often decisive in the formulation of the core features of regulation, although less so at the margins. Often robust economic theories reflect—or are reflected by—popular views about the benefits or costs of government policy. In such cases theory and politics converge. By contrast, when the theory is controversial or many features of a market are not well understood, then interest-group pressures acquire greater sway and tend to drive policy-making. This view of regulation takes ideas about the economic merits of regulation more seriously than does a great deal of writing in both history and political or public-choice theory.

Neoclassical policy-making about the business firm concerned mainly corporate finance and the theory of firm organization. These two bodies of literature rarely cited one another, but they subscribed to a common vision about the firm's nature and goals. Both were strictly marginalist. By the middle of the twentieth century, corporate-finance theory came to see the firm as a maximizer of its own value. Yale economist Irving Fisher's "separation theorem," published early in the century, distinguished the firm's profit-maximizing goals from the preferences of individual shareholders. This line of thinking culminated with the efficient capital market hypothesis in the 1960s. Neoclassical finance theory was relentless in separating the goals and behavior of the firm from any observed preferences of shareholders or managers. It simply assumed that both groups wanted to maximize the firm's value.¹³

13. See Herbert Hovenkamp, *Neoclassicism and the Separation of Ownership and Control*, 4 VA. L. & BUS. REV. 373, 375 (2009) (discussing how the firm's only goal in microeconomics is maximization of value); Herbert Hovenkamp, *The Marginalist Revolution in Corporate Finance*,

The marginalist theory of firm organization and structure was already fully developed in Ronald Coase's path-breaking article, *The Nature of the Firm*, which was published in London in 1937.¹⁴ Coase offered an elegant, purely marginalist explanation for why firms grow as large as they do and how they choose what to produce internally and what to purchase from outside. Coase theorized that use of the market is itself costly. Firms continuously compare the marginal costs of internal production against the marginal costs of market acquisition, always selecting the more profitable alternative. The aggregation of these choices determined both the size of the firm and its "scope," or the range of markets in which it operated. The firm relentlessly pursued value maximization, and the individual preferences of shareholders and managers were all irrelevant. The genius of Coase's argument was that it took everything into account—production and distribution costs, competitive as well as anticompetitive opportunities, the market conditions that a firm faced, and the legal regime in which it operated.

But Coase's work was almost completely ignored in the dominant economics literature for several decades, and even longer in legal writing. Meanwhile, economists continued to wrestle with theories that were far more myopic and much less satisfactory. The theories of vertical integration that developed within neoclassicism prior to the 1970s generally fell into two classes. One class, which tracked the thinking of the classical political economists, focused on savings in production costs that result when production within the same plant eliminates costly steps. Pulling in the opposite direction were theories driven by product differentiation, high concentration, and the strategic value of excluding rivals. In a differentiated market, products compete with each other but are not exactly the same. As a result, different groups of customers have different preferences for one seller over another. Experts believed product differentiation blunted the forces of competition,¹⁵ but it also required firms to have specialized inputs. For example, a Ford engine block or a Maytag washing-machine motor from the 1920s could be used only in that particular firm's products. As a result, product-differentiated firms increasingly integrated "upstream" into production of their own inputs. As distribution needs became more specialized, particularly in markets that required dealers trained in the attributes of a single brand, vertical integration "downstream" into sales became more common as well.

1880–1965, at 8 (Univ. of Iowa Legal Studies, Working Paper No. 08-29, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1141291 (discussing how the marginalist revolution turned the corporation into a rational actor, intent on maximizing value).

14. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 404 (1937). On this article and its relation to the rise of modern law and economics, see generally Herbert Hovenkamp, *Coase, Institutionalism, and the Origins of Law and Economics* (Univ. of Iowa Legal Studies, Working Paper No. 10-07, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1538279.

15. See Hovenkamp, *supra* note 10, at 320 ("Product differentiation served to limit firms' competition with one another even when they were in the same general market.").

Industrial organization, which was the subject of Coase's work and that of many others, was concerned with how the firm's size and structure are determined. Perhaps by happenstance, the rise of marginalist theory occurred simultaneously with the growth of the large corporation. To some, the large firm appeared to be inevitable, while to others it threatened to undermine the competitive fabric of the American economy.

This Article examines the development of economic and legal policy toward vertical integration in the United States prior to 1960. It begins in Part II with the rise of marginalism in economics (II.A) and the important work of Frank Knight and Ronald Coase (II.B). Part III then turns to the history of legal policy, beginning with the common-law offenses of forestalling, regrating, and engrossing (III.A); the increasing threat that vertical integration posed to small business (III.B); courts' hostility toward contractual vertical integration based on their opposition to restraints on alienation (III.C); and the managerial revolution in American enterprise and ownership vertical integration (III.D). Part IV then examines evolving judicial attitudes toward vertical restraints, first as expressed in intellectual-property law's first-sale doctrine (IV.A), then in the developing contract law concerning long-term "relational" contracts (IV.B), and the extension of that analysis to commercial agency relationships and business-method franchises (IV.C). Next, Part V traces increasing antitrust hostility toward contractual vertical integration, including the Robinson-Patman Act (V.A) and the development of entirely novel uses of the Sherman Act (V.B). Finally, Part VI considers antitrust aggressiveness toward outright ownership vertical integration, reflected mainly in antitrust policy toward vertical mergers and monopolization. During this entire period, Ronald Coase's important observations—made in 1937 about a firm's rationales for vertical integration—were almost entirely ignored, although they were rediscovered in the 1970s.

II. VERTICAL INTEGRATION IN ECONOMICS BEFORE 1960

A. INTRODUCTION

Vertical integration never played much of a role in classical economic theory. Most of the classicists simply assumed that the firm procured some of its needs on the market and did other things for itself depending on convenience. Adam Smith expressed some distrust of multiowner stock companies, doubting that managers watching "other people's money" would have the same "anxious vigilance" as active owners.¹⁶ But that argument was apparently directed at absolute size rather than at vertical involvement in many different markets. In addition, Smith's observation that "the division of labour [is limited] by the

16. 5 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 330 (Penguin Books 1999) (1776).

extent of the market”¹⁷ was later interpreted as a theory of vertical integration by the prominent Chicago School economist, George J. Stigler.¹⁸ Smith’s argument, quite simply, is that there are economies of scale to specialization. As a result, larger markets lead to vertical *dis*-integration. For example, in a small, isolated village, each farmer must be his own butcher, but a larger community might be able to support the activities of a specialized butcher who could perform the job better or at lower cost. From this Stigler suggested that in earlier stages of development industries might be more vertically integrated because sufficiently robust markets had not yet emerged for some inputs. However, with growth and maturity these markets began to work better and procurement from others became gradually more efficient than self-supply. The history of American industry generally supports that proposition.¹⁹

The early marginalist economists did not do much more with vertical integration than the classicists did. In 1919, late in life, the great Cambridge marginalist Alfred Marshall wrote a lengthy book entitled *Industry and Trade*,²⁰ which was never to have the career that his famous *Principles of Economics* had. However, *Industry and Trade* contained some detailed accounts of vertical integration, most of which attributed it to production cost savings or to firms’ fussiness about quality.²¹ Marshall anticipated the subsequently held view that product differentiation required some vertical integration because, with differentiated products, inputs became more specialized.²² This was quite consistent with the Stigler observation noted previously: If a firm’s inputs were unique to that firm’s own product, such as Ford engines for Ford automobiles, then Ford would very likely be just as efficient a producer of the engines as others. In contrast, Marshall argued that the rise of standardization generally led to vertical *dis*-integration because standardized markets were more efficient than specialty markets.²³ *Industry and Trade* also contained an interesting discussion of the steel industry, suggesting that widespread collusion led to

17. *Id.* at 267.

18. George J. Stigler, *The Division of Labor Is Limited by the Extent of the Market*, 59 J. POL. ECON. 185, 185 (1951).

19. See generally Richard N. Langlois, *Economic Change and the Boundaries of the Firm*, 144 J. INSTITUTIONAL & THEORETICAL ECON. 635, 642 (1988) (“As the market for the final product expands, however, it becomes profitable for the increasing-returns activities to spin off and exploit their economies of scale by aggregating the demands for their services across the industry.”).

20. ALFRED MARSHALL, *INDUSTRY AND TRADE: A STUDY OF INDUSTRIAL TECHNIQUE AND BUSINESS ORGANIZATION; AND OF THEIR INFLUENCES ON THE CONDITION OF VARIOUS CLASSES AND NATIONS* (1919). Marshall was seventy-seven years old at the time, and he died in 1924. His *Principles of Economics* was published in 1890.

21. *Id.* at 147–48, 156, 373.

22. *Id.* at 156; see discussion *infra* text accompanying notes 215–16.

23. MARSHALL, *supra* note 20, at 380–81.

vertical integration as vertically related parties tried to avoid cartel prices by refining their own steel.²⁴

All in all, Marshall's observations about vertical integration were empirically realistic and many were ahead of their times. Unfortunately, they were fairly random, not well integrated into Marshall's general theory, and buried in a meandering, descriptive, 600-page account of the details of industry drawn mainly from armchair observation. *Industry and Trade* contained none of the technical apparatus that made Marshall's *Principles of Economics* such an important book thirty years earlier.

Further, Marshall's casual empiricism was the exception in a genre that had grown increasingly technical and infatuated with mathematics. Indeed, the lack of empirical investigation into the business firm's organizational choices once led Ronald Coase to groan that economic theory consisted of "consumers without humanity, firms without organization, and even exchange without markets."²⁵ Even in the 1920s and 1930s, most economic discussions of vertical integration focused on production or management cost savings, or assurance of supply or outlet.²⁶ Within neoclassical modeling, the business firm was simply a "production function," represented by a demand curve, a marginal revenue curve and a series of cost curves. Little thought was given to the organization that either generated these curves or responded to them.

In the 1940s and 1950s, neoclassical industrial-organization economists, such as Joe Bain, the leading protagonist of the Harvard School of industrial economics,²⁷ tended to view the competitive rationales for vertical integration as driven purely by technology—justified where a physical step could be eliminated between two processes, but not otherwise.²⁸ At the same time, Bain had a heightened fear of "foreclosure" and a belief that the procompetitive rationales for vertical integration tended to diminish as markets became more concentrated.²⁹ He reasoned that in "atomistically" competitive markets, firms would be forced to integrate vertically where vertical integration reduced costs and deterred from integrating vertically where it increased costs.³⁰ As a result, one could conclude with reasonable confidence that vertical integration in highly competitive markets was beneficial.

Bain viewed vertical integration in oligopoly or monopoly markets quite differently. Here, even uneconomical vertical integration might be profitable

24. *Id.* at 559–61.

25. R. H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 3 (1988).

26. *E.g.*, Lawrence Frank, *The Significance of Industrial Integration*, 33 J. POL. ECON. 179 (1925) (noting how discussion within business and industry was usually concerned with questions about relative economy, profitability, and efficiency).

27. On the Harvard School, see Hovenkamp, *supra* note 10, at 348 (noting how Joe Bain became the most prominent spokesperson for Harvard School structuralism).

28. JOE S. BAIN, *INDUSTRIAL ORGANIZATION* 168, 357–58 (1959).

29. *Id.* at 358.

30. *Id.* at 168.

to a firm if it produced offsetting benefits in the form of increased barriers to entry by new firms.³¹ Although Bain lacked good empirical data, he voiced “a considerable suspicion from casual observation that there is a good deal of vertical integration which, although not actually uneconomical, was also not justified on the basis of any cost savings.”³² In particular, Bain cited the increase in vertical integration into distribution and sales as involving situations where “the rationale of the integration is . . . the increase of the market power of the firms involved rather than a reduction in cost.”³³ For example, to the extent vertical integration reduces costs it compels a new rival to enter at two different market levels so that it can afford to compete with established firms. This can raise the costs and risks of entry. Bain also noted the existence of vertical integration in manufacturing that appeared to be motivated by “market advantage” rather than cost savings.³⁴ He was referring to situations where firms integrated vertically in order to avoid paying monopoly prices to suppliers who would otherwise be in highly concentrated markets. Today we would be inclined to think of vertical integration in this context as highly efficient and beneficial to consumers.³⁵ However, Bain found it troubling, believing that vertical integration by large firms in order to avoid higher market prices from concentrated suppliers would exacerbate a tendency toward large-scale production.³⁶ In sum, under Bain’s thinking vertical integration was beneficial in highly competitive markets but at best neutral and frequently harmful as market structures became less competitive.

Bain was even more suspicious of vertical integration by contract, particularly if the contract involved the exclusion of rivals, as in the case of tying and exclusive dealing.³⁷ “Most such practices or policies are dually effective in (a) restricting or weakening existing competition, and (b) preventing or discouraging the entry of new competitors.”³⁸

B. KNIGHT AND COASE

The two important exceptions to this line of thinking were University of Chicago economist Frank Knight’s *Risk, Uncertainty and Profit* (1921),³⁹ and

31. *Id.* at 168–69.

32. *Id.* at 357.

33. BAIN, *supra* note 28, at 168, 358.

34. *Id.* at 358.

35. See, e.g., Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 299 (1978) (describing “vertical integration . . . as a means of economizing on the costs of avoiding risks of appropriation of quasi rents in specialized assets by opportunistic individuals”).

36. BAIN, *supra* note 28, at 358.

37. *Id.* at 330.

38. *Id.* at 331.

39. FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921).

Ronald Coase's *The Nature of the Firm* (1937).⁴⁰ Knight's book was heavily concerned with problems of trusting the market when information is incomplete and actors are self-interested. In general, managers emerge because they have considerable skill in understanding the capabilities of others, and markets dominate when firms lack this understanding and use the price system as a surrogate. Switching between internal management and production rather than procurement on the market can be a way of dealing with differing amounts of uncertainty.⁴¹

Knight himself often danced at the edges of neoclassicism and has been characterized as an institutionalist.⁴² By and large the American institutionalists of the inter-war years were economics' dissidents and leftists. They wrote a great deal about the business firm, although their work was typically descriptive and empirical. The principal example was Berle and Means's important and controversial *The Modern Corporation and Private Property*,⁴³ although Thorstein Veblen's argument about the separation of ownership and control preceded them by nearly a decade.⁴⁴

Veblen, Berle and Means, and more traditional neoclassicists were all in complete agreement that the separation of ownership and control was a distinguishing feature of the modern large corporation. The difference was that Veblen and Berle and Means decried that development as promoting lack of corporate social responsibility. By contrast, the neoclassicists praised it as permitting the corporation to become an efficient vehicle for value maximization.⁴⁵ As a group, the institutionalists and the legal realists who picked up their mantle were suspicious of vertical integration, seeing it as a complement to monopolistic control.⁴⁶ Institutionalists, such as Berle and

40. Coase, *supra* note 14.

41. KNIGHT, *supra* note 39, at 245; see Richard N. Langlois & Metin M. Cosgel, *Frank Knight on Risk, Uncertainty, and the Firm: A New Interpretation*, 31 *ECON. INQUIRY* 456, 462 (1993) (explaining the use of judgment to deal with uncertainty); see also Yoram Barzel, *Knight's "Moral Hazard" Theory of Organization*, 25 *ECON. INQUIRY* 117, 177 (1987) (arguing Knight's "moral hazard" theory is the central feature of the firm); Donald J. Boudreaux & Randall G. Holcombe, *The Coasian and Knightian Theories of the Firm*, 10 *MANAGERIAL & DECISION ECON.* 147, 148 (1989) ("An alternative, which corresponds to Knight's concept of the firm, is to model the entrepreneur as choosing to bring new goods to market or to use new production processes where the outcome is uncertain.").

42. See Pier Francesco Asso & Luca Fiorito, *Was Frank Knight an Institutionalist?*, 20 *REV. POL. ECON.* 59, 60 (2008) (arguing that Knight was an institutionalist).

43. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

44. THORSTEIN VEBLEN, *ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES: THE CASE OF AMERICA* 5 (1923). On Veblen as a predecessor to Berle and Means, see HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW, 1836-1937*, at 357-61 (1991).

45. See Hovenkamp, *Neoclassicism and the Separation of Ownership and Control*, *supra* note 13, at 381 ("Neoclassicism largely disregarded the ownership/control problem by positing that both the firm and its shareholders had only profit-maximization in mind.").

46. See, e.g., JOHN R. COMMONS, *LEGAL FOUNDATIONS OF CAPITALISM* 270 (1924) (explaining how goodwill gained through unbridled vertical integration would quickly result in a monopoly); Comment, *Vertical Integration in Aluminum: A Bar to "Effective Competition"*, 60 *YALE L.J.* 294 (1951)

Means, generally saw the interests of managers as conflicting with those of owners, a phenomenon that they believed led to both inefficiency and excessive vertical integration.⁴⁷ Indeed, the dominance of legal realists and their law students in the post-war years explains much of the hostility toward vertical integration that characterized antitrust policy in the 1950s and 1960s.⁴⁸

The Nature of the Firm, published in 1937 while Coase was still at the London School of Economics,⁴⁹ came to be viewed as an attempt to synthesize some components of institutionalism with the dominant marginalist theory. By Coase's own admission, the article received scant attention prior to the 1970s. Joe Bain's principal book on industrial organization, which was published in 1959,⁵⁰ contained lengthy discussions of vertical integration but never cited Coase. Coase's article had no explicit influence on policy-making prior to the 1980s.

Notwithstanding his self-identification with institutionalism, Coase's article was an exercise in pure marginalism, beginning with the premise that the firm, like any rational economic actor, maximizes value by equating utilities. As Coase wrote his friend Ronald Fowler, an assistant lecturer at the London School of Economics, in 1932, the purpose of internal organization by a firm is to "reproduce market conditions," which a firm would do until the "cost of organizing marginal market transaction was equal to marketing cost of that transaction."⁵¹ In *The Nature of the Firm*, Coase declared:

When we are considering how large a firm will be the principle of marginalism works smoothly. The question always is, will it pay to bring an extra exchange transaction under the organising authority? At the margin, the costs of organising within the firm

(arguing that establishing effective competition requires changing natural industry patterns). Walton Hamilton, the author of *Vertical Integration in Aluminum: A Bar to "Effective Competition,"* was a Professor at Yale Law School from 1928 to 1948, although he trained as an economist rather than a lawyer. In particular, he argued that Alcoa's integration into fabrication served to foreclose that market to independent fabricators. The government's case against Alcoa's exclusionary vertical practices is made in Harold G. Reuschlein, *Aluminum and Monopoly: A Phase of an Unsolved Problem*, 87 U. PA. L. REV. 509, 535–37 (1939). See also EUGENE V. ROSTOW, A NATIONAL POLICY FOR THE OIL INDUSTRY 71–76 (1948) (discussing the evils of vertical integration in the oil industry); Eugene V. Rostow, *The New Sherman Act: A Positive Instrument of Progress*, 14 U. CHI. L. REV. 567, 591–600 (1947) (discussing vertical integration in the motion-picture industry). Rostow was a professor of law who served as the dean of Yale Law School from 1955 to 1965. For more on this topic from a legal realist perspective, see Karl N. Llewellyn, *The Effect of Legal Institutions upon Economics*, 15 AM. ECON. REV. 665, 666 (1925) (discussing that because law operates under the "principle of scarcity" lawyers have begun turning to principles of economics).

47. On this point, see Patrick Bolton & David S. Scharfstein, *Corporate Finance, the Theory of the Firm, and Organizations*, J. ECON. PERSP., Fall 1998, at 95.

48. See *infra* text accompanying note 73.

49. Coase moved to the United States in 1951 and became affiliated with the University of Chicago in 1964.

50. See BAIN, *supra* note 28.

51. R.H. Coase, *The Nature of the Firm: Origin*, 4 J.L. ECON. & ORG. 3, 4 (1988).

will be equal either to the costs of organising in another firm or to the costs involved in leaving the transaction to be “organised” by the price mechanism. Business men will be constantly experimenting, controlling more or less, and in this way, equilibrium will be maintained.⁵²

Coase’s theory of firm decision-making and size was purely marginalist. It treated the firm as a single entity, was completely indifferent to the preferences of its stockholders, and was absolutely driven by the neoclassical proposition that firms maximize their value.⁵³ To be sure, the observation and classification of “transaction costs” is an empirical exercise that may involve a great deal of study about how firms work, thus appealing to institutionalists. Nonetheless, Coase’s definition of how a firm determines its boundaries was pure neoclassicism and had no empirical content whatsoever.

The Nature of the Firm offered a theory of vertical integration that was at once purely market driven and completely non-monopolistic. Of course, monopoly in the economy could be relevant. For example, a firm might integrate vertically in order to avoid an upstream supplier’s monopoly because in that case the costs of using the market would be too large in relation to the cost of internal production. But that is simply to say that a firm constantly compares the marginal costs of internal production versus those of using the market in the situation in which it finds itself, imperfections and all.⁵⁴

As Coase’s insights lay ignored within neoclassical economics, U.S. antitrust policy was about to undertake a thirty-year war against the evils of vertical integration. Today, we are inclined to view the law of the middle decades of the twentieth century as unreasonably hostile, understating the economic value of vertical integration and exaggerating its potential for competitive harm.⁵⁵ As the previous discussion suggests, however, if one sets aside the work of such dissenters as Knight and Coase, the prevailing legal theory was not that far removed from the prevailing economics. Failure to incorporate transaction costs into their analysis led neoclassical economists like Bain to understate the economic value of vertical integration. As a result, he

52. Coase, *supra* note 14, at 404.

53. See generally Hovenkamp, *The Marginalist Revolution in Corporate Finance, 1880–1965*, *supra* note 13 (stating that the marginalist concept of the corporation entirely separated corporate decision-making from all human preference, unless those preferences were simply asserted to maximize value).

54. On the debate over marginalism and profit-maximization as explanatory devices for the business firm, see Fritz Machlup, *Theories of the Firm: Marginalist, Behavioral, Managerial*, 57 AM. ECON. REV. 1, 2–6 (1967). See generally RICHARD M. CYERT & JAMES G. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963) (arguing for a more institutionalist behavioral theory of the firm).

55. E.g., 3B PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶¶ 756–62 (3d ed. 2006) (explaining that vertical integration lacks anticompetitive consequences when both markets are competitive); Robert Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157, 159 (1954) (noting that the law has “consistently condemned” vertical integration).

saw vertical integration as much more pervasive than the search for economies justified. Given the lack of an efficiency explanation, he tended to find the rationales for vertical integration in the prospect of monopoly—mainly, higher entry barriers or market foreclosure.⁵⁶

The progressive and legal realist institutionalists took a more empirical and historical approach, but they were, if anything, even more concerned about vertical integration's harmful effects. In sum, vertical integration became a monopoly problem. When the revision occurred, largely in the 1970s and after, it occurred entirely within marginalist, neoclassical economics through the simple vehicle of applying marginalist analysis to every decision the firm made to both the pricing of its products and also to its internal scope and structure.

III. VERTICAL INTEGRATION AND LEGAL POLICY: CHARACTERIZATION AND FEARS

As the previous illustrations suggest,⁵⁷ vertical integration did not originate with the large business corporation that emerged in the late nineteenth century. Classical business enterprise prior to the industrial revolution was typically integrated quite fully. Many firms, like the village cobbler, tended to produce their own inputs and do their own advertising, marketing, and sales even though they were very small. Later on, when driven by technological progress, firms went through a period when they became much larger horizontally but smaller vertically. For example, the United Shoe Machinery Company was very large by early twentieth-century standards and a twice-condemned monopolist, even though it occupied less vertical space than the village cobbler did.⁵⁸ By contrast, even modern industries in a very early stage of development tended to be highly integrated vertically. For example, the early history of the automobile industry is filled with stories of manufacturers who engineered and manufactured their own automobile parts. At one time, Henry Ford even grew his own soybeans for the manufacture of plastic horn buttons.⁵⁹ However, as the industry developed, its needs became more standardized, and it quickly came to rely on outside suppliers.⁶⁰ International Harvester, the largest early twentieth-century maker of agricultural implements, initially acquired and operated its own steel mills,

56. BAIN, *supra* note 28, at 168–69.

57. See *supra* text accompanying notes 1–2 (describing the example of the village cobbler).

58. See generally *United Shoe Mach. Corp. v. United States*, 258 U.S. 451 (1922) (condemning anticompetitive lease agreements); *United States v. United Shoe Mach. Corp.*, 110 F. Supp. 295 (D. Mass. 1953), *aff'd mem.*, 347 U.S. 521 (1954) (similar).

59. G. E. Hale, *Vertical Integration: Impact of the Antitrust Laws upon Combinations of Successive Stages of Production and Distribution*, 49 COLUM. L. REV. 921, 922 (1949).

60. See Richard N. Langlois & Paul L. Robertson, *Explaining Vertical Integration: Lessons from the American Automobile Industry*, 49 J. ECON. HIST. 361, 365 (1989) (explaining the early evolution of automobile industry).

coalmines, railroads, and parcels of land producing lumber, but gave them up in the 1930s.⁶¹

A. *FORESTALLING, REGRATING, AND ENGROSSING*

The common law actually compelled a significant amount of vertical integration because of its hostility toward “middlemen,” or intermediaries in the distribution system. The common-law crimes of forestalling, regrating, and engrossing, which were recognized at least as early as the thirteenth century, involved practices such as interrupting sellers on their way to market and purchasing their wares in order to hold them for a higher price.⁶² Within such a regime, producers of commodities were generally encouraged to do their own marketing to consumers, just as the village cobbler did. In short, classical legal theory was highly suspicious of intervening market transactions, even to the point of making buying for the purpose of reselling a crime. At common law, forestalling, regrating, and engrossing were regarded as “*mala in se*,” which meant that they were not merely regulatory crimes but were treated as reprehensible conduct in a manner such as fraud.⁶³ Indeed, for a ten-year period in the fourteenth century, forestalling was punishable by death, although it appears that no one was ever actually executed.⁶⁴ In his history of the Sherman Act, William Letwin portrayed the common-law offenses as predecessors of monopolization law by condemning “cornering” of the market.⁶⁵ But the statutes themselves contained no requirement of “cornering,” or market control. Rather, the gravamen of the offenses was to buy at one price in order to resell at a higher price. While the word “forestalling” implied force or even foreclosure, the force was apparently directed at the producers from whom goods were purchased. Further, the offense did not require that the defendant purchase all or even a sizeable portion of that which was available on the market.⁶⁶

61. See FED. EXCH. COMM’N, CAUSES OF THE HIGH PRICES OF FARM IMPLEMENTS 672–75 (1920) (discussing the plan for a division of International Harvester). See generally *International Harvester*, FORTUNE, Aug. 1933, at 21.

62. See 4 WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 375–79 (2d ed. 1937) (relating the offenses to Medieval price-control policies); Wendell Herbruck, *Forestalling, Regrating and Engrossing*, 27 MICH. L. REV. 365, 378–80 (1929) (discussing relevant eighteenth-century events). Technically, the crime of regrating involved the purchasing of commodities from their producers and then reselling them within four miles from the point of purchase. *Id.* at 377.

63. WILLIAM ILLINGWORTH, AN INQUIRY INTO THE LAWS, ANCIENT AND MODERN, RESPECTING FORESTALLING, REGRATING, AND ENGROSSING: TOGETHER WITH ADJUDGED CASES, COPIES OF ORIGINAL RECORDS, AND PROCEEDINGS IN PARLIAMENT, RELATIVE TO THOSE SUBJECTS 102 (London, Luke Hansard 1800).

64. 27 Edw. 3, c. 3, § 2 (1353) (Eng.) (death penalty for forestalling), *repealed by* 38 Edw. 3, c. 6, § 1 (1363) (Eng.).

65. WILLIAM LETWIN, LAW AND ECONOMIC POLICY IN AMERICA: THE EVOLUTION OF THE SHERMAN ANTITRUST ACT 33–34 (1956).

66. See Herbruck, *supra* note 62, at 367–79.

B. THE INCREASING THREAT TO SMALL BUSINESS

In contrast to the common-law position, which virtually compelled vertical integration into distribution, vertical integration came to be viewed by twentieth-century legal policymakers as competitively dangerous and was eventually condemned under the antitrust laws even when the firms failed to occupy anything approaching a dominant market position.⁶⁷

The history of legal policy toward vertical integration in the United States reflects an extraordinary amount of antipathy, but also indecisiveness. The common law held very benign attitudes toward vertical expansion by internal growth. Simply integrating vertically into a new line of business was not an offense. Under nineteenth-century state corporate law, vertical integration was often restricted by corporate “business purpose” clauses. For example, a corporation chartered to operate a railroad might violate state corporate law by building a factory to manufacture its own railroad trackage or cars. But a generally benign corporate-law environment subsequent to the Andrew Jackson administration developed the “collateral transactions” rule, under which corporations were permitted to integrate vertically into areas of enterprise deemed essential to their operation.⁶⁸ By the second decade of the twentieth century, however, large corporations were nearly all incorporated under provisions that permitted them to engage in “any lawful business.”⁶⁹ Corporate law itself was no longer a significant impediment to vertical integration.

In the 1920s, antitrust law began to condemn vertical integration by dominant firms if the court saw it as a mechanism for displacing independent rivals.⁷⁰ Vertical mergers also became increasingly suspect. The common law had virtually nothing to say about a firm’s acquisition of an upstream supplier or a downstream retail outlet. Until New Jersey changed its law early in the twentieth century, state corporate law generally forbade one corporation from owning the shares of a different corporation (“holding companies”), and this prohibition applied equally to horizontal and vertical acquisitions.⁷¹ But firms were able to evade this limitation through the use of asset acquisitions rather than stock acquisitions. Rather than purchase an upstream or downstream company, they would simply purchase all of its plant and equipment. Indeed, firms followed this strategy after the passage of the first federal antimerger provision. As originally enacted in 1914, section 7 of the Clayton Act applied only to mergers that threatened to lessen competition “between” the merging

67. See *e.g.*, *Brown Shoe Co. v. United States*, 370 U.S. 294, 346 (1962) (condemning a vertical merger by clearly non-dominant firms).

68. See HOVENKAMP, *supra* note 44, at 335–60; VICTOR MORAWETZ, *A TREATISE ON THE LAW OF PRIVATE CORPORATIONS* §§ 362–365, 393 (2d ed. 1886) (discussing the collateral-transactions rule).

69. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 *GEO. L.J.* 1593, 1669–70, 1687 (1988).

70. See *infra* text accompanying notes 82–85.

71. On this point, see 1 AREEDA & HOVENKAMP, *supra* note 55, ¶ 102.

firms, and only to stock acquisitions.⁷² Mergers of competitors—or horizontal mergers—did lessen competition between the merging firms, but vertical mergers involved firms in a buyer–seller relationship. Originally, the Clayton Act provision did not cover asset acquisitions at all. Congress amended the statute in 1950 to make it apply to both vertical mergers and to asset acquisitions. Almost immediately thereafter, the Justice Department and the Supreme Court launched an aggressive campaign against vertical mergers.⁷³

Economists had not been able to develop a robust theory showing why a firm’s participation in multiple stages of production and distribution should be regarded as competitively harmful. Early on, however, economists recognized benefits in the form of reduced production costs. At the same time, vertical integration caused obvious and painful economic dislocations, ruining thousands of small family businesses. As a result, vertical integration became a playground for special-interest groups seeking both federal and state protective legislation.⁷⁴ For example, the drafting of the Robinson–Patman Act in the mid-thirties was virtually taken over by the leading association of small wholesale grocers,⁷⁵ largely after they had failed to roll back the chain-store revolution by the use of privately orchestrated boycotts.⁷⁶ By preventing price discrimination in upstream transactions, Congress designed the statute to limit the power of chain stores to purchase goods at lower prices than smaller businesses paid. The Natural Industrial Recovery Act, which had been passed during the first New Deal and then struck down by the Supreme Court, was also hostile toward vertical integration.⁷⁷ The principal intent behind the post-Depression “fair trade” laws, which permitted manufacturers to control retailer prices within their borders, was to encourage states to force chain stores to charge just as high a price as smaller single-store operations charged.⁷⁸ In

72. Clayton Act, ch. 323, § 7, 38 Stat. 730 (1914) (current version at 15 U.S.C. § 18 (2006)).

73. See discussion *infra* text accompanying notes 82–84.

74. For an excellent survey of the political environment at the time, see generally JOSEPH C. PALAMOUNTAIN, JR., *THE POLITICS OF DISTRIBUTION* (1955).

75. See FREDERICK M. ROWE, *PRICE DISCRIMINATION UNDER THE ROBINSON–PATMAN ACT* 3–25 (1962) (describing the background of the Act); Hugh C. Hansen, *Robinson–Patman Law: A Review and Analysis*, 51 *FORDHAM L. REV.* 1113, 1119 n.33 (1983) (explaining that the counsel for the U.S. Wholesale Grocers’ Association “is credited with drafting most of the Act”).

76. See generally *Ark. Wholesale Grocers’ Ass’n v. FTC*, 18 F.2d 866 (8th Cir. 1927) (condemning the grocers’ association boycott of suppliers who sold to chain-store retailers at the same price as they sold to the defendant wholesalers, thus limiting the latter’s markup and placing their own purchaser/retailers at a disadvantage); *United States v. S. Cal. Wholesale Grocers’ Ass’n*, 7 F.2d 944 (S.D. Cal. 1925) (similar Justice Department suit). Much of the history is recounted in Richard C. Schragger, *The Anti-Chain Store Movement, Localist Ideology, and the Remnants of the Progressive Constitution, 1920–1940*, 90 *IOWA L. REV.* 1011 (2005).

77. Natural Industrial Recovery Act, ch. 90, 48 Stat. 195 (1933), *invalidated* by *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

78. See Amendment to the Antitrust Laws, ch. 690, 50 Stat. 693 (1937) (creating a “fair trade” exemption from the Sherman Act); Act of July 14, 1952, ch. 745, 66 Stat. 631 (1952) (adding the exemption to the Federal Trade Commission Act).

order to make these chain stores less competitive, many states began to levy “corrective taxes” on them, typically with tax rates that varied in proportion to the number of stores a chain controlled.⁷⁹ In addition, several states passed “divorcement” statutes that forbade gasoline refiners from owning their own retail stations.⁸⁰ State regulation of franchising began mainly in the automobile industry and then passed into other markets as well. The principal perceived evils were manufacturers’ increasing demands for larger investments by dealers and also the tying of collateral goods or services such as aftermarket parts and financing.⁸¹

Economists and even lawyers were well aware that vertical integration could reduce the costs of distribution, but that fact did not always make them more sanguine. To the contrary, mid-twentieth-century antitrust policymakers tended to view the cost savings created by vertical integration as harmful. Those concerns were manifest in the legislative history of 1950 amendments to the antitrust laws, which Congress designed to make antitrust treatment of vertical mergers more aggressive.⁸² The Supreme Court’s *Brown Shoe*⁸³ decision in 1962 was faithful to these concerns. At the government’s request, the Court condemned a vertical merger into retailing precisely *because* the lowered costs

79. See PALAMOUNTAIN, *supra* note 74, at 159–87 (discussing various taxes levied against chain stores in the 1930s); see also Louis K. Ligett Co. v. Lee, 288 U.S. 517, 540–41 (1933) (upholding a state tax that was graduated according to the number of stores a firm owned); GODFREY M. LEBHAR, CHAIN STORES IN AMERICA, 1859–1962, at 125–55 (3d ed. 1963) (discussing the chain taxes enacted in many states during the 1920s through the 1940s as well as various other anti-chain legislation from that time period); Carl H. Fulda, *Food Distribution in the United States, the Struggle Between Independents and Chains*, 99 U. PA. L. REV. 1051, 1076–82 (1951) (discussing the local backlash to the growth of chain grocers and the state-chain-tax movement during the early 1930s); Thomas W. Ross, *Store Wars: The Chain Tax Movement*, 29 J.L. & ECON. 125, 137 (1986) (discussing certain economic variables that led some states to introduce franchise taxes and explaining why they did not have a major long-term impact).

80. See Asher A. Blass & Dennis W. Carlton, *The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice*, 44 J.L. & ECON. 511, 511–12 (2001) (discussing the introduction of state divorcement legislation, as well as other legislation and litigation aimed at limiting refiner-owned gas stations); Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217, 217–18 (2000) (discussing the history and purpose of divorcement legislation).

81. See THOMAS S. DICKE, FRANCHISING IN AMERICA: THE DEVELOPMENT OF A BUSINESS METHOD, 1840–1980, at 45–84 (1992) (presenting a case study of The Ford Motor Company franchising practices from 1903–1956); see also David Gurnick & Steve Vieux, *Case History of the American Business Franchise*, 24 OKLA. CITY U. L. REV. 37, 54–55 (1999) (discussing Congress’s reasons for passing the Automobile Dealers Day in Court Act).

82. See Derek C. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 234–36 (1960) (discussing the broad range of anticompetitive influences under which Congress amended section seven of the Clayton Act); Herbert Hovenkamp, *Derek Bok and the Merger of Law and Economics*, 21 U. MICH. J.L. REFORM 515, 524–28 (1988) (discussing the anticompetitive political influence present in the legislative history of Congress’s amendment of section seven of the Clayton Act and Bok’s response thereto).

83. *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962).

that resulted permitted the firm to undersell smaller, unintegrated rivals. As the district court wrote in condemning that merger:

[I]ndependent retailers of shoes are having a harder and harder time in competing with company-owned and company-controlled retail outlets. National advertising by large concerns has increased their brand name acceptability and retail stores handling the brand named shoes have a definite advertising advantage. Company-owned and company-controlled retail stores have definite advantages in buying and credit; they have further advantages in advertising, insurance, inventory control . . . and price control. These advantages result in lower prices or in higher quality for the same price and the independent retailer can no longer compete⁸⁴

In some cases, the protection of small business per se was articulated as the goal, even if it was to come at consumers' expense. In other situations, legislatures or courts envisioned harm to consumers, although there was typically little evidence of it. Often the theory appears to have been that large enterprises would drive small firms out with low prices in order to charge higher prices later. More often, however, it seems to have been a poorly articulated position that an economic landscape populated by small businesses was what the country really wanted—a regime of small business “for its own sake and in spite of possible costs,” as Judge Hand described the goals of the antitrust laws in 1945.⁸⁵

C. CONTRACTUAL VERTICAL INTEGRATION AND RESTRAINTS ON ALIENATION

The law reserved its harshest treatment for vertical integration by contract, which consisted mainly of long-term franchise relationships between manufacturers and dealers. Late nineteenth- and early twentieth-century views of contractual integration invoked two common-law doctrines that had always existed in tension. One was liberty of contract, and the other was the strong policy against restraints on alienation. The common law was deeply committed to both principles, notwithstanding profound conflict between them. Liberty of contract entailed that contracting parties could agree to do anything not contrary to positive law or public policy and expect that their agreement would

84. *United States v. Brown Shoe Co.*, 179 F. Supp. 721, 738 (E.D. Mo. 1959). The Federal Trade Commission took the same position. See *In re Foremost Dairies, Inc.*, 60 F.T.C. 944, 1084 (1962) (concluding that efficiencies resulting from a merger were bad because they gave post-merger firms a “decisive advantage . . . over . . . smaller rivals”). On the *Brown Shoe* decision and the subsequent revolution in antitrust policy, see Christina Bohannon & Herbert Hovenkamp, *IP and Antitrust: Reformation and Harm*, 51 B.C. L. REV. (forthcoming 2010).

85. *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 429 (2d Cir. 1945) (“Throughout the history of these statutes it has been constantly assumed that one of their purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other.”).

be enforced. Further, vertical distribution agreements were contracts between experienced businesspersons who were not generally thought to require any special favoritism from the law. Many of these contracts injured no one—except, perhaps, the contracting parties themselves.

On the other side was the common law's deep hostility toward restraints on alienation, which generally took the form of restrictions on how a purchaser or other acquirer of property could dispose of it once it had been acquired. In the commercial context, restraints on alienation were contractual. However, the law carved out a very significant exception to liberty of contract even as the Supreme Court was elevating that doctrine to strong constitutional status. The *Dr. Miles* decision, which condemned agreements between suppliers and retailers specifying the retailers' resale prices, came only six years after the *Lochner* decision struck down maximum-hours laws during the heyday of constitutional liberty of contract.⁸⁶ And long before *Dr. Miles*, the judicially created first-sale doctrine in patent law provided that a patentee could not use the patent laws to enforce restrictions on a patented good once the good had been sold.⁸⁷

Today, after nearly a century of economic thinking about such matters, we tend to see the differences between ownership and contract vertical integration as minimal. One of Ronald Coase's insights in 1937 was that equity ownership and contract are simply two ways of accomplishing the same thing, and the rational firm will select the most profitable option.⁸⁸ Some shoe manufacturers will simply own a shoe store in the front of their shops. Others will wholesale them to department stores, while yet others will enter into long-term contracts with independent "franchise" outlets. Indeed, law and economics today tends to look at business firms as nothing more than "bundles of contracts."⁸⁹ Legally, of course, the differences are more substantial; and corporate law, liability, and tax consequences can attach to one's decision to integrate by ownership or contract.

Nevertheless, in the area of contract law, individual business autonomy remained a significant legal obstacle to vertical control. It was clearly lawful for an employer to tell its own employee operating a retail branch (1) what price

86. *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 397 (1911) (condemning resale-price-maintenance contracts); *Lochner v. New York*, 198 U.S. 45, 59 (1905) (striking down the maximum-hours provision applied to bakers). Justice Holmes dissented in both cases. See Herbert Hovenkamp, *The Political Economy of Substantive Due Process*, 40 STAN. L. REV. 379, 395–98 (1988) (discussing the effect of the Fourteenth Amendment).

87. See *infra* text accompanying notes 98, 100 (discussing why legal policy was so hostile towards vertical agreements).

88. Coase, *supra* note 14, at 394–95.

89. For an example of this view, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 794 (1972). See also Harold Demsetz, *The Theory of the Firm Revisited*, in OWNERSHIP, CONTROL, AND THE FIRM: ORGANIZATION OF ECONOMIC ACTIVITY 144, 147 (1990) (stating that greater weight must be given to information costs in order to create a more complete theory of the firm).

to charge, (2) that he could sell only his employer's products, or (3) that he must use only his employer's stencils and ink in the shop's mimeograph machine.⁹⁰ However, if the employee was a small-business person and the relationship was contractual, the story was entirely different. All three of these practices were at one time or another regarded as unlawful per se under the antitrust laws—that is, they were presumed unlawful without needing to show specific anticompetitive effects.⁹¹

Given the broad legal approval of ownership vertical integration and disapproval of vertical integration by contract, the law effectively forced firms to prefer ownership integration even when contract integration would have worked at least as well. Or to state it bluntly, legal policy often had the perverse effect of destroying the very small businesses it was intended to protect. Justice Douglas expressed this view in an otherwise completely out-of-character dissent in the *Standard Oil* exclusive-dealing decision in 1949.⁹² Douglas was both an aggressive enforcer of the antitrust laws and an outspoken supporter of the independent rights of small-business persons. Nevertheless, he objected to the Supreme Court's decision that condemned exclusive dealing imposed by large refiners on independent service stations.⁹³ The decision effectively gave independently owned gasoline stations the legal right to operate "split-pump" stores that sold multiple brands of gasoline. Douglas predicted the consequences accurately. Rather than permitting split-pump sales, the refiners would simply open gasoline stations of their own and terminate their franchise arrangements with the independents. His objection is worth quoting at some length:

The lessons Brandeis taught on the curse of bigness have largely been forgotten in high places. Size is allowed to become a menace to existing and putative competitors Local leadership is diluted

. . . .

It is common knowledge that a host of filling stations in the country are locally owned and operated. Others are owned and operated by the big oil companies. This case involves directly only the former. It pertains to requirements contracts that the oil companies make with these independents. It is plain that a filling-station owner who is tied to an oil company for his supply of

90. *Cf. Henry v. A.B. Dick Co.*, 224 U.S. 1, 31 (1912) (declining to apply the first-sale doctrine to A.B. Dick's tying of its paper, ink, and stencils to the use of its patented mimeograph machine).

91. *See infra* text accompanying notes 195–97.

92. *Standard Oil Co. of Cal. v. United States*, 337 U.S. 293, 316 (1949) (Douglas, J., dissenting).

93. *Id.*

products is not an available customer for the products of other suppliers

The Court answers the question for the oil industry by a formula which under our decisions promises to wipe out large segments of independent filling-station operators. The method of doing business under requirements contracts at least keeps the independents alive.

The elimination of these requirements contracts sets the stage for Standard and the other oil companies to build service-station empires of their own. The opinion of the Court does more than set the stage for that development. It is an advisory opinion as well, stating to the oil companies how they can with impunity build their empires⁹⁴

D. THE MANAGERIAL REVOLUTION AND OWNERSHIP VERTICAL INTEGRATION

Alfred Chandler's panoramic view of 1970s history of American business growth and integration saw growth entirely as a consequence of technological developments and changes in markets. In a book citing Ronald Coase's article *The Nature of the Firm* only once and misnaming him "Richard,"⁹⁵ Chandler nevertheless argued that vertical integration occurred when it became more cost effective for firms to use managers rather than markets in order to procure inputs or distribute their products. Chandler believed that managers became superior to markets when the economy and firms grew large enough so that the manager could produce something within the firm as efficiently as an independent intermediary could do for a group of smaller firms. The principal engine for this revolution in Chandler's model was the railroad, for two reasons. First, the railroads were the first firms that were large enough to accomplish things efficiently through managers rather than markets. Second, the railroads made it possible for other firms to combine spatially separated production and distribution functions under a single management. In sum, economies of scale in production generated by the industrial revolution produced firms of large horizontal size. These larger firms were less dependent on suppliers and distribution agents ("factors") that aggregated the needs of many firms, and by integrating vertically they were able to avoid the otherwise considerable costs of using the market.

Within Chandler's model, antitrust was a beneficial instrument for encouraging appropriate industry structure, although not necessarily for the reasons its framers intended. Not all business combinations and expansions

94. *Id.* at 318–20. Douglas was referring to LOUIS D. BRANDEIS, *THE CURSE OF BIGNESS* (Osmond K. Fraenkel ed., 1934).

95. ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 515 n.3 (1977).

were good ones. He distinguished between holding companies and other combinations that were little more than disguised cartels from those that were driven by real technological or transactional efficiencies.⁹⁶ The real impact of antitrust, Chandler wrote, was to condemn loose combinations and cartels and to preserve well-integrated unitary businesses. As a result, antitrust encouraged firms to expand for the right reasons and actually “hastened the growth of big business in the United States.”⁹⁷ He concluded that antitrust policy “provided a powerful pressure that did not exist elsewhere to force family firms to consolidate their operations into a single, centrally operated enterprise administered by salaried managers.”⁹⁸

IV. DEVELOPING LEGAL RESISTANCE TO VERTICAL INTEGRATION BY CONTRACT

A. FROM THE FIRST-SALE DOCTRINE TO ANTITRUST

The law of vertical contracting in the early twentieth century raises one vexing question: Why was legal policy so hostile toward vertical agreements between experienced businesspersons, even as it was protecting liberty of contract so aggressively in other contexts, even to the point of striking down minimum-wage and other labor provisions enacted for the benefit of unsophisticated laborers? The legal presumptions against vertical contracting in particular antedated any coherent economic argument against them. Indeed, one characteristic of the antitrust decisions concerning vertical restraints is that the courts condemned them aggressively even as they fumbled for rationales explaining why they were anticompetitive.

The common-law bias against restraints on alienation accounts for part of this attitude. Significantly, minimum-wage and maximum-hours laws were relatively new phenomena during the Progressive Era, and the courts viewed them with suspicion. Further, they did not explicitly involve the sale of property. In sharp contrast, the well-established common-law hostility toward alienation restraints predated the U.S. Constitution, and the courts had a far easier time assimilating those concerns into the doctrine of liberty of contract. For example, John Chipman Gray’s influential 1890s treatise, *Restraints on the Alienation of Property*, both lauded liberty of contract as a virtue and regarded the common-law rules prohibiting restraints on alienation as virtually sacred.⁹⁹ In its *Dr. Miles* decision, which condemned resale-price limitations on goods that dealers had purchased, the Supreme Court relied on both Gray and the

96. *Id.* at 334–38.

97. *Id.* at 375, 499.

98. *Id.* at 499.

99. JOHN CHIPMAN GRAY, *RESTRAINTS ON THE ALIENATION OF PROPERTY* iii–viii (2d ed. Boston Book Co. 1895) (1883).

English common law to hold that a dealer could not “contract away” the right to set any resale price he pleased.¹⁰⁰

The Supreme Court regarded resale-price maintenance as a contractual practice, thus falling within the Sherman Act’s prohibition of contracts in restraint of trade. By contrast, restraints on alienation were dealt with under property rules—Gray’s entire treatise was organized under the common-law estates in real and personal property. The strong property policy on alienability crept into antitrust law in the early twentieth century from mid-nineteenth century Supreme Court decisions limiting restraints on the alienation of patented goods. “Crept” is the operative term. Rules associated with the origins of antitrust policy governing vertical restraints were in fact rules developed a half-century earlier under the patent and copyright act’s first-sale doctrine.

The first-sale rule, commonly referred to as the “exhaustion” doctrine, held that the sale of a patented good exhausted all of the patentee’s rights in that particular unit of the good. As a result, the patentee could not impose restrictions that attached subsequent to the sale. Significantly, the patent-exhaustion doctrine enabled courts to avoid the contract issue because the disputes were patent-infringement actions, not claims for breach of contract. The doctrine dates to the mid-nineteenth century case of *Bloomer v. McQuewan*,¹⁰¹ but the best-known expression was in *Adams v. Burke* in 1873, an early vertical territorial-restraints case. The Supreme Court refused to enforce a restriction that forbade a purchaser of patented coffin lids from reselling them more than ten miles from Boston.¹⁰² The patentee had licensed the manufacturing rights, subject to the ten-mile limitation, to the firm of Lockhart and Seelye, who had manufactured the lid in question and placed it on a coffin. The firm then sold the coffin to Burke, a mortician who used the coffin for a burial in Natick, Massachusetts, which was about seventeen miles from Boston. The patentee claimed that the burial violated the terms of the patent license and thus constituted infringement. In the subsequent dispute, the Court assumed that the geographic restriction imposed on Lockhart and Seelye’s manufacturing license was enforceable, but once a finished coffin lid was produced and sold to another, the purchaser took it free and clear of all patent obligations.¹⁰³

While courts enforce the first-sale rule to this day,¹⁰⁴ this distinction between the conditions imposed in a manufacturing license and those imposed on the sale of a finished good proved to be an enormously complicating factor in the twentieth-century law of distribution restraints involving patented or

100. *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 405, 409 (1911).

101. *Bloomer v. McQuewan*, 55 U.S. (14 How.) 539, 549 (1853) (“[W]hen the machine passes to the hands of the purchaser, it is no longer within the limits of the [patent] monopoly.”).

102. *Adams v. Burke*, 84 U.S. (17 Wall.) 453, 460 (1873).

103. *Id.* at 457.

104. *See Quanta Computer, Inc. v. LG Elec., Inc.*, 128 S. Ct. 2109, 2117 (2008) (reaffirming a broad first-sale rule for patents).

copyrighted goods. As Gray's treatise suggests, historically the first-sale doctrine was a "property" rule.¹⁰⁵ It applied to a good that happened to be patented and not to the transfer of the patent itself that was not attached to any good—as, for example, a manufacturing license.

The rules actually originated in the Blackstonian distinction between incorporeal property rights "in gross" and "appurtenant," which also involved property rights and not intellectual-property ("IP") rights. An easement "in gross" was an incorporeal property right—such as the right to take firewood from the seller's land—that was given to a person as an individual. Because there was no natural limit on the amount of firewood that the recipient could take, subdivision, and overuse was a serious problem. Nothing would prevent the owner of the easement from dividing it into ten parts. Each of the ten owners could then take as much firewood as he wanted. As early as the sixteenth century the common law limited the division of easements in gross, either prohibiting them altogether or else permitting them to be divided only for the coordinated use of, say, business partners or operators of a corporation.¹⁰⁶ A patent license was an incorporeal interest of the same nature; that is, there was no inherent limit on the number of times it could be used. For this reason, the emerging law gave patentees wide latitude to impose restrictions on patent licenses that defined the limits of the license. For example, one could license a patent only for the manufacture of one hundred units per year, or only for units to be resold in the state of Nevada, or only for noncommercial purposes.

In sharp contrast, an easement "appurtenant" was an incorporeal interest that attached to a particular piece of land. For example, one landowner might sell another the right to take firewood for heating the home on the purchaser's land. To be sure, the house itself could be subdivided, perhaps by dividing it into apartments, and each tenant could then use the firewood to heat his portion. But the tying of the right to the purchaser's house imposed a natural limit on the overuse of the easement, making further restraints unnecessary.¹⁰⁷ As a result, the policy against restraints on alienation overrode the policy favoring liberty of contract. The patent law's first-sale rule said, quite simply, that while the patentee could impose a territorial or other restriction on how or where a patented article was manufactured, once the article was manufactured and resold, that particular copy of the article was no longer

105. See generally GRAY, *supra* note 99 (characterizing the first-sale doctrine as a common-law property rule).

106. See *Earl of Huntington v. Lord Mountjoy (Mountjoy's Case)*, (1583) 123 Eng. Rep. 488 (C.P.D.) (holding that an easement in gross could be divided only if co-owners operated it as "one stock"). The rule was followed in the United States in *Miller v. Lutheran Conference & Camp Ass'n*, 200 A. 646, 652 (Pa. 1938) (granting a recreational license to use lake required "common consent" by co-owners in partnership).

107. *E.g.*, *Martin v. Music*, 254 S.W.2d 701 (Ky. 1953) (holding that an owner of an easement benefitting a defined parcel of land could divide the parcel and each co-owner could share the easement).

covered by the patent law and could be resold freely. As early as 1886, prior to passage of the Sherman Act, a federal court analogized to patent law's first-sale doctrine to deny enforcement of a covenant limiting the territories in which the plaintiff's unpatented, but trademarked, spring water could be resold.¹⁰⁸

The first-sale doctrine explains why the sale-plus-resale of a physical article became so decisive in the antitrust law of distribution restraints, even though economically speaking it is a mere detail. For example, the antitrust resale-price-maintenance rules applied to a distribution arrangement in which a firm sold to a retailer who in turn resold to consumers. Historically, they did not apply to "agency" or "consignment" arrangements in which the retailer never took title and simply operated as a representative of the manufacturer.¹⁰⁹

In its 1908 *Bobbs-Merrill* decision, the Supreme Court applied the first-sale doctrine under copyright law to a resale-price-maintenance agreement created in the context of an early restricted-distribution system.¹¹⁰ *Bobbs-Merrill* was the publisher of *The Castaway*, a novel written by Hallie Ermine Rives, a writer of popular and historical novels and books on etiquette.¹¹¹ The book contained a notice printed on the copyright page prohibiting anyone from reselling the book at a price lower than \$1.00 per copy. The defendant was Macy's stores, which purchased the book from a distributor and then resold it to a customer for eighty-nine cents. Relying on both the patent-exhaustion cases and the general policy against restraints on alienation, the Supreme Court held that the sale of the book exhausted all rights conferred by the Copyright Act, leaving Macy's free to resell it at any price it chose.¹¹²

The Court evaded the liberty of contract issue by noting that the books had been sold to a distributor who had in turn resold them to Macy's. As a result there was no resale-price-maintenance agreement between *Bobbs-Merrill* and Macy's, and the publisher was forced to rely on nothing more than the license. However, in its *Dr. Miles* decision three years later the Supreme Court cited both the first-sale doctrine and the Sherman Act for the proposition that even an explicit resale-price-fixing agreement between a manufacturer of a patent medicine and a retailer was contrary to legal policy. The Court expressly incorporated the common-law policy against restraints on alienation into its interpretation of the Sherman Act, quoting from *Coke on Littleton*, an early seventeenth-century edition of a fifteenth-century treatise on property law.¹¹³

108. *Appollinaris Co. v. Scherer*, 27 F. 18 (S.D.N.Y. 1886).

109. See discussion *infra* text accompanying notes 112–13.

110. *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339, 349–51 (1908).

111. HALLIE ERMINIE RIVES, *THE CASTAWAY* (1904).

112. *Bobbs-Merrill Co.*, 210 U.S. at 349–50.

113. *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 404–05 (1911). The Court was referring to Lord Chief Justice Edward Coke's *Commentary upon Littleton* (1628), typically cited as *Coke on Littleton*, which was Volume 1 of Coke's *Institutes of the Lawes of England*. That volume was a largely verbatim copy of Sir Thomas Littleton's *Tenures*, first printed in 1481 or 1482. The Court quoted the following:

Even its *Schwinn* decision more than a half-century later, which condemned a dealer distribution system that involved territorial restraints, cited this “ancient rule against restraints on alienation” as a rationale for applying the antitrust laws.¹¹⁴ The Court finally repudiated this rationale for applying the antitrust laws to distribution restraints in its 1977 *Sylvania* decision, which very largely brought an end to antitrust condemnation of non-price distribution restraints.¹¹⁵

Except for a brief interlude, the law of vertically imposed exclusivity provisions showed the same resistance toward contractual integration. In its *Henry* decision in 1912, the Supreme Court declined to apply the first-sale doctrine to a patented-mimeograph-machine seller’s requirement that purchasers must use the seller’s paper, ink, and stencils with the machine.¹¹⁶ Significantly, *Henry* was not a party to any contract with A.B. Dick. Rather, he sold the supplies to an owner of the machine while knowing that they would be used in violation of the license terms. Under the patent doctrine of contributory infringement, one who knowingly participates in another’s patent infringement could be held liable for infringement itself. So the Court did not have to trouble itself about liberty of contract. It distinguished *Bobbs-Merrill* from *Henry* by finding an important difference between patents and copyrights. The copyright act gave a copyright owner the exclusive right to make and sell copies of the copyrighted article, while the patent act additionally gave the patentee the exclusive right to “use” the patented good. The license restriction in *Henry* was thus a lawful restraint on how the good could be used.¹¹⁷

Congress was displeased with *Henry* and responded two years later with section 3 of the Clayton Act, which condemned the sale of both patented and unpatented goods on the condition that the buyer not deal in the goods of a

“[That if someone] be possessed of a horse or any other chattel, real or personal, and give his whole interest, or property therein, upon condition that the donee or vendee shall not alien the same, the same is void, because his whole interest and property is out of him, so as he hath no possibility of reverter; and it is against trade and traffic and bargaining and contracting between man and man.”

Dr. Miles, 220 U.S. at 404–05 (quoting *John D. Park & Sons Co. v. Hartman*, 153 F. 24, 42 (6th Cir. 1907) (referencing 1 COKE ON LITTLETON bk. 3, ch. 5, § 360, at 223 (n.p. 1628))).

The Court also referenced John Chipman Gray’s *Restraints on Alienation of Property*. See *supra* note 99 and accompanying text. Gray’s book never mentioned patented or copyrighted goods. GRAY, *supra* note 99.

114. *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 380 (1967) (“But to allow this freedom where the manufacturer has parted with dominion over the goods—the usual marketing situation—would violate the ancient rule against restraints on alienation and open the door to exclusivity of outlets and limitation of territory further than prudence permits.”). The dissent cited *Coke on Littleton* and accused the majority of embracing a legal rule “merely on grounds of its antiquity.” *Id.* at 391 (Stewart, J., dissenting in part).

115. *Cont’l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 67–68 (1977) (White, J., concurring).

116. *Henry v. A. B. Dick Co.*, 224 U.S. 1, 11–12 (1912).

117. *Id.* at 46.

competitor. Soon after, in the *Motion Picture Patents Company* case (“MPPC”), the Supreme Court reverted to the original first-sale rule to hold that one who sold a film projector could not use a license to limit the purchaser’s use to the showing of the seller’s own films.¹¹⁸ The restriction was a lingering portion of a failed attempt by interests who owned Thomas Edison’s projector and film patents¹¹⁹ to monopolize the entire United States motion-picture industry. The attempt even included the blacklisting of actors and actresses who had agreed to work on films produced by competitors of the Motion Picture Patents Company.¹²⁰ By the time the Supreme Court decided the case, the monopoly had fallen apart. Nevertheless, the Clayton Act had been passed, and the Court used *MPPC* as an opportunity to state that the new statute “confirmed” its pre-*Henry* first-sale cases. *MPPC* itself was a first-sale decision. As the Court concluded:

[T]he right to vend is exhausted by a single, unconditional sale, the article sold being thereby carried outside the monopoly of the patent law and rendered free of every restriction which the vendor may attempt to put upon it. The statutory authority to grant the exclusive right to “use” a patented machine is not greater, indeed it is precisely the same, as the authority to grant the exclusive right to “vend,” and, looking to that authority, for the reasons stated in this opinion we are convinced that the exclusive right granted in every patent must be limited to the invention described in the claims of the patent and that it is not competent for the owner of a patent by notice attached to its machine to in effect, extend the scope of its patent monopoly by restricting the use of it to materials necessary in its operation but which are no part of the patented invention, or to send its machines forth into the channels of trade of the country subject to conditions as to use or royalty to be paid to be imposed thereafter at the discretion of such patent owner. The patent law furnishes no warrant for such a practice and the cost,

118. *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 518–19 (1917). On the centrality of this decision to both the antitrust law of contractual vertical integration and the developing doctrine of patent “misuse,” see Christina Bohannon, *IP Misuse as Foreclosure* 4–6 (Univ. of Iowa Legal Studies, Working Paper No. 09-41, 2009), available at <http://ssrn.com/sol3/papers.cfm?abstract=1474407>.

119. While not the earliest inventor, Edison was one of the earliest commercial developers of the sprocketed-projector take-up wheel and film with little holes on the side that engaged the sprocket, thus permitting the film to run smoothly and eliminating the jerkiness that often appeared in very early motion pictures. Ownership of the technology itself was disputed. See CHARLES MUSSER, *THE EMERGENCE OF CINEMA: THE AMERICAN SCREEN TO 1907*, at 130–80 (1994).

120. On the history, see MICHAEL CONANT, *ANTITRUST IN THE MOTION PICTURE INDUSTRY: ECONOMIC AND LEGAL ANALYSIS* 16–21, 77–80 (1960); BENJAMIN B. HAMPTON, *HISTORY OF THE AMERICAN FILM INDUSTRY* 8–11, 17–24, 34, 64–76, 79–81 (1970); LEWIS JACOBS, *THE RISE OF THE AMERICAN FILM* 8, 81–85, 88, 164–65, 291–92 (1939).

inconvenience and annoyance to the public which the opposite conclusion would occasion forbid it.¹²¹

From that point on, the first-sale doctrine became aligned with antitrust law and the related patent doctrine of “misuse.”¹²² Between them, these doctrines placed the Court in a position of extreme hostility toward intellectual property, in particular, vertical licensing practices, which lasted for a half-century. In the process, they imported the common law’s traditional hostility toward restraints on alienation into antitrust law.

B. THE RISE OF THE RELATIONAL FRANCHISE CONTRACT

The classical law of contracts tended to view them as governing agreements that were discrete in time: I’ll do this for you, and you pay me the money. Enforceable contracts had to delineate scope and time of obligation with at least minimal specificity.¹²³ Common-law judges were considerably less comfortable about more open-ended agreements that had uncertain duration or that called for an uncertain rate of supply or, even more, an uncertain price. But the essence of vertical integration by contract was the development of bilateral business relationships that required the parties to cooperate on future market developments that could not be known at the time the relationship was created.¹²⁴ This type of contract required a forward-looking theory of rational expectations, and thus, a fundamentally more marginalist conception of the contract arrangement.

A “relational” contract is one that is open-ended in the sense that it contemplates an ongoing relationship among the parties, with adjustments in price, quantity, or other terms that must be made from time to time.¹²⁵ The earliest important category of relational contracts was patent licenses, particularly those in which the licensee promised to pay a specified sum for each unit of the patented good that he produced, but where the contract itself

121. *Motion Picture Patents Co.*, 243 U.S. at 516.

122. See Bohannon, *supra* note 118, at 4–5 (describing the origins of the misuse doctrine).

123. Classical contract theory reached its apex in Samuel Williston’s treatise, *The Law of Contracts*. On classical contract law, see MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870–1960: THE CRISIS OF LEGAL ORTHODOXY* 9–31 (1992) (providing background on late nineteenth-century classical legal thought), and WILLIAM M. WIECEK, *THE LOST WORLD OF CLASSICAL LEGAL THOUGHT: LAW AND IDEOLOGY IN AMERICA, 1886–1937*, at 102–05 (1998).

124. David Charney, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 392–93 (1990); Simon Deakin et al., *‘Trust’ or Law? Towards an Integrated Theory of Contractual Relations Between Firms*, 21 J.L. & SOC’Y 329, 334–35 (1994); Ian R. MacNeil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 857 (1978).

125. See sources cited *supra* note 123 (describing classical contract law and legal thought); cf. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 62 (1963) (“[R]elatively contractual methods are used to make adjustments in ongoing transactions and to settle disputes.”).

left open the amount to be made.¹²⁶ Already in the middle of the nineteenth century, the McCormick Harvesting Co. used a set of regional patent and trademark licenses to create ongoing relationships with local manufacturer-dealers who could produce its machines locally and sell them to farmers, thus making national shipment of this bulky equipment unnecessary.¹²⁷ The arrangement also permitted McCormick to share the risk and cost of developing a nationwide distribution system. Such a licensee might agree to be the exclusive resale agent for McCormick's reapers in a certain territory, or it might agree that it would not sell any reapers other than McCormick's. Singer did the same thing with its sewing machines.¹²⁸ The Supreme Court's previously discussed first-sale decision, *Adams v. Burke*, involved a Civil War era patentee of coffin lids who created a restricted distribution system by licensing various makers to produce them for sale in defined geographic areas. Once one of these licensee-makers sold the coffin bearing the patented lid to an undertaker within the ten-mile restriction, however, the first-sale doctrine kicked in and the undertaker was free to use it for a burial wherever he pleased. As a result, the first-sale doctrine performed an "antitrust" function through the patent licensing system by limiting the ability of manufacturers to impose territorial restraints.¹²⁹ However, in a subsequent decision involving patented beds, a federal court held that if the manufacturer had created multiple exclusive territories via patent licenses, a dealer who purchased the good in one territory had no right to resell the good in a territory to which a different licensee had an exclusive right.¹³⁰

126. However, there was an earlier history of "inside contracting," in which skilled artisans acted as non-employee, independent contractors supplying their services to manufacturers. Most inside contracts were relatively long-term commitments under which the artisans were paid by the piece rather than by the hour. See DAN CLAWSON, *BUREAUCRACY AND THE LABOR PROCESS: THE TRANSFORMATION OF U.S. INDUSTRY, 1860-1920*, at 71-73 (1980) (providing examples of how inside contracting worked); Ernest J. Englander, *The Inside Contract System of Production and Organization: A Neglected Aspect of the History of the Firm*, 28 *LAB. HIST.* 429, 432-37 (1987) (describing the origins and workings of inside contracting).

127. See *Seymour v. McCormick*, 57 U.S. (16 How.) 479, 490 (1854) (describing the arrangement). McCormick later changed to a more centralized distribution system with wholly owned outlets. On the company's history, see CHANDLER, *supra* note 95, at 305-07, 402-08 (discussing the company's success in using a centralized distribution system), and DICKE, *supra* note 81, at 18-19 (same).

128. RUTH BRANDON, *A CAPITALIST ROMANCE: SINGER AND THE SEWING MACHINE* 117 (1977) ("Clark solved the problem by taking McCormick's idea several stages further. 'Why not rent a sewing machine to the housewife and apply the rental fee to the purchase price of the machine?'); Andrew B. Jack, *The Channels of Distribution for an Innovation: The Sewing-Machine Industry in America, 1860-1865*, 9 *EXPLORATIONS IN ENTREPRENEURIAL HIST.* 113, 114 (1957) (discussing the successful launch of the Wheeler & Wilson Co., the Grover and Backer Co., and I.M. Singer & Co.).

129. See *Adams v. Burke*, 84 U.S. (17 Wall.) 453, 457 (1873). For a fuller statement of the facts, see generally *Adams v. Burks*, 1 F. Cas. 100 (C.C.D. Mass. 1871) (No. 50).

130. *Hatch v. Adams*, 22 F. 434, 438 (C.C. Pa. 1884). *Contra* *McKay v. Wooster*, 16 F. Cas. 183, 185 (C.C.D. Cal. 1873) (No. 8847) (permitting good, a patented container for transporting

The automobile industry quickly became the most important economic example of nationwide franchise arrangements that imposed distribution restrictions on independent, locally owned dealers. Automobile franchising began in the late nineteenth century and the franchise system was well developed by around 1910.¹³¹ Although Henry Ford initially experimented with company-owned local offices and even with traveling salesmen, he quickly changed to focus on franchising of locally owned dealerships. The franchise agreements were open-ended contracts that required Ford to supply cars to the dealers and permitted the dealers to hold themselves out as a part of the Ford enterprise. But the agreements did not specify the amount or the price of the automobiles to be sold, and they required the dealer to represent Ford and to make its best efforts to sell Ford vehicles. Eventually they came to require the dealers to stock and sell Ford aftermarket parts and to perform service on Ford vehicles.

The developing franchise system typically involved both the sale and resale of goods from manufacturers to independent dealers, as well as licensing of trademarks, because the franchisee had to hold itself out as part of the manufacturer's branded distribution network. But the agreements sometimes included licensing of patents, copyrights, and trade secrets as well. Franchising law thus became a blend of common-law contract, which was essentially backward looking and which focused on completed transactions, and the law of intellectual-property licensing, which was typically much more open ended and contemplated ongoing future relationships. Two of the largest early franchisors were retailers of consumer products—Western Auto and Ben Franklin Stores—both of which developed in the 1920s and had several thousand stores doing business under the franchisor's name by 1960.¹³²

Marginalist economics' focus on future expectations was a more realistic vehicle for interpretation and enforcement of such arrangements, but it also injected a great deal of uncertainty into the calculus. Sales contracts that did not specify an amount or a price had always been viewed by the courts with considerable suspicion. For example, common-law courts had traditionally been reluctant to enforce "requirements" contracts, which were agreements that specified that the buyer would purchase all of its needs for the seller's good over a period of time. The typical requirements contract specified a price but not a quantity. Typically, the franchise agreements specified even less

eggs, to be resold in exclusive territory of a different licensee, but relying on construction of grant language rather than first-sale rule).

131. Norman D. Axelrad, *Franchising—Changing Legal Skirmish Lines or Armageddon? Some Observations from the Foxhole*, 26 BUS. LAW. 695, 699 (1971); see also *Ellis v. Dodge Bros.*, 246 F. 764, 768 (5th Cir. 1917) (finding an open-ended agreement requiring Dodge to sell automobiles to franchisee not void for lack of mutuality). On the Ford Motor Company's early experiences, see DICKE, *supra* note 81, at 59–74.

132. See MARTIN MENDELSON, *INTERNATIONAL FRANCHISING: AN OVERVIEW* 4–5 (Martin Mendelsohn ed., 1984) (discussing that major franchising growth occurred after World War II).

because they permitted the franchisor to change the price or make other adjustments in the business relationship. Further, requirements contracts typically involved staples such as coal for an electric utility and did not provide either for ongoing regulation of the buyer's business or the licensing of trademarks or other intellectual-property rights.

When the quantity was not a part of the agreement itself, the common-law courts often saw lack of consideration, or mutuality of obligation, and this rendered the contract void.¹³³ As Harvard's Samuel Williston wrote in his highly influential treatise on contracts in 1920:

A promise to buy such a quantity of goods as the buyer may thereafter order, or to take goods in such quantities "as may be desired," or as the buyer "may want" is not sufficient consideration since the buyer may refrain from buying at his option and without incurring legal detriment himself or benefiting the other party.¹³⁴

A few courts additionally held the contracts invalid if they did not require the buyer to take exclusively from the seller, because then the buyer could effectively stay in business but purchase nothing.¹³⁵ By contrast, others enforced the contracts when they did in fact require the buyer to take all of its requirements from the seller.¹³⁶

As with requirements contracts, common-law courts often found that open-ended franchise agreements did not have sufficient mutuality of obligation.¹³⁷ A few of the more creative decisions upheld franchise agreements by such devices as treating each dealer's order for additional automobiles and the manufacturer's acceptance of that order as creating a

133. See, e.g., *Bailey v. Austrian*, 19 Minn. 535, 535 (1873) (holding that a requirements contract to supply pig iron to a foundry lacked mutuality because buyer was not required to purchase any particular amount of a good); see also Harold C. Havighurst & Sidney M. Berman, *Requirement and Output Contracts*, 27 ILL. L. REV. 1, 3 (1932) (discussing requirements contracts and their potential lack of consideration and mutuality).

134. SAMUEL WILLISTON, *THE LAW OF CONTRACTS* § 104 (1920) (citing numerous decisions).

135. See, e.g., *Oscar Schlegel Mfg. Co. v. Peter Cooper's Glue Factory*, 132 N.E. 148, 149 (N.Y. 1921) (holding a contract invalid where it imposed no obligations on buyer).

136. See, e.g., *Ellis*, 246 F. at 766-67 (holding a contract valid as to mutuality where buyer had to meet requirements); *E.C. Dailey Co. v. Clark Can Co.*, 87 N.W. 761, 762 (Mich. 1901) (upholding a contract where buyer could only purchase requirements from seller).

137. See, e.g., *Huffman v. Paige-Detroit Motor Car Co.*, 262 F. 116, 116 (8th Cir. 1919) (holding an open-ended franchise contract terminable at will for insufficient mutuality of obligation); *Oakland Motor Car Co. v. Ind. Auto. Co.*, 201 F. 499, 499-500 (7th Cir. 1912) (holding that a contractual provision allowing cancellation for just cause was too indefinite to be valid). *But see Moon Motor Car Co. of N.Y. v. Moon Motor Car Co.*, 29 F.2d 3, 4 (2d Cir. 1928) (holding that the contract had sufficient mutuality of obligation and distinguishing *Huffman* and *Oakland*). See also Arthur L. Corbin, *The Effect of Options on Consideration*, 34 YALE L.J. 571, 586 (1925) (discussing lack of mutuality in open-ended franchise agreements); Note, *Options and Consideration in Automobile Dealership Agreements*, 22 VA. L. REV. 324, 324 (1936) (examining courts' refusal to grant relief in open-ended franchise contracts).

series of enforceable contracts that implicitly incorporated all of the terms of the franchise agreement.¹³⁸ In the 1930s and 1940s, the courts became increasingly comfortable with more open-ended agreements.¹³⁹ They also tended to interpret the contracts literally and to enforce even harsh provisions against dealers who knowingly entered into them. As one court put it:

While there is a natural impulse to be impatient with a form of contract which places the comparatively helpless dealer at the mercy of the manufacturer, we cannot make contracts for parties or protect them from the provisions of contracts which they have made for themselves. Dealers doubtless accept these one sided contracts because they think that the right to deal in the product of the manufacturer, even on his terms, is valuable to them; but, after they have made such contracts, relying upon the good faith of the manufacturer for the protection which the contracts do not give, they cannot, when they get into trouble, expect the courts to place in the contracts the protection which they themselves have failed to insert.¹⁴⁰

The common law was most likely to enforce requirements contracts when they were fairly strict and tied the buyer's hands, thus tending to establish mutuality of obligation, but not when the buyer was free to deal with others. However, the judicial concern flipped 180 degrees after the Clayton Act was passed in 1914.¹⁴¹ Courts increasingly worried that such exclusivity provisions could tend to perpetuate monopoly. Reflecting these new concerns, in 1922, the Supreme Court refused to enforce a requirements contract under which a dominant producer of dress patterns required its licensee-retailer to purchase all of its patterns from the seller.¹⁴² The agreement created a franchise relationship between the pattern manufacturer and thousands of dry-goods stores across the country, giving the retailers steep discounts in exchange for their promise to sell the manufacturer's patterns exclusively and only from

138. *E.g.*, *Buick Motor Co. v. Thompson*, 75 S.E. 354, 356 (Ga. 1912); *see also* *Erskine v. Chevrolet Motors Co.*, 117 S.E. 706, 710 (N.C. 1923) (asserting the importance of information costs).

139. *E.g.*, *Buggs v. Ford Motor Co.*, 113 F.2d 618 (7th Cir.), *cert. denied*, 311 U.S. 688 (1940).

140. *Ford Motor Co. v. Kirkmyer Motor Co.*, 65 F.2d 1001, 1006 (4th Cir. 1933); *see also* *Bushwick-Decatur Motors, Inc. v. Ford Motor Co.*, 116 F.2d 675, 677 (2d Cir. 1940) (noting the problem of adhesion contracts, but refusing to address it judicially in the absence of legislation).

141. 15 U.S.C. § 14 (2006). On the congressional concern, *see* H.R. REP. No. 63-1168, at 11-12 (1914).

142. *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346, 355-57 (1922). The common law generally refused to condemn such arrangements. *See, e.g.*, *Chi., St. Louis & New Orleans R.R. Co. v. Pullman S. Car Co.*, 139 U.S. 79, 89-91 (1891) (applying the common law and upholding exclusive-dealing agreement in Pullman sleeping cars); *Brown v. Rounsavell*, 78 Ill. 589, 590 (1875) (upholding a merchant's agreement to deal exclusively in seller's sewing machines and accessories in exchange for a thirty-percent discount).

specified locations.¹⁴³ The very definiteness of the contract proved to be its undoing, for the Supreme Court found that it tended to create a monopoly, particularly in light of the fact that the exclusivity provisions reached to many towns that had only a single dry-goods store.¹⁴⁴

Intellectual-property licenses, often attached to open-ended contracts for the sale of goods, were used increasingly to create ongoing business relationships in which the seller regulated the activities of the buyer by stipulating resale prices, controlling the territories in which resellers could sell the supplier's product, or by controlling the way that the product was used so as to promote consumer satisfaction. The courts were skeptical, mainly because of their concern about restraints on alienation, and Congress reinforced those concerns in the antitrust laws. For a lengthy period of time, manufacturers who desired to integrate vertically by contract were forced to "invent around" legal doctrine that was at best unfriendly.

Exclusive dealing may not have been so obviously essential in the market for department-store dress patterns. But increasingly it also appeared problematic to most courts in the gasoline industry, since the product was so generic. Early decisions lauded the franchise gasoline-distribution system as of great benefit to the public because it made gasoline more widely available and enabled drivers to see which brand they were buying. In the early 1920s, several federal decisions rejected the Federal Trade Commission's conclusion that it was anticompetitive for refiners to provide branded pumps and other insignia to locally owned gasoline stations on the condition that the pumps be used only for the manufacturer's gasoline:

Every pumping station is an advertisement; each bears the name of the oil producer whose gasoline is supplied therefrom, if the retailer honestly observes his bargain. The system is a great convenience to the public; it has increased enormously the ease with which motor drivers may obtain "gas" even in remote and thinly settled districts. It is the only method known or suggested, of keeping before the consuming public the oil manufacturers' trade-mark, and it has largely succeeded the system of distributing oil in barrels, which barrels bore the maker's trade-mark and were practically loaned to the vendees, to be returned empty.¹⁴⁵

143. *Standard Fashion Co.*, 258 U.S. at 351–53.

144. *Id.* at 357.

145. *Standard Oil Co. of N.Y. v. Fed. Trade Comm'n*, 273 F. 478, 480 (2d Cir. 1921). The Supreme Court agreed with the Second Circuit in *Federal Trade Commission v. Sinclair Co.*, 261 U.S. 463 (1923). See also DICKE, *supra* note 81, at 85–86, 115 (discussing the history of gasoline franchising).

But twenty-five years later, the Court condemned similar arrangements under aggressive antitrust rules that did not demand any showing of a tendency toward monopoly.¹⁴⁶

C. *FRANCHISE BARGAINS IN THE SHADOW OF THE LAW: AGENCY
AGREEMENTS AND BUSINESS-METHOD FRANCHISES*

The modern franchise system largely developed in spite of, rather than because of, the legal environment. While manufacturers opted for self-owned outlets when the legal prohibitions became too harsh, they also experimented with franchising methods intended to preserve separate ownership for dealers while avoiding the most aggressive legal prohibitions. The two most important mechanisms were agency distribution and the business-method franchise.

The common law tended to draw the line between firms in terms of purchase and sale. If a manufacturer sold to someone downstream for resale, the downstream actor was a “firm” whose entrepreneurial freedom was deemed worthy of protection. But if the manufacturer simply licensed a process or offered a good to someone under consignment, then the downstream actor was nothing more than an agent or broker of the manufacturer. Initially, the biggest concern for franchisors was to avoid direct liability for their products, particularly for breach of warranty, which could result if franchisees were simply designated as agents of the manufacturer.¹⁴⁷ As a result, early franchise agreements typically declared that the franchisees were purchasers, or vendees, and then resellers.¹⁴⁸ But it quickly became clear that the policies against restraints on alienation that defined both the “first-sale” doctrine and antitrust distribution rules applied only when the upstream firm sold the good in question to a dealer who then resold the good to someone else. However, if the owner of an intellectual-property right simply licensed another to manufacture for itself, it could place restraints on the licensee’s output. For example, if a patentee sold its patented coffin lid to a purchaser the patentee could not impose a territorial limitation on where the lid could be resold or used. However, if the same patentee simply licensed someone else to manufacture the patent lid itself, then the first-sale doctrine did not apply.¹⁴⁹ By the same token, when a manufacturer sold a product to a dealer for resale to the public, the rules limiting restraints on alienation applied. However, if the intermediary

146. See, e.g., *Standard Oil Co. of Cal. v. United States*, 337 U.S. 293, 302 (1949) (applying aggressive antitrust rules to gasoline exclusive dealing even though the covered market shares were relatively small); see *supra* notes 82–84 and accompanying text.

147. For example, prior to *MacPherson v. Buick Motor Co.*, 111 N.E. 1050 (N.Y. 1916), a manufacturer could avoid breach-of-warranty claims for a defective product if the good had been sold first to a dealer.

148. See, e.g., *Joslyn v. Cadillac Auto. Co.*, 177 F. 863, 867 (6th Cir. 1910) (classifying franchisees as vendees); *Isbell v. Anderson Carriage Co.*, 136 N.W. 457, 457–58 (Mich. 1912). (classifying franchisees as purchasers).

149. See *supra* notes 129–30 and accompanying text (discussing how the first-sale doctrine performs an antitrust function).

was not a purchaser at all but merely a broker or “agent,” then there was no sale-plus-resale and the rules governing restraints on alienation were not invoked.

In 1926, the Supreme Court held that General Electric could lawfully supply light bulbs to dealers on consignment and stipulate the price at which the dealers sold them.¹⁵⁰ However, fifteen years earlier in *Dr. Miles* the Supreme Court had warned that it, and not the parties, would decide when a relationship with a dealer constitutes a sale and when it is a mere consignment. Arrangements nominally labeled “consignment” could in fact be found to be sales.¹⁵¹ By the same token, a manufacturer could not create a scheme of licensing the patents in a device, but not formally transfer title to the device itself, in order to avoid either the first-sale doctrine or the resale-price-maintenance rule. In *Victor Talking Machines*, the manufacturer “licensed” its patented phonographs to its 7000 dealers, stipulating the resale price and imposing other dealer controls.¹⁵² The Supreme Court condemned the arrangement, finding it to be nothing more than a way of evading the *Dr. Miles* decision by taking advantage of the fact that the phonograph was covered by patents. It invalidated the resale-price restriction under both the first-sale doctrine and antitrust’s resale-price-maintenance rule.¹⁵³ During the high point of hostility toward vertical distribution contracts in the 1960s, the Court held that a gasoline refiner with a large dealership network could not avoid the resale-price-maintenance rule simply by labeling its transfers to dealers “consignments” rather than sales.¹⁵⁴ In this case, unlike *General Electric*, the seller did not assume any of the risk of loss or of changes in the market price, but did very little more than substitute the word “consignment” for “sale” in its dealership contracts.¹⁵⁵ By the mid-sixties, the so-called “consignment” exception to antitrust rules limiting distribution restraints proved to be ineffectual.

A second experiment met with somewhat more success. The “business method” franchise, which was intended to avoid the first-sale doctrine as well as the harshest antitrust restrictions, often did not involve the sale of any goods whatsoever. Such franchises typically included detailed contractual oversight of a franchisee’s business, but the main thing that the franchisee received from

150. *United States v. Gen. Elec. Co.*, 272 U.S. 476, 481–83 (1926).

151. *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 394–98 (1911). The Court reached the same conclusion in *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346, 354–55 (1922).

152. *Straus v. Victor Talking Mach. Co.*, 243 U.S. 490, 494–96 (1917). See generally *Ford Motor Co. v. Union Motor Sales Co.*, 244 F. 156 (6th Cir. 1917) (holding that Ford could not by agreement “license” the patents in its cars to car dealers on the condition that the dealers adhere to Ford’s stipulated resale prices; such a license was a mere subterfuge in order to avoid the resale-price-maintenance rule).

153. *Straus*, 243 U.S. at 500–01.

154. *Simpson v. Union Oil Co. of Cal.*, 377 U.S. 13, 24 (1964).

155. *Id.* at 20–22.

the franchisor was intellectual-property rights plus a standardized format that provided national or regional consumer recognition. Business-method franchises were developed in the 1950s with the rise of such firms as McDonald's.¹⁵⁶ McDonald's as a franchisor sold almost no products. Rather, its principal business was real estate. It helped potential franchisees identify sites, which it typically purchased and leased to franchisees at a price that depended on the dollar volume of the franchisee's sales. However, the franchisees purchased their own equipment and food products from other sources under strict specifications supplied by the franchisor. The first-sale rule did not apply because there was no patented or copyrighted good that was being sold and resold. By the same token, the rule against resale-price maintenance did not apply because there was no qualifying resale. Except for a few brushes with the law of tying arrangements, which it generally won, McDonald's was able to develop a franchise system largely free of antitrust scrutiny.¹⁵⁷ Those franchises that were found guilty of unlawful tying were typically the ones that sold a physical product and that insisted that the franchisee sell the franchisor's product exclusively from stores that held themselves out as the manufacturer's franchisees.¹⁵⁸

V. THE ANTITRUST ATTACK ON CONTRACTUAL VERTICAL INTEGRATION

By the World War II era, both federal and state legislators had come to believe that restricted distribution systems were a major cause of manufacturer abuse of both dealers and the public. They intervened on dealers' behalf with statutes that regulated the franchising process. Roughly half of the states passed automobile-dealer-franchise acts designed to protect dealers from harsh terms that manufacturers imposed.¹⁵⁹ A few of these statutes required a state regulatory agency to provide advance approval of franchise agreements.¹⁶⁰ Most forbade manufacturers from terminating dealers—except for proven cause—and from imposing unwanted goods on manufacturers. However, a move for federal legislation at least partially backfired when an inquiry by the Federal Trade Commission produced evidence that dealer collusion, rather than manufacturer coercion, created the impetus for most of the requested

156. See DICKE, *supra* note 81, at 3 (“By the late 1950s perceptive entrepreneurs realized that, to use a popular example, there was more money to be made selling hamburger stands than in selling hamburgers.”).

157. See, e.g., *Kypta v. McDonald's Corp.*, 671 F.2d 1282, 1286 (11th Cir. 1982) (rejecting the claim that the franchisor unlawfully tied the license of its name and trademark to the restaurant lease); *Principe v. McDonald's Corp.*, 631 F.2d 303, 308 (4th Cir. 1980) (same), *cert. denied*, 451 U.S. 970 (1981).

158. E.g., *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 47–48 (9th Cir. 1971) (condemning an arrangement under which franchisor did not charge franchise fee but required franchisee to take various supplies at prices higher than the market rate), *cert. denied*, 405 U.S. 955 (1972).

159. For a catalog and description of the statutes, see Friedrich Kessler, *Automobile Dealer Franchises: Vertical Integration by Contract*, 66 YALE L.J. 1135, 1169 & n.224 (1957).

160. *Id.*

practices.¹⁶¹ The National Automobile Dealers Association turned to Congress, and, after a fifteen-year lobbying campaign interrupted by the War, Congress passed the Automobile Dealers' Day in Court Act in 1956.¹⁶² The House Report justified the legislation as based on the premise that automobile manufacturer "concentration of economic power has increased to the degree that traditional contractual concepts are no longer adequate to protect the automobile dealers under their franchises."¹⁶³ The statute required manufacturers to act in good faith when canceling or failing to renew a franchise and gave the dealer a cause of action to have good faith judicially determined. The preamble to the statute expressly stated that its intent was "to balance the power now heavily weighted in favor of automobile manufacturers."¹⁶⁴

A. THE UNFORESEEN CONSEQUENCES OF THE ROBINSON-PATMAN ACT

During the 1930s, small businesses felt assaulted by larger firms, but suppliers were hardly the biggest culprits. The injuries visited on small firms by distribution restraints paled in comparison with those caused by ownership vertical integration and the emergent chain store. The Great Depression resulted in thousands of small business bankruptcies, and the victims viewed the emergent chain store, particularly the Great Atlantic and Pacific Tea Company ("A & P"), as the dominant culprit.¹⁶⁵ In contrast to the smaller grocers, A & P either integrated vertically into sources of supply or else entered into heavily managed supply contracts that required not only competitive bidding among potential suppliers, but also that suppliers package items in A & P branded containers according to A & P's specifications.¹⁶⁶

In 1934, the FTC published a stinging critique of chain stores, accusing them of undermining the traditional retail economy populated by small family-

161. *E.g.*, FED. TRADE COMM'N, ANNUAL REPORT 24-25 (1939), available at <http://www.ftc.gov/os/annualreports/ar1939.pdf>; see also PALAMOUNTAIN, *supra* note 74, at 136 (discussing the discovery that statutes regulating the franchising process were the result of dealer collusion).

162. Automobile Dealers' Day in Court Act, Pub. L. No. 1026, 70 Stat. 1125 (1956) (codified at 15 U.S.C. §§ 1221-1225 (2006)); see Donald P. McHugh, *The Automobile Dealer Franchise Act of 1956*, 2 ANTITRUST BULL. 353, 354 (1957) (discussing the Act's relationship to antitrust law).

163. H.R. REP. No. 2850, at 3 (1956).

164. Automobile Dealers' Day in Court Act pmbl.

165. See ROWE, *supra* note 75, at 3-35 (discussing the background and legislative history of the Robinson-Patman Act); PALAMOUNTAIN, *supra* note 74, at 169-222; Schragger, *supra* note 76, at 1011 (discussing the anti-chain movement and the loss of progressive constitutionalism since the New Deal).

166. See JAMES M. MAYO, THE AMERICAN GROCERY STORE 78-82 (1993); WILLIAM I. WALSH, THE RISE AND DECLINE OF THE GREAT ATLANTIC & PACIFIC TEA COMPANY 36 (1986); Lizabeth Cohen, *The Class Experience of Mass Consumption: Workers as Consumers in Interwar America*, in THE POWER OF CULTURE: CRITICAL ESSAYS IN AMERICAN HISTORY 135, 149 (Richard Wrightman Fox & T.J. Jackson Lears eds., 1993).

owned stores, mainly by forcing suppliers to discriminate in price between larger and smaller buyers.¹⁶⁷ Congress followed two years later with the Robinson–Patman Act, mainly at the behest of small retail grocers, who were a powerful interest group. The statute made it unlawful for a seller to charge different prices to two different dealers who resold in competition with each other, if the effect was to injure the business of the dealer who was charged the higher price.

Historically, one of the most notable things about this controversial statute is the “flip” that occurred in its drafting and interpretation, which essentially changed it from an anti-chain-store provision into an anti-franchise and distribution-control provision. Chain stores such as A & P were large organizations that owned their own stores. Since the Robinson–Patman Act applied only to “sales,” it did not cover transfers between A & P’s warehouses and its individual stores. In fact, the statute was supposedly intended to cover A & P’s *buying* practices—that is, its forcing suppliers such as Borden¹⁶⁸ to charge A & P a lower price for dairy products than smaller grocers were required to pay. This in turn permitted A & P to retail these products for lower prices.

But the buyer’s liability section of the Robinson–Patman Act was in fact a legislative afterthought that has never been used as effectively as the main provision, which applied only to discriminatory *sales*.¹⁶⁹ As a result, the dominant use of the Robinson–Patman Act was not against chain stores but rather against manufacturers who discriminated in price as between two different *dealers*. For example, if an automobile manufacturer rewarded an aggressive, successful dealer with lower wholesale prices, while a less ambitious, nearby dealer paid more, this became grist for a Robinson–Patman claim.¹⁷⁰

Although the ideology of the day was just as hostile toward large dealership networks as it was toward the chain stores, the impact of Robinson–Patman Act enforcement was undoubtedly perverse. By condemning differential sale prices to independent dealers, the statute encouraged large manufacturers and suppliers to integrate vertically into retailing even more.¹⁷¹

167. FED. TRADE COMM’N, FINAL REPORT ON THE CHAIN STORE INVESTIGATION 57–58, 85–97 (1934); see ELLIS W. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY 248–50 (1966) (arguing that when large chain stores push down prices, they do so at the expense of small, family-owned stores).

168. See FED. TRADE COMM’N, *supra* note 167, at 57–58, 85–97.

169. See 14 HERBERT HOVENKAMP, ANTITRUST LAW ¶ 2361 (2d ed. 2006) (“The concern of [the] original §2 was predatory pricing in which those paying the low price are the long-term victims.”).

170. *E.g.*, Standard Oil Co. v. Fed. Trade Comm’n, 340 U.S. 231, 249–50 (1951); Myers v. Shell Oil Co., 96 F. Supp. 670, 673 (S.D. Cal. 1951); Goodyear Tire & Rubber Co., 22 F.T.C. 232, 237 (1936) (holding that it was unlawful to charge Sears a lower price for similar tires sold to branded Goodyear dealers).

171. See RICHARD A. POSNER, THE ROBINSON–PATMAN ACT 26–27 (1976); Philip Elman, *The Robinson–Patman Act and Antitrust Policy: A Time for Reappraisal*, 42 WASH. L. REV. 1, 11–13 (1966) (questioning the efficacy of the Robinson–Patman Act); Frederick Rowe, *The FTC’s Administration of the Anti-Price Discrimination Law: A Paradox of Antitrust Policy*, 64 COLUM. L. REV.

For example, an automobile manufacturer facing potential liability for charging two independent dealers in the same town different prices could completely solve the problem by acquiring at least one of the two dealers and operating it as a subsidiary. The statute required separate high- and low-priced sales and a transfer to a retailer subsidiary was not regarded as a sale.¹⁷²

So what was intended as an anti-chain-store provision essentially became an anti-franchising provision. While the power of large chains such as A & P was important in the anti-chain-store rhetoric leading up to the Robinson–Patman Act, the statute itself contained no power requirement. Even small sellers could violate the statute if they charged retailers different prices for the same good. For example, a gasoline refiner that maintained a set of independent dealers would violate the statute if it used price discounts to reward particularly aggressive or successful dealers or if it lowered prices to a dealer in order to enable it to compete with a rival brand.¹⁷³

Of course, the statute also reached large producers such as Borden, who supplied dairy products to grocery stores and was convicted of charging A & P a lower price than smaller grocers paid.¹⁷⁴ However, writing in the early 1960s, Frederick M. Rowe, one of the most discerning analysts of the statute, complained that the conspicuous fact about the first twenty-five years of FTC enforcement history was “the sparseness of cases against buyers.”¹⁷⁵ Rowe concluded that the enforcement history was largely “unrelated” to the statute’s originally intended purpose of disciplining the purchasing practices of large buyers.¹⁷⁶ Rather, Rowe complained, the most typical defendant in a Robinson–Patman Act proceeding was a relatively small firm—typically a small supplier who favored one dealer over another through the provision of some allowance or award.¹⁷⁷ Rowe concluded that over a twenty-five-year enforcement period the FTC had brought a total of 11 out of 1040 complaints against large buyers—a record which he described as an “enforcement fiasco.”¹⁷⁸ On top of that, the most recent enforcement activity against buyers

415, 416 (1964) (arguing that the Robinson–Patman Act is not a true antitrust measure because it “arose from efforts to shelter traditional distribution channels from competition”); Note, *The Good Faith Defense of the Robinson–Patman Act: A New Restriction Appraised*, 66 YALE L.J. 935, 943 (1957) (stating that “giving to the vertically-integrated distributor a competitive advantage unrelated to his performance . . . frustrates the antitrust laws’ attempt to promote efficiency”).

172. See 14 HOVENKAMP, *supra* note 169, ¶ 2312.

173. *Standard Oil Co. v. Brown*, 238 F.2d 54, 57 (5th Cir. 1956); *Enter. Indus. v. Tex. Co.*, 136 F. Supp. 420, 421 (D. Conn. 1955), *rev’d on other grounds*, 240 F.2d 457 (2d Cir.), *cert. denied*, 353 U.S. 965 (1957). For a full canvas, see Note, *Gasoline Marketing and the Robinson–Patman Act*, 82 YALE L.J. 1706 (1973).

174. *United States v. Bordon Co.*, 347 U.S. 514, 515 (1954); *In re The Great Atl. & Pac. Tea Co.*, 26 F.T.C. 486, 486 (1938).

175. ROWE, *supra* note 75, at 536.

176. *Id.* at 538.

177. *Id.* at 538–40.

178. *Id.* at 541.

had been directed at buyers' cooperatives of small merchants. The typical defendant was "rarely a titan of the market, but more typically . . . the smaller concern trapped in the legal maze."¹⁷⁹

B. *CONTRACTUAL INTEGRATION AND ANTITRUST POLICY THROUGH THE 1960S*

Modern modes of distribution tailored for product-differentiated markets developed in the United States through the first half of the twentieth century, largely in spite of, rather than as a result of, the legal environment. Interest-group pressures were obvious, but legal policy-making was disturbingly short of coherent economic theory to explain why contractual vertical integration should be regarded as socially harmful. This was not much of a problem when the courts were interpreting explicit anti-distribution statutes such as state franchise laws or the Robinson-Patman Act. The court had little more to do than follow the statutory language. What was interesting, however, was the extent to which the courts strained to find competitive harm in the more general antitrust laws. Section 3 of the Clayton Act condemned tying and exclusive dealing where the effect might be to lessen competition substantially, an effect that the courts found readily, often without a serious inquiry into alternative rationales.¹⁸⁰ But they were also quick to find competitive harm in actions brought under the Sherman Act—a statute that said nothing at all about vertical practices but merely condemned those who "monopolize[d]" or entered into agreements "in restraint of trade."¹⁸¹ These broad provisions left judges entirely free to fill in the blanks.

The situations can be divided into two rough classes. The first involved manufacturer establishment and control of networks of independent dealers by regulating their pricing, location, or internal operations. The second involved situations in which manufacturers of durable goods wanted to control the distribution of complementary products, partly for quality-control purposes, partly to facilitate price discrimination, and partly to exclude rivals. Some markets, such as automobile distribution, involved both simultaneously. For example, an automobile manufacturer might specify a dealer's location, which regulated distribution of its own cars but did not affect rival manufacturers. But in the same franchise contract it might specify that the dealer not sell the new cars of a different manufacturer (single branding, which is a form of exclusive dealing) or that it use only the manufacturer's own aftermarket repair parts (tying). Both of these could serve to limit market access by rivals.

During the 1920s and after, *Dr. Miles* and *MPPC* became the coordinated divisions in a federal legal assault on vertical integration by contract under a

179. *Id.* at 541–42.

180. *E.g.*, *Standard Oil Co. of Cal. v. United States*, 337 U.S. 293, 293 (1949) (finding a violation of section 3 of the Clayton Act).

181. Sherman Act, 15 U.S.C. §§ 1–2 (2006).

variety of legal and economic theories. The domain of *Dr. Miles* was “intra-brand” restraints, or restrictions on how dealers sold the restraining manufacturer’s own brand. The province of *MPPC* was “inter-brand” restraints, or manufacturer-imposed limitations on a dealer’s ability to sell the goods of competing manufacturers. The *Dr. Miles* and *MPPC* decisions themselves involved activities that were almost certainly anticompetitive. The resale-price maintenance scheme in *Dr. Miles* was carried out in furtherance of a cartel by drug retailers who tried to keep price cutters out of the market by forcing firms such as *Dr. Miles* to impose resale-price maintenance.¹⁸² And as previously noted, the *MPPC* case was in fact part of a well-documented scheme to monopolize the incipient movie industry.¹⁸³

But the laws of both resale-price maintenance and tying arrangements very quickly lost their moorings in competition policy and condemned these practices when no harm to competition was in sight. The per se rule against resale-price maintenance made the practice categorically illegal without regard to market structure, ease of entry, purpose, or even the slightest possibility of monopoly or collusion.¹⁸⁴ It refused to distinguish between resale-price maintenance in furtherance of dealer collusion or the power of large dealers, which are more typically anticompetitive, and resale-price maintenance imposed by suppliers in order to induce appropriate levels of dealer service, which is procompetitive.¹⁸⁵ The *Dr. Miles* per se rule was finally rejected by the Supreme Court in 2007 in a 5-4 decision that itself reflects the ambiguity of this practice, which remains poorly understood to this day.¹⁸⁶

The law of tying arrangements turned into a competitive travesty, where ties of ordinary commodities such as salt by non-monopolists were condemned when no possibility of monopoly was in sight. The Supreme Court accomplished this primarily in its 1947 *International Salt* decision, although there were other important decisions as well.¹⁸⁷ The Court held that the

182. On the details of the cartel, see HOVENKAMP, *supra* note 44, at 331–48 (stating that the organization imposing the maintenance of resale prices represented ninety percent of the wholesale drug trade at the time of the cartel). See generally *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007) (discussing the use of resale price maintenance in *Dr. Miles* as a cartel facilitator (relying on HOVENKAMP, *supra* note 11, at 186–88)). *Leegin* overruled *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 406–07 (1911) (applying rule of reason to a resale-price-maintenance claim).

183. See *supra* text accompanying notes 118–20 (noting that certain groups tried to monopolize the film industry using Thomas Edison’s projector and film patents).

184. On the development of the case law, see 8 PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* ¶¶ 1620–1627 (2d ed. 2000).

185. On this point, see Lester Telser, *Why Do Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86, 87 (1960) (stating the free-rider explanation for resale price maintenance).

186. *Leegin*, 551 U.S. at 887 (overruling *Dr. Miles*, 220 U.S. at 373 (applying the rule of reason to a resale-price-maintenance claim)).

187. *Int’l Salt Co. v. United States*, 332 U.S. 392 (1947). On the development of tying law’s per se rule, see 9 AREEDA & HOVENKAMP, *supra* note 184, ¶¶ 1720–1722. On the lack of any foreclosure in many of these early decisions, see Bohannon, *supra* note 118, at 25–27.

defendant's market power could be presumed if it held at least one patent in the tying product, in this case a salt-injecting machine.¹⁸⁸ Further, in order to show anticompetitive effects one need prove only that the arrangement covered a large quantity of salt.¹⁸⁹ In reality, very few patents actually confer any market power. The patent-power presumption, although later extended to copyrights,¹⁹⁰ was widely believed to be significantly over-deterrent and the court finally overruled it in 2006.¹⁹¹ The ability to prove illegality without any showing of market exclusion led to many perverse results, from condemnation of a minor chicken fast-food franchisor for requiring franchisees to use its own trademarked paper plates and napkins¹⁹² to the Supreme Court's initial willingness to condemn a prefabricated-housing manufacturer's attempt to supply home financing only for the purchases of its own homes.¹⁹³ During its most aggressive years, tying law significantly impeded dealer distribution by condemning such practices as automobile manufacturers' insistence on making good on car warranties only if car dealers used General Motors' own aftermarket parts.¹⁹⁴

While the Supreme Court continued to cite the need to protect dealer freedom from restraints on alienation, the concerns moved increasingly into economics. But the rationales were poorly articulated, inconsistent at best, and ludicrous at worst. The Court inconsistently expressed concerns about both monopoly prices and market foreclosure, even though higher dealer prices are generally conducive to competitive entry. Further, while the expressed concern was sometimes stated as foreclosure, the practices that were condemned involved small firms and tied-up products that were commodities, where no monopoly could conceivably be created.

The high point of government and judicial aggressiveness occurred from the late 1940s through the 1960s and early 1970s. The Supreme Court's ambivalence toward vertical integration turned into downright hostility during the Warren Court era. In the *Schwinn* bicycle case, the Supreme Court made it unlawful per se for a manufacturer to limit the locations of its dealers or limit sales only to its own franchised retailers.¹⁹⁵ And in *Albrecht*, it became unlawful

188. *Int'l Salt Co.*, 332 U.S. at 396–97.

189. *Id.* at 396.

190. *United States v. Loew's, Inc.*, 371 U.S. 38, 45–46 (1962).

191. *Ill. Tool Works Inc. v. Indep. Ink, Inc.*, 547 U.S. 28, 45–46 (2006).

192. *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 51–52 (9th Cir. 1971), *cert. denied*, 405 U.S. 955 (1972).

193. *Former Enters. v. U.S. Steel Corp.*, 394 U.S. 495, 508–09 (1969); *see also* *United States v. Gen. Motors Corp.*, 121 F.2d 376, 400–01 (7th Cir. 1941) (condemning tying of General Motors' own financing to financed purchases of its automobiles), *cert. denied*, 314 U.S. 618 (1941).

194. *See* *Gen. Motors Corp.*, 34 F.T.C. 58, 86 (1941), *modified*, 34 F.T.C. 84 (1942) (forbidding General Motors from requiring its dealers to use only its parts). On tying claims in the automobile industry, *see* Kessler, *supra* note 159, at 1161.

195. *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 382 (1967).

per se for a supplier to control its dealer's *maximum* prices.¹⁹⁶ The Supreme Court condemned a newspaper's termination of a carrier because his subscription prices were too high.¹⁹⁷ *Albrecht* virtually guaranteed that large numbers of manufacturers would simply stop using independent dealer networks and switch to ownership vertical integration. High dealer prices can kill any manufacturer's distribution system, and local dealer markets are particularly prone to collusion or to high dealer markups in areas where dealers have exclusive territories or are relatively isolated.¹⁹⁸ That is precisely what happened in the newspaper industry. The independent carrier who purchases newspapers and resells them is largely a thing of the past, having been replaced by employee carriers and subscription prices set by the newspaper itself.¹⁹⁹

Writing in the late 1970s, Robert Bork generally blamed an economically insensitive, overly paternalistic Supreme Court for such decisions, which he rightfully regarded as socially harmful.²⁰⁰ But the Supreme Court was not the only or even the central culprit. With a few exceptions such as *Albrecht*, these antitrust cases were not brought by private plaintiffs who were allegedly injured by an antitrust violation. Mainly, they were brought by the government, and typically under standards that did not require a showing of any measurable harm to competition at all. The Supreme Court simply gave the Justice Department or Federal Trade Commission what they asked for.

The *Schwinn* bicycle case—the proverbial straw that broke the camel's back—was a government-enforcement action against a major bicycle manufacturer for trying to control the distribution of its bicycles.²⁰¹ In fact, Schwinn was a declining firm in the market and its restricted distribution network had proven to be not all that successful. The government's brief was signed by what in retrospect seems like an odd trio. Thurgood Marshall, later to become one of the Supreme Court's great liberals, was the Solicitor General in charge of representing the government's position in litigation. The second signatory was Donald F. Turner, the Harvard Law Professor then serving as head of the antitrust division. The third, and a principal drafter, was Richard A. Posner, serving as a staff attorney in the Antitrust Division and assistant to the

196. *Albrecht v. Herald Co.*, 390 U.S. 145, 153 (1968).

197. *Id.*

198. See Herbert Hovenkamp, *Vertical Integration by the Newspaper Monopolist*, 69 IOWA L. REV. 451, 456, 458–59 (1984) (explaining how high newspaper-carrier prices disadvantage newspapers).

199. See, e.g., *Paschall v. Kan. City Star Co.*, 727 F.2d 692, 704 (8th Cir. 1984) (en banc) (holding that the newspaper did not unlawfully monopolize distribution market by terminating contracts with independent carriers and switching to an employee-distribution scheme), *cert. denied*, 469 U.S. 872 (1984).

200. ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR AGAINST ITSELF* 210–16 (1978).

201. *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 367 (1967).

Solicitor General.²⁰² The brief emphasized the legal policy against restraints on alienation but struggled to find any reason why Schwinn's limitations on its dealership network should be considered anticompetitive. It rested mainly on the premise that Schwinn was trying to preserve an image of high quality by limiting its distribution to high-quality dealers because discount stores would have sold Schwinn's bicycles more cheaply. Even if this strategy were to succeed and make Schwinn a more successful company overall, the brief argued that Schwinn had no right under the antitrust laws to limit the ways in which it distributed its bicycles.²⁰³ The government acknowledged that a firm that owned its own retail outlets could restrict distribution of its own product in whatever way it pleased; but it argued, oddly, that permitting firms with contractual distribution networks to do the same thing would simply create multiple monopolies.²⁰⁴ Neither the government nor the Supreme Court ever considered the impact of restricted distribution on Schwinn's output, and thus, never addressed the real question: How can limiting distribution of one's own brand create a monopoly? Both Posner and Turner subsequently repudiated these positions.²⁰⁵ The *Schwinn* era lasted only a decade, ending with the *GTE Sylvania* decision in 1977, which condemned restricted distribution systems only if anticompetitive effects could be proven.²⁰⁶ Since then very few decisions have condemned such arrangements.

One notable feature of the law of vertical distribution restraints during this period was how unrelated it was to any coherent theory of the firm. As a result, the courts placed great legal significance on things that were economically inconsequential. For example, in the law of resale-price maintenance it did not matter whether collusion was occurring or whether the market was even prone to collusion. But what *did* matter was whether there was a sale-plus-resale, as opposed to a mere agency or consignment arrangement. The per se tying rule did not ask whether the markets at issue were competitively structured or whether tied-up products were even capable of being monopolized. Exclusion was far more imagined than real. As George Ellery Hale, one of the more astute critics of the vertical-restraints policies of his day, observed in the mid-fifties:

Unless there is an element of horizontal monopoly at one level or another, there can be no exclusion: if there are many filling stations in a given area, the making of a requirements contract

202. Brief of the United States, *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967) (No. 25), 1967 WL 129568.

203. *Id.* at 46–50.

204. *Id.* at 50–51.

205. Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 7–8 (1981); see also 3 PHILLIP E. AREEDA & DONALD F. TURNER, ANTITRUST LAW ¶ 734c, at 262 (1978) (explaining that vertically imposed territorial restrictions, even by a monopolist, are not presumed unlawful; no citation to *Schwinn*).

206. *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 36–37 (1977).

between the proprietor of one of them and a refiner of gasoline will not foreclose rival refiners because they may turn to the remaining stations. Instances of actual exclusion will be found to rest upon some such monopoly element at one horizontal level or another²⁰⁷

VI. OWNERSHIP VERTICAL INTEGRATION: MERGERS AND MONOPOLY

While outright vertical integration by ownership is more “absolute” and generally more durable than integration by contract, neither the common law nor the antitrust laws were traditionally as hostile. This fact itself suggests that legal policy was far removed from any coherent economic theory of the business firm. Most of the battles over vertical integration by contract concerned the “independence” of small dealers rather than the prospect of monopoly. Ironically, the most likely monopoly problem addressed by contractual distribution restraints was dealer collusion—i.e., monopoly by the very small businesses that antitrust during this period was at pains to protect. Resale-price maintenance and vertical non-price restraints tended to be anticompetitive when they facilitated price fixing by dealers, as was the case of the druggist cartel in *Dr. Miles*.²⁰⁸ *Albrecht* limited the power of manufacturers to control monopoly pricing by dealers—so much so that manufacturers were forced into ownership integration as an alternative.²⁰⁹ The law of tying and exclusive dealing was theoretically more concerned with the exclusion of rivals, but the law of tying in particular wandered so far from this concern that it led to wholesale condemnation in situations where market foreclosure of rivals was not even conceivable or relevant to the Court’s analysis. Tying and exclusive law became yet another incentive for firms to acquire their own retail outlets.

The law of ownership vertical integration forced courts to confront the monopoly problem more directly, because the freedom of small dealers and the common-law doctrine against restraints on alienation were not at issue. To be sure, sometimes the Supreme Court made dealer freedom an issue, but the result generally exposed the rationales of the decision making as anticompetitive. For example, in *Brown Shoe*, the Supreme Court condemned a vertical merger of a non-dominant shoe manufacturer and a non-dominant retailer precisely because the merger would lead to lower costs, thus driving out small independent shoe sellers who were struggling for survival.²¹⁰ The Supreme Court was not alone to blame. *Brown Shoe* represented a confluence

207. GEORGE ELLERY HALE & ROSEMARY D. HALE, MARKET POWER: SIZE AND SHAPE UNDER THE SHERMAN ACT 49 (1958).

208. See *supra* note 182 and accompanying text (discussing the details of the *Dr. Miles* cartel).

209. See *supra* text accompanying notes 195–98 (discussing *Albrecht*’s per se rule against maximum-price restraints).

210. *Brown Shoe Co. v. United States*, 370 U.S. 294, 343–44 (1962).

of congressional, executive and judicial opinion. Congress had been concerned about the “rising tide of industrial concentration” and rewrote the merger provision in 1950 so as to make bigness for its own sake an offense.²¹¹ The government brought the case, which successfully challenged the acquisition as both a merger of competitors (both firms owned shoe stores) and as an acquisition by one manufacturer of another’s retail shops. The government argued in its brief that the merger would exacerbate a trend toward lower-priced shoes, thus making it more difficult for small retailers to compete.²¹² As the government wrote, after the merger, retailer Kinney would be

able to take advantage of the marked discounts on raw material purchases previously available to Brown alone in the industry. Similarly, to the increasing extent Kinney’s shoes are acquired directly from Brown it will be able, in view of the intercorporate savings . . . to retail them at lower prices than it could offer if the same shoes were purchased from outside sources. And finally, regardless of the trade name Kinney uses, independent retailers selling Brown brand-name shoes, or comparable branded shoes of other manufacturers, are going to be adversely affected when shoes similar in appearance and workmanship are available at substantially cheaper prices in the Kinney stores.²¹³

With that, antitrust policy set out on a counterproductive, decade-long enterprise of condemning efficient mergers that would have benefitted consumers, simply because they made it more difficult for smaller rivals to compete.

Policy toward vertical integration *de novo*, or by construction of new facilities rather than acquisition, never became quite this aggressive. A few early cases condemned ownership vertical integration found to be part of a scheme to monopolize. For example, in the 1911 *American Tobacco* case, the Supreme Court ordered the defendant to divest its retail stores as part of the breakup of a monopoly.²¹⁴ By contrast, the 1911 *Standard Oil* decision, which effected substantial dissolution of John D. Rockefeller’s petroleum empire, took a largely benign attitude toward Standard’s very significant vertical integration into transportation and marketing.²¹⁵ For two decades following *Standard Oil*, the lower courts were favorably inclined toward vertical integration in the

211. Celler-Kefauver Act, Pub. L. No. 81-899, 64 Stat. 1125 (1950) (rewriting section 7 of the Clayton Act, 15 U.S.C. § 18 (1946)). On the legislative history, see Derek C. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 249 (1960), and Hovenkamp, *supra* note 82, at 521–22.

212. Brief for the United States at 136–37, *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962) (No. 4), 1961 WL 101890.

213. *Id.* (footnotes omitted).

214. *United States v. Am. Tobacco Co.*, 221 U.S. 106, 187–88 (1911).

215. *Standard Oil Co. v. United States*, 221 U.S. 1, 76–77 (1911).

petroleum industry.²¹⁶ Likewise, in refusing to condemn the United States Steel merger in 1920, the Supreme Court gave broad approval to vertical integration, which it described as “a facility of industrial progress” that reduced costs and made the production process operate more smoothly.²¹⁷

The earliest antitrust decisions to condemn ownership vertical integration as such were *Kodak* and *Corn Products*, both of which involved downstream vertical mergers into distribution. The anti-merger provision of the day did not cover vertical acquisitions, so they were treated by the courts as acts of monopolization. Kodak was first condemned in 1915 for acquiring some wholesale camera distributors, apparently for the purpose of excluding competing manufacturers from distribution channels.²¹⁸ *Corn Products* condemned a corn-syrup manufacturer’s acquisition of a candy factory and its entering into competition with its own customers, who were rival candy makers.²¹⁹ These early decisions were not attacks on vertical integration as such, but rather what the courts perceived as strategic acquisitions used to deny rivals access to important facilities or markets.²²⁰

At the same time, vertical integration was the subject of a great deal of populist and progressive opposition, particularly if it involved firms thought to have a monopoly, such as the railroads. Indeed, many of the so-called “Granger Cases” in the middle and late nineteenth century involved railroad acquisitions or construction of grain elevators, which placed the railroads in the business of purchasing and storing grain as well as shipping it. This caused an outcry among farmers, particularly in the Midwest, who believed that the railroad companies were using railroad/grain-elevator combinations to suppress the price of wheat and corn. The controversy culminated in state legislation regulating grain-elevator prices, which the Supreme Court approved in *Munn v. Illinois*.²²¹

After the New Deal, discomfort toward ownership vertical integration began to harden. Neoclassical economists increasingly believed that the amount of vertical integration was excessive in relation to any cost savings it produced, that it increased entry barriers and facilitated excessive product differentiation.²²² More generally, however, was the feeling that the Depression

216. See, e.g., *United States v. Standard Oil Co.*, 47 F.2d 288, 309–11 (E.D. Mo. 1931) (praising vertical integration in petroleum for its efficiency).

217. *United States v. U.S. Steel Corp.*, 251 U.S. 417, 442 (1920).

218. *United States v. Eastman Kodak Co.*, 226 F. 62, 79–80 (W.D.N.Y. 1915).

219. *United States v. Corn Prods. Refining Co.*, 234 F. 964, 984–90 (S.D.N.Y. 1916).

220. *Id.* at 1013; *Eastman Kodak Co.*, 226 F. at 80.

221. *Munn v. Illinois*, 94 U.S. 113, 135–36 (1876); see HOVENKAMP, *supra* note 44, ch. 12 (discussing the history, purpose, and effect of the development of railroad regulation).

222. For a reading that strongly promotes these views, see ARTHUR R. BURNS, *THE DECLINE OF COMPETITION: A STUDY OF THE EVOLUTION OF AMERICAN INDUSTRY* 445 (1936). See also DAVID LYNCH, *THE CONCENTRATION OF ECONOMIC POWER* 132 (1946) (“Organized in a vertical manner, they operate all stages of the productive process.”). *But see* HAWLEY, *supra* note 167, at 218–20 (presenting the potential benefits of integration).

was very much a monopoly problem, and that widespread vertical integration was simply one manifestation of a sick industrial establishment that had to be brought under control.²²³ Cost savings were quickly reinterpreted as unfair advantages that threatened to destroy small business. A 1941 Temporary National Economic Committee (“TNEC”) monograph on the petroleum industry was extremely critical of vertical integration, claiming that it was inherently monopolistic.²²⁴ University of Chicago economist Henry Simons argued that vertical integration should be permitted only “so far as clearly compatible with the maintenance of real competition.”²²⁵

These feelings did not subside with World War II. In sharp contrast to *Standard Oil* thirty years earlier, in 1948, prominent Yale law professor and economist Eugene Rostow declared that the “essential instrument of economic power in the oil industry is integration,” particularly into “transportation facilities,” and further that vertical integration “is the basic means of achieving and maintaining monopolistic control over price.”²²⁶ Corwin Edwards, a prominent political scientist and constitutional-law scholar at Princeton, believed that vertical integration was a significant bottleneck in the economy. He called for a statute that would determine the proper “proportioning” of vertical integration by any firm and make adjustments to those that were integrated excessively.²²⁷ In the 1948 *Paramount Pictures* decision, Justice Douglas wrote for the majority that vertical integration violates the antitrust laws “if it was a calculated scheme to gain control over an appreciable segment of the market and to restrain or suppress competition, rather than an expansion to meet legitimate business needs.”²²⁸

Increasing sensitivity toward product differentiation accounts for much of the theoretical basis for the increased concerns about vertical integration during and after the New Deal. Product differentiation had been a fact of life in the economy for centuries. However, the first influential economic theory in which product differentiation was an important component was Edward Chamberlin’s *The Theory of Monopolistic Competition* in the early 1930s.²²⁹ The switch from industrial theories involving fixed costs and fungible products to those based on product differentiation very largely explains the abrupt switch in antitrust policy that occurred during the Roosevelt Administration. Between

223. See ALFRED E. KAHN, *THE ECONOMICS OF REGULATION* 9–10 (2d ed., MIT Press 1988) (1971) (describing the economic climate during the Depression).

224. See Roy C. Cook, *Control of the Petroleum Industry by Major Oil Companies* 51–52 (Temp. Nat’l Econ. Comm., Investigation of Concentration of Economic Power Monograph No. 39, 1941) (describing how integration has handicapped smaller business in the oil industry).

225. HENRY SIMONS, *A POSITIVE PROGRAM FOR LAISSEZ-FAIRE* 20–21 (1934).

226. ROSTOW, *supra* note 46, at 117. Rostow later became the dean of Yale Law School, from 1955 to 1965.

227. CORWIN D. EDWARDS, *MAINTAINING COMPETITION* 130 (1949).

228. *United States v. Paramount Pictures, Inc.*, 334 U.S. 131, 174 (1948) (citations omitted).

229. EDWARD CHAMBERLIN, *THE THEORY OF MONOPOLISTIC COMPETITION* 71–73 (1933).

the First to the Second New Deal, the administration abruptly switched from a position of fostering collusion through government-observed private associations to one of extremely strict antitrust enforcement.²³⁰ Within emerging post-New Deal economic models for competition policy, product differentiation enabled firms with significant fixed costs to avoid excessive competition by committing their resources to differentiating their products rather than producing more.²³¹

Many New Deal and post-war economists believed that product differentiation in the economy was excessive and that vertical integration and product differentiation went hand in hand. Chamberlin himself had argued that the vertical integration resulting from product differentiation led to a great deal of waste as firms developed into areas that were already adequately served by others, but were committed to somewhat different products.²³² To the extent firms produced differentiated products, their needs became more specialized and accordingly more difficult to procure on the open market. Complex differentiated products had diverse needs for aftermarket servicing and parts, and a manufacturer's reputation depended critically on its products' acceptability to consumers after they left the store. For example, differentiated automobiles, cameras, or kitchen appliances increasingly required differentiated repair parts and servicing requirements, and it was less likely that a single supplier could service every manufacturer. In addition, distribution became more complex and required greater knowledge of and commitment to a particular manufacturer's brand.

This type of sophisticated distribution was both costly and came with some risk, and vertically distributed ownership permitted these risks to be spread. These facts help to explain the success of franchising in some markets as an alternative to vertical ownership. Finally, and not to be ignored, distribution became an important element of business strategy, and the strategies could be both pro- and anticompetitive. These tendencies were not limited to products that were differentiated by means of significant structural or technological change. Relatively minor design differences or even differences in branding could create a value to specialized distribution.

Many economists and antitrust policymakers from the 1940s through the 1960s saw a landscape marked by increasing product differentiation, increasing vertical integration, and declining competitiveness. The increased hostility

230. See Hovenkamp, *supra* note 10, at 344 (describing that in “sharp contrast” to the First New Deal, the Second New Deal ushered in antitrust policies that were “highly suspicious of any form of agreement among rivals and increasingly hostile toward both dominant firms and vertical integration”).

231. See *id.* at 341 (describing how Edward Chamberlin's model of monopolistic competition “solved the ruinous competition puzzle by illustrating how firms in product differentiated markets would shift their efforts into repositioning their products rather than producing more”).

232. CHAMBERLIN, *supra* note 229, at 123.

toward vertical integration in post-New Deal antitrust policy did little more than reflect that view. In particular, economists feared the move from monopolistic competition, where new entry was generally presumed to be easy, to oligopoly, which had all the evils of excessive product differentiation, but high entry barriers and higher prices as well. Writing in the early 1960s, Joe Bain, the leading industrial economist of the Harvard School, concluded that product differentiation was a significant barrier to entry and that it was exacerbated by widespread vertical integration.²³³ Indeed, for Bain one of the principal sources of high entry barriers was the fact that new entrants at a single production stage had to face firms operating at multiple production stages, and in many cases were even forced to purchase from them.²³⁴ Bain concluded that the “undoing” of vertical integration that was found not to be justified by production cost savings could “actually reduce barriers to entry without offsetting social loss and be conducive to more workable competition.”²³⁵

While Bain did not suggest that vertically integrated firms be broken apart *because* of their cost savings, his observations were dangerous because they implied that courts should look at vertically integrated industries, and, after concluding that the integration was not justified by cost savings, the economy could be improved by dis-integration.²³⁶ Bain’s concerns were reflected a few years later in the Justice Department’s 1968 guidelines for challenging vertical mergers:

While it is true that in some instances vertical integration may raise barriers to entry or disadvantage existing competitors only as the result of the achievement of significant economies of production or distribution (as, for example, where the increase in barriers is due to achievement of economies of integrated production through an alteration of the structure of the plant as well as of the firm), integration accomplished by a large vertical merger will usually raise entry barriers or disadvantage competitors to an extent not accounted for by, and wholly disproportionate to, such economies as may result from the merger.²³⁷

While judicial doctrine often reflected the substantive views of the economists, their articulated rationales often did not. Sometimes they approached the absurd. In one of its most hostile statements concerning

233. JOE S. BAIN, BARRIERS TO NEW COMPETITION: THEIR CHARACTER AND CONSEQUENCES IN MANUFACTURING INDUSTRIES 142–43, 212 (1956). While Bain was Harvard trained and became the principal spokesperson for the Harvard School industrial organization theory in the 1950s, he spent most of his academic career at the University of California, Berkeley.

234. *Id.* at 144–66.

235. *Id.* at 212.

236. *Id.*

237. U.S. DEP’T OF JUSTICE, 1968 MERGER GUIDELINES 9–10 (1968), *available at* <http://www.usdoj.gov/atr/hmerger/11247.pdf>. These Guidelines were drafted while Donald F. Turner was head of the Department’s Antitrust Division and issued on his last day in office.

vertical integration, the Supreme Court suggested that the vertically related divisions of a single firm could “conspire” with each other for purposes of the Sherman Act.²³⁸ Thereupon followed a series of actions by the Justice Department against vertical integration, including most prominently the motion-picture industry, in which the principal claim was that independent film producers and exhibitors were being driven from the market.²³⁹ But there were also government actions challenging the movement of automobile manufacturers into the taxicab industry²⁴⁰ and vertical integration in steel.²⁴¹ The arguments against vertical integration became increasingly fantastic, including the claims that a firm could vertically integrate in order to force its own subsidiary to purchase at monopoly prices;²⁴² that vertically integrated firms received an unfair advantage because they could buy from their subsidiaries at cost, while others had to pay monopoly prices;²⁴³ or that they engaged in predation by charging below cost prices at one level, subsidized by excessive profits at a different level.²⁴⁴ Writing in the mid-1950s, Robert Bork concluded that the courts, between 1946 and 1949, developed a virtual per se rule against vertical integration.²⁴⁵

While not exactly a per se rule, the government’s emerging position in the late 1940s seemed to be that a vertical merger was unlawful if the participants intended to deal only, or even substantially, with each other, and the merger accounted for a substantial number of sales. It argued unsuccessfully in the *Columbia Steel* decision in 1948 that a merger should be unlawful if it was

238. *United States v. Yellow Cab Co.*, 332 U.S. 218, 227 (1947). There the Court claimed:

The fact that these restraints occur in a setting described by the appellees as a vertically integrated enterprise does not necessarily remove the ban of the Sherman Act. . . . Such a restraint may result as readily from a conspiracy among those who are affiliated or integrated under common ownership as from a conspiracy among those who are otherwise independent.

Id. This “intraenterprise conspiracy” doctrine was later overruled by the Supreme Court in *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 752 (1984). See 7 AREEDA & HOVENKAMP, *supra* note 184, ¶ 1463 (discussing the evolution and demise of the “intraenterprise conspiracy” doctrine between *Yellow Cab Co.* and *Copperweld Corp.*).

239. *United States v. Paramount Pictures, Inc.*, 334 U.S. 131, 131–32 (1948). The problem had already been cited during the New Deal. See Daniel Bertrand et al., *The Motion Picture Industry—A Pattern of Control* (Temp. Nat’l Econ. Comm., Investigation of Concentration of Economic Power Monograph No. 43, 1941) (noting the disadvantaged position of independent exhibitors of motion pictures in comparison with affiliated exhibitors).

240. *Yellow Cab Co.*, 332 U.S. at 226–27.

241. *United States v. Columbia Steel Co.*, 334 U.S. 495, 495 (1948); see also Note, *The Columbia Steel Case: New Light on Old Antitrust Problems*, 58 YALE L.J. 764, 768 (1949) (discussing the problems of antitrust law that arise from vertical integration).

242. *Yellow Cab Co.*, 332 U.S. at 226–27.

243. *United States v. N.Y. Great Atl. & Pac. Tea Co.*, 173 F.2d 79, 85 (7th Cir. 1949).

244. See *United States v. N.Y. Great Atl. & Pac. Tea Co.*, 67 F. Supp. 626, 641 (E.D. Ill. 1946) (explaining that the government accused the defendant of predation).

245. Bork, *supra* note 55, at 181.

undertaken “for the purpose of monopolizing the business of supplying the rolled steel requirements of the acquired company.”²⁴⁶ The use of the word “monopolize” is odd here because it applies entirely to intrafirm sales. For example, a farmer with a vegetable stand who sells only her own vegetables through the stand can be said to “monopolize” the sales in that stand—but this is not the kind of “monopoly” that has anything to do with antitrust policy.

Nonetheless, the government’s developing position, which it followed at least through the 1960s,²⁴⁷ was that there was something inherently anticompetitive about a firm dealing with its own subsidiaries, at least if the firm was relatively large. Because the only economic purpose of vertical integration is self-provision or self-distribution, the government’s position was basically that vertical integration was legal only if it made no economic sense to do so in the first place. This argument carried the day in the *du Pont* merger case, when the Supreme Court condemned *du Pont*’s acquisition of a large interest in General Motors (“GM”) stock on the theory that a subsidiary would be likely to discriminate in favor of its own parent in purchasing necessary supplies.²⁴⁸ Here, the argument was that GM would give *du Pont* preferential treatment in purchasing fabrics for seat covers and paints for automobile bodies.²⁴⁹ The government had alleged that *du Pont* “formed the combination with General Motors with the intention of getting a preference in the trade of General Motors.”²⁵⁰ On the theory that every senseless action deserves an equally senseless reaction, General Motors and *du Pont* argued in return that GM “did not favor *du Pont*” at all.²⁵¹ While the Supreme Court disagreed with such claims in the 1948 *Columbia Steel* case, the 1950 amendments to the merger law had criticized that decision.²⁵² Even though the government brought *du Pont* prior to 1950, the Supreme Court applied the “policy” of the amended statute and sided with the government.²⁵³ The result was that the very self dealing that makes vertical integration desirable became the basis for the antitrust offense.

246. Brief for the United States at 2, *United States v. Columbia Steel Co.*, 334 U.S. 495 (1948) (No. 461), 1948 WL 47544 (emphasis added).

247. See generally U.S. DEP’T OF JUSTICE, *supra* note 237 (outlining the U.S. Department of Justice’s hostility toward vertical mergers).

248. *United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. 586, 588 (1957).

249. *Id.* at 588–89.

250. Brief for the United States at 113, *du Pont*, 353 U.S. 586 (No. 3) (emphasis omitted), 1956 WL 88967.

251. Brief for Appellee Gen. Motors Corp. at 171, *du Pont*, 353 U.S. 586 (No. 3), 1956 WL 88968.

252. Compare *United States v. Columbia Steel Co.*, 334 U.S. 495 (1948) (holding that excluding competition via vertical integration does not necessarily violate the Sherman Act), with H.R. REP. NO. 81-1191, at 11 (1949) (noting that the amendment of section 7 of the Clayton Act was intended to “make it clear that the bill applies to all types of mergers and acquisitions, vertical and conglomerate as well as horizontal”).

253. For the Court’s solution to the retroactivity problem, see *du Pont*, 353 U.S. at 590.

VII. CONCLUSION

Although Coase himself denies it,²⁵⁴ the belated interest in his 1937 article *The Nature of the Firm* surely resulted from the swirl of publicity attending publication of his *The Problem of Social Cost* in 1960.²⁵⁵ The later article brought transaction costs into the general vocabulary of legal policy, at least at the academic level, and virtually started the modern law and economics movement.²⁵⁶ Coase's article *The Nature of the Firm* became a kind of special case of *The Problem of Social Cost*. For whatever reason, today it would be unthinkable to write theory about firm size and structure without considering the costs of using the market as an important variable and seeing the firm as a rational maximizer of its own value.

By Coase's own admission, *The Nature of the Firm* had "little or no influence for thirty or forty years after it was published."²⁵⁷ That would change dramatically in the 1970s and 1980s,²⁵⁸ although to this day courts rarely cite Coase's important article. At the time of this writing, the Supreme Court has cited it only once—in its *Leegin* decision, which overruled the *Dr. Miles* rule of per se illegality for resale-price maintenance.²⁵⁹ The Court cited Coase for the proposition that whether a firm uses resale-price maintenance or ownership vertical integration depends on "the relative costs of vertical integration and vertical agreement by making the former more attractive based on the per se rule, not on real market conditions."²⁶⁰

The truly extraordinary thing about vertical integration of all kinds is how robustly it developed through the twentieth century in the face of a legal regime that was rarely accommodating and often hostile. But just as legal policymakers did not understand the economic rationales for vertical integration, so too did they fail to understand the economic consequences of their own policies. For example, per se rules against contractual vertical integration distort firm incentives by raising contractual distribution costs relative to those of ownership vertical integration. The marginalist firm always maximizes its value in the environment in which it finds itself, including the legal environment, by comparing the incremental costs and

254. See Ronald H. Coase, *The Nature of the Firm: Influence*, 4 J.L. ECON. & ORG. 33, 34 (1988) (asserting that his two articles had two separate aims).

255. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

256. See Herbert Hovenkamp, *The Coase Theorem and Arthur Cecil Pigou*, 51 ARIZ. L. REV. 633, 633 (2009) (discussing Arthur Cecil Pigou's influence on Ronald Coase and the transaction-costs model).

257. Coase, *supra* note 254, at 33.

258. See generally OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975) (using Coase's ideas of transaction costs and uncertainty); Klein, Crawford & Alchian, *supra* note 35, at 298 (1978) (citing Coase's article, *The Nature of the Firm*, as fundamental and aiming to expand on Coase's ideas).

259. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 877 (2007).

260. *Id.* at 903.

benefits of doing things a certain way. If controlling dealer pricing is valuable to a firm's business, then it must compare that value against the other values and costs of using a resale contract as opposed to outright ownership. To the extent that aggressive legal rules make the contract alternative more costly, the firm may respond by acquiring or developing its own retail outlets. If the impetus for vertical control is coming from a cartel of dealers, that is another cost that the firm must consider in its calculus. Many firms have built their own outlets in order to avoid dealer cartels. As a result, hostility toward vertical integration by contract leads to more ownership vertical integration. While market outcomes often seem unpredictable and unsatisfying, the outcomes of legal policy often fare no better, particularly when policymakers do not understand the phenomenon they are regulating.