

## CASE 15

# Resale Price Maintenance Reexamined: *Monsanto v. Spray-Rite* (1984)

Frederick R. Warren-Boulton

### INTRODUCTION

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On August 31, 1968, the Monsanto Company, a major U.S. manufacturer of chemical products, declined to renew its distributorship with the Spray-Rite Service Corporation, a small Iowa herbicide distributor whose net revenue from sales of Monsanto herbicides in 1968 had been about \$16,000. Sixteen years and millions of dollars in legal costs later, the Supreme Court upheld a Federal District Court's award of \$10.5 million to Spray-Rite.<sup>1</sup>

*Monsanto Co. v. Spray-Rite Service Corp.* is really two stories. The first is a legal saga that exemplifies many of the worst characteristics of private antitrust cases. But the Monsanto case is also the story of the ongoing attempt to transform antitrust into rational public policy.

### THE ECONOMICS OF RPM

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Resale price maintenance (RPM), or “fair trade,” is the practice whereby an upstream entity (e.g., a manufacturer) specifies a minimum price (or sometimes a maximum price) to which a downstream entity (e.g., a retailer) is required to adhere in its sales efforts. Note immediately that the manufacturer is not the direct beneficiary of this action, since RPM specifies the retail price, whereas the manufacturer's profits are determined by its wholesale price. In essence, once the wholesale price is given, RPM specifies a retail margin.

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<sup>1</sup>*Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752 (1984).

How might RPM be anticompetitive? Two possible explanations hinge on RPM's being a cover or facilitating device for horizontal price fixing or a horizontal cartel. One possibility is a cartel among manufacturers that cannot observe each others' wholesale prices but can observe retail prices. They may collectively fear that "price wars" among their retailers may tempt individual manufacturers among them to cut wholesale prices surreptitiously, thereby undermining the cartel. Resale price maintenance would prevent these price wars.

Alternatively, RPM might be motivated by a dealer cartel (among a group of dealers that collectively have market power, if they could succeed in colluding) that find that they cannot collude without external help. Accordingly, they ask one or more manufacturers to enforce their cartel by establishing RPM.

These cartel-motivated views of RPM, supplemented by a general notion that RPM had to be anticonsumer because it meant higher prices, were prevalent until the 1960s. They were reinforced by the experience of the 1930s, in which political pressures by small retailers (especially drug-gists) led to individual states' passing of fair trade laws for intrastate commerce and to the Congress's passing of the Miller-Tydings Act of 1937, which permitted RPM on a state-option basis for goods involved in interstate trade that were sold in the relevant state.

This general view of RPM as anticompetitive and harmful to consumers began a slow process of reversal when Telser (1960) laid out the first of the "free-rider" efficiency explanations for RPM. Telser began by pointing out that a manufacturer would appear only to lose from a higher retail margin. Any supranormal return to the retailer acts as a tax on the product, appropriating revenue that could have gone to the manufacturer. Using RPM to impose a higher retail margin could be in the manufacturer's interest only if the higher retail margin were somehow necessary to induce retailers to provide services that were worth more to consumers than they cost the retailers.

One example<sup>2</sup> of this phenomenon, suggested by Telser, is the provision of information or other services at the point of sale, for which the retailer cannot charge a separate fee. Suppose the following: A manufacturer of a complicated item—for example, a stereo receiver—believes that its product is best sold if the retailer provides a great deal of point-of-sale service, such as information, demonstration models, and the opportunity to hook up the receiver with many other combinations of stereo components, even if this high level of retailing services is costly and means that the receiver will carry a higher retail price than in the absence of these services. But retailers usually find it difficult to charge a separate fee for these services. Under these circumstances, some retailers would be tempted to

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<sup>2</sup>There have been a number of elaborations on Telser's theme since 1960; for a recent contribution that has references to earlier studies, see Butz (1997).

establish the equivalent of catalog stores, urging their customers to obtain the necessary information and demonstrations at a neighboring full-service retailer and then to return to the catalog store, which could sell the product for less (because the catalog store did not have the extra costs of providing the information and the demonstrations). In essence, the catalog retailer would free ride off the full-service retailer; however, the full-service retailers would then lose sales, no one would want to be a full-service retailer of that product, and the manufacturer's sales would suffer.

One solution for the manufacturer would be for it to insist that all of its retailers provide a full range of services; but policing their provision of service may be difficult. An alternative would be to establish a system of RPM. By insisting that all retailers sell at the same minimum retail price, the manufacturer would eliminate the price advantage of the catalog retailer, thereby reducing the free-riding problem. In essence, by restricting price competition among its retailers, the manufacturer would be virtually forcing its retailers to compete among themselves on the basis of service (since, with prices uniform among the retailers, improved service would presumably be the means by which the retailer would attract and retain customers). If it is easier for the manufacturer to police the RPM scheme than to police a direct insistence on the provision of retailer service, then RPM could be the manufacturer's preferred method.<sup>3</sup>

At first glance, even the unilateral imposition of RPM by a manufacturer may appear to be anticompetitive. After all, the manufacturer is restraining price competition among its retailers. But if the manufacturer is correct in its judgment that a high level of retail service is best for selling the product, this outcome should generally mean enhanced satisfaction for consumers.<sup>4</sup> As another way of seeing this point, consider that the manufacturer could vertically integrate, establish its own retail outlets, specify the retail price of the product sold by these outlets, and instruct its own retail employees to provide a high level of retail service in conjunction with the sales of the product. Would this latter situation generally be considered anticompetitive? Resale price maintenance, in essence, achieves the same outcome.

## THE LEGAL TREATMENT OF RPM

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In contrast with the changed economics perception of RPM, the legal treatment of RPM has remained harsh. In the 1911 *Dr. Miles Medical* case,<sup>5</sup> the

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<sup>3</sup>This could be true if it were easier for the manufacturer to verify instances of off-price sales—perhaps in response to other retailers' complaints—than to verify instances of the lack of adequate service.

<sup>4</sup>For arguments that even unilateral RPM may not be in the interest of most consumers, see Scherer (1983), Comanor (1985), and Comanor and Kirkwood (1985). For a criticism of these arguments, see White (1985).

<sup>5</sup>*Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

Supreme Court declared RPM to be a per se violation of Section 1 of the Sherman Act; that is, this form of vertical restraint was placed in the same category of condemned practices as horizontal price fixing among competitors (and, indeed, RPM is frequently characterized as “vertical price fixing”). Eight years later, in the 1919 *Colgate* case, the Supreme Court appeared to open a major loophole for RPM, declaring,

In the absence of any purpose to create or maintain a monopoly, the act does not restrict the long recognized right of a trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell.<sup>6</sup>

Thus, it appeared that a manufacturer could legally enforce an RPM program by simply announcing the expected retail prices in advance and refusing to deal with any retailer who did not adhere to those prices. But the Court quickly closed the loophole, consistently finding in subsequent cases<sup>7</sup> that manufacturers’ efforts to enforce RPM among their dealers constituted agreements between the manufacturer and the dealers and hence were violations of the Sherman Act, consistent with *Dr. Miles Medical*. In a long line of cases since then, the Court has repeatedly reaffirmed its condemnation of RPM as a per se violation.<sup>8</sup> The Court in 1968 even condemned RPM in a situation in which a newspaper attempted to impose *maximum* resale prices on its distributors.<sup>9</sup> In 1997, the Court reversed itself on this last point and unanimously declared that maximum RPM should be judged under the rule of reason; the Court specifically stated, however, that “arrangements to fix minimum prices . . . remain illegal per se.”<sup>10</sup>

The Supreme Court has not been nearly as consistently harsh with respect to nonprice vertical restraints—for example, a manufacturer’s instructions to retailers of its products as to where they may locate or in which geographic areas they may sell. Here, after condemning these practices as a per se violation in 1967,<sup>11</sup> the Court in 1977 reversed itself and declared them instead to be subject to the rule of reason.<sup>12</sup> This disparity in legal treatment is striking, since the economic logic underlying the two

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<sup>6</sup>*United States v. Colgate Co.*, 250 U.S. 300, 307 (1919).

<sup>7</sup>See *United States v. Schrader’s Son, Inc.*, 252 U.S. 85 (1920); *Frey & Sons, Inc. v. Cudahy Packing Co.* 256 U.S. 208 (1920); and *FTC v. Beech-Nut Packing Co.*, 257 U.S. 441 (1922).

<sup>8</sup>See *United States v. Bausch & Lomb Optical Co.*, 321 U.S. 707 (1944); *United States v. Parke, Davis & Co.*, 362 U.S. 29 (1960); and *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964).

<sup>9</sup>*Albrecht v. Herald Co.*, 390 U.S. 145 (1968).

<sup>10</sup>*State Oil Co. v. Khan*, 66 L.W. 4001, 4005 (1997).

<sup>11</sup>*United States v. Arnold, Schwinn and Co.*, 388 U.S. 365 (1967).

<sup>12</sup>*Continental T.V. v. GTE Sylvania*, 433 U.S. 36 (1977).

forms of vertical restraint is fundamentally similar, and both (since they restrain competition among the retailers of a manufacturer's product) are likely to cause retail prices of the relevant product to be higher than in the absence of the practice.<sup>13</sup>

## THE CASE

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Monsanto is a major American manufacturer of chemical products, including agricultural herbicides.<sup>14</sup> During the 1960s, several companies, including Monsanto, Geigy, Stauffer, Eli Lilly, DuPont, and Rohrer AmChem, developed a new generation of weed killers for use on corn and soybeans. Previous herbicides were sprayed on weeds after the weeds were grown and had already injured the crops. The new "preemergent" herbicides prevented this damage by killing weed seeds before they germinated.

By 1968, the leading producer of corn herbicides was Geigy, whose Atrazine brand held a 70-percent market share, while Monsanto's Radox (introduced in 1956) and Ramrod (introduced in 1966) brands accounted for 15 percent of the corn herbicide market. In soybean herbicides, where the two leading firms held market shares of 37 percent and 33 percent, Monsanto's market share was only 3 percent.

Monsanto marketed its herbicides primarily through about 100 independent distributors who resold to retail dealers, including feed stores and farm implement dealers, who in turn resold to farmers. Each distributor was assigned a geographic "area of primary responsibility," but that assignment was nonexclusive: authorized distributors could sell herbicides of other manufacturers; distributors could sell outside their assigned area of primary responsibility; and Monsanto assigned approximately ten to twenty distributors to each area.

Between 1957 and 1968, one of those distributors was the Spray-Rite Service Corporation. Spray-Rite was a small family business whose owner and president was also its sole salaried salesman. Spray-Rite bought herbicides from Monsanto and other manufacturers and resold them to retail dealers and farmers in northern Illinois and adjacent areas. In 1968, 90 percent of Spray-Rite's sales volume came from herbicide sales. Spray-Rite was the tenth largest of the approximately 100 distributors of Monsanto's primary corn herbicide. Monsanto's products, however, accounted for only about 16 percent of Spray-Rite's \$3.4 million in total sales in 1968; Geigy's Atrazine corn herbicide accounted for 73 percent of Spray-Rite's herbicide sales. Spray-Rite was a low-margin, high-volume operation that even characterized itself as a "brokerage house." Spray-Rite sold

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<sup>13</sup>See White (1981).

<sup>14</sup>Monsanto's sales in 1974 were about \$3.5 billion, with about 10% of those sales accounted for by its agricultural chemical products group.

primarily to large seed-corn companies, large sprayers, and large dealers; 30 percent of its 1968 sales were made to one large seed-corn company, De Kalb, and only six customers combined accounted for nearly 75 percent of its total sales of Monsanto products.

In 1967, faced with a flat market share in corn herbicides and a declining market share in soybean herbicides, Monsanto decided to change its marketing strategy in order to stress dealer education. Herbicide application is technically complex and risky. The optimal application depends on location, soil, weather, and weed type, and selecting an inappropriate herbicide or misapplying an appropriate one can result in an ineffective application or even serious crop damage. Monsanto relied upon its distributors to educate the dealers, who in turn would provide individual farmers with specific technical advice on the optimal selection and application of its herbicides.

In September 1967, Monsanto informed each of its distributors, including Spray-Rite, that for the upcoming 1967–1968 season it would appoint distributors for only one-year terms and that authorized distributorships would expire automatically unless renewed by Monsanto. Renewal would depend on compliance with six criteria, including the following:

Is the Distributor's primary activity the solicitation and distribution of agricultural chemical products to dealers? . . .

Is the Distributor willing and capable of carrying out Monsanto's technical programs at both the Dealer and Farmer levels with properly trained personnel? . . .

Can the Distributor be expected to "exploit fully" the potential markets for the Goods in the Distributor's area of primary responsibility? (plaintiff's exhibit no. 196)

In October 1968, Monsanto declined to renew its contract with Spray-Rite and four other distributors. After its termination by Monsanto, Spray-Rite continued to purchase some Monsanto products from other distributors. In 1969, its total sales increased by 52 percent to \$5.2 million, although its sales of Monsanto products declined. Spray-Rite also reported its first net loss on herbicide operations since 1965. In 1970, total sales fell to \$2.4 million, and net losses rose to over \$91,000. While sales recovered and losses fell in 1971, by 1972, with sales down to \$1.4 million and losses over \$75,000, Spray-Rite went out of business.

In the meantime, jolted by a 30-percent fall in sales in 1968, Monsanto had taken several other marketing actions. First, it tried to push dealer education directly: It hired additional sales personnel to work with dealers, established herbicide training schools for dealers and for distributor personnel, offered cash bonus payments to distributors that sent salesmen to training classes, and offered distributors price discounts on herbicides resold to

dealers who attended Monsanto's technical programs. Second, it changed its shipping policies to encourage distributors to develop the market in their areas of primary responsibility. Beginning in 1968, it permitted distributors to pick up products only at Monsanto warehouses within each distributor's area and provided free deliveries of products to the distributor or its customers only within that area. A distributor that resold the product outside its primary area had to pay the additional shipping costs. Third, it reduced the prices charged to its distributors as well as the suggested resale prices. While this reduced the suggested distributor profit margin from 11 percent to 7 percent, Monsanto also offered price discounts, rebated to the distributor at the end of the season, on orders purchased early in the season. Fourth, in 1969, it introduced its "third-generation" corn and soybean herbicide, LASSO.

The combined effect was dramatic. Monsanto's share of the corn herbicide market went from 15 percent in 1968 to 28 percent in 1972; its market share in soybean herbicides went from 3 percent in 1968 to 19 percent in 1972. These increases came largely at the expense of the firms with the largest market shares. In corn herbicides, Geigy's share fell from 70 percent in 1968 to 52 percent in 1972. In soybean herbicides, the combined share of the two leading firms (Eli Lilly and AmChem) fell from 70 percent in 1968 to 55 percent in 1972. During the same period, total use of corn and soybean herbicides grew by approximately 15 percent and 75 percent, respectively.

### The District Court

In 1972, Spray-Rite sued Monsanto for violating Section 1 of the Sherman Act, alleging that Spray-Rite had been terminated as part of a conspiracy to fix the resale price of Monsanto herbicides and that the termination, combined with a post-termination boycott by Monsanto and its distributors and the use by Monsanto of such nonprice vertical restraints as areas of primary responsibility and dealer compensation and shipping programs, had eventually forced Spray-Rite out of business. Spray-Rite's case thus consisted of three separable factual allegations: (1) Its termination was pursuant to an RPM conspiracy among Monsanto and some of its distributors; (2) Monsanto's nonprice policies were pursuant to that conspiracy; and (3) Monsanto and some of its distributors conspired to boycott Spray-Rite after the termination.

On the first and most important allegation, Monsanto denied ever engaging in RPM and contended that it had decided unilaterally not to renew Spray-Rite's distributorship because of the latter's failure to satisfy Monsanto's announced criteria for renewal. Monsanto also argued that Spray-Rite failed to prove the existence of an agreement among Monsanto and any of its distributors to terminate Spray-Rite because of its price cutting and pointed out that price cutting by other, nonterminated distributors was

widespread. But Spray-Rite was able to show that Monsanto was concerned about the resale prices of its herbicides, that Monsanto had agreed that its company-owned outlets would not undercut its suggested retail prices, that Monsanto had received price complaints about Spray-Rite from other distributors, that Monsanto representatives had informed Spray-Rite of those complaints and requested that prices be maintained, and that Monsanto terminated Spray-Rite subsequent to those complaints but without ever having discussed with Spray-Rite the distributorship criteria that were the alleged basis for the action. In addition, evidence was introduced that, subsequent to Spray-Rite's termination, Monsanto had advised price-cutting distributors that if they did not maintain the suggested resale price they would not receive adequate supplies of Monsanto's new herbicide, LASSO.

On the boycott allegation, Spray-Rite was able to deliver testimony from Monsanto employees and from distributors that Monsanto had threatened to terminate distributors who sold to Spray-Rite. Finally, with respect to Monsanto's nonprice policies, Spray-Rite did not argue that Monsanto's promotional programs and distribution policies were illegal under the *Sylvania* rule-of-reason standard. Indeed, it agreed that Monsanto had become a more effective competitor after their introduction. Spray-Rite did argue, however, as the court eventually instructed the jury, that it was per se unlawful for a manufacturer to utilize customer or territorial restrictions as part of a comprehensive price-fixing plan or boycott and that the jury could consider the effect of Monsanto's distributor compensation programs as circumstantial evidence of the conspiracy to boycott.

These three allegations were reformulated by the court and given to the jury as three special interrogatories:

1. Was the decision by Monsanto not to offer a new contract to plaintiff for 1969 made by Monsanto pursuant to a conspiracy or combination with one or more of its distributors to fix, maintain, or stabilize resale prices of Monsanto herbicides?
2. Were the compensation programs and/or areas of primary responsibility and/or shipping policy created by Monsanto pursuant to a conspiracy to fix, maintain, or stabilize resale prices on Monsanto herbicides?
3. Did Monsanto conspire or combine with one or more of its distributors so that one or more of those distributors would limit plaintiff's access to Monsanto herbicides after 1968?

The jury responded "yes" to each interrogatory and returned a general verdict against Monsanto.

### **Damages**

Spray-Rite argued that a herbicide distributor needed to carry a "full line" of different products because dealers and farmers wanted to buy all

their herbicides from one seller. Access to Monsanto's products was thus essential for survival. The combination of Monsanto's 1968 termination of Spray-Rite, the post-termination boycott, and Monsanto's post-termination compensation programs, delivery policies, and territorial restrictions forced Spray-Rite out of business in 1972. Further, the conspiracy to impose RPM and boycott Spray-Rite was the only event of substance that would have affected Spray-Rite's actual or potential business after 1968. It would thus be reasonable to expect that, in the absence of the alleged conspiracy, the relationship from 1969 to 1978 between Spray-Rite's total sales and the total corn and soybean herbicide sales in the region would have been the same as it had been from 1963 to 1968. Extrapolation of sales and profits to 1978 brought the latter to a grand total of about \$3.3 million.

Alternative calculations of Spray-Rite's damages, more favorable to Monsanto, would have yielded considerably smaller figures. But the jury accepted Spray-Rite's estimates and apparently rounded them up to \$3.5 million, which the court then trebled.

### Strategy

The jury can hardly be blamed, however, for this decision. *Monsanto* was argued as a per se case; the jury was not to wonder if Monsanto's actions benefited either its customers or society in general. As the Supreme Court later noted, Monsanto's lawyers never argued that a rule-of-reason standard should apply to RPM, nor did they dispute Spray-Rite's contention that any nonprice practices instituted as part of an RPM conspiracy should also be subject to per se treatment.

Monsanto's trial strategy was to argue the case on as narrow grounds as possible. The appropriateness of a per se standard for RPM was never disputed, which meant that a potential opportunity to argue RPM as a rule-of-reason case was missed: The facts of the case provided strong support for an efficiency explanation for RPM and no support for any inference that RPM had been part of a price-fixing conspiracy by either dealers or manufacturers.

For a litigator, however, that same evidence of the social desirability of RPM carried several dangers. First, to the extent that RPM is a rational, profit-maximizing, appropriate, efficient, and effective response to free-riding by distributors, it is also a more likely response. Spray-Rite's factual allegations thus become more plausible, and it becomes harder to convince the jury that RPM never occurred. Second, the attorney's goal is to win, putting the interests of his or her client first and ignoring any potential social or precedential impact of the case.

Third, any trial attorney has limited resources, and any jury has a limited ability to absorb information; putting on a rule-of-reason case could distract attention or resources away from other lines of defense. Finally, it

can be difficult for attorneys to evaluate the potential for a defense that removes them from strictly legal and evidentiary issues where they are sure of their competence and places them in the unknown, speculative, uncertain, and uncontrollable world of economics.

Balanced against these dangers from a rule-of-reason strategy were only limited benefits. The jury might have been persuaded that any use of RPM by Monsanto was in the public as well as the private interest, and this might have countered some of the natural sympathy for a small, local businessman and his family in their battle against a huge corporation. But even after the recent decision in *Sylvania*,<sup>15</sup> the probability that *Monsanto* would be the case in which the Supreme Court would finally reverse its long-standing position on the per se illegality of RPM must have seemed small. The social gain from using *Monsanto* as a vehicle for such a reversal was an externality appropriately ignored by Monsanto's legal staff. It was thus left to the Department of Justice, whose friend-of-the-court (amicus brief) program was designed precisely to respond to the social externalities that private attorneys would ignore, to use *Monsanto* to argue for an end to the per se treatment of RPM.

In retrospect, however, the decision to forgo a rule-of-reason defense at the district court level may have been expensive for both Monsanto and for society. The use of a per se strategy meant that the full evidentiary record that was needed to support a rule-of-reason argument before the Supreme Court case was never developed. In addition, the Supreme Court was able to argue that the failure to raise the issue at the District Court level meant that the Court was not required to reach the broader issue in *Monsanto*.

## The Court of Appeals

Monsanto appealed, arguing that there were errors in the District Court judge's charge to the jury, that there was insufficient evidence to support the verdict, and that the District Court made several erroneous evidentiary rulings. The United States Court of Appeals for the Seventh Circuit found none of these arguments persuasive and affirmed the judgment of the District Court.<sup>16</sup>

The principal nonfactual issue was evidentiary: Monsanto argued that evidence of price complaints coupled with evidence of termination in response to those complaints should be insufficient to prove the existence of an RPM agreement. The Court of Appeals disagreed, stating, "We believe . . . that proof of termination following [rephrased in the subsequent paragraph in the opinion as "in response to"] competitor complaints is sufficient to support an inference of concerted action."<sup>17</sup>

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<sup>15</sup>*Continental T.V. v. GTE Sylvania*, 433 U.S. 36 (1977).

<sup>16</sup>*Spray-Rite Service Corp. v. Monsanto Co.*, 684 F.2d. 1226 (1982).

<sup>17</sup>684 F.2d 1226, 1238, 1239 (1982).

Monsanto also argued that its promotion and distribution policies should be tested under the *Sylvania* rule-of-reason standard. The Court of Appeals held, however, that *Sylvania* did not limit the Supreme Court's earlier holding in *Sealy*<sup>18</sup> that otherwise lawful vertical restrictions imposed as part of an unlawful scheme to fix prices are per se illegal and that *Sylvania* applies only if there is no allegation that the territorial restrictions are part of a conspiracy to fix prices.

## The Supreme Court

On petition from Monsanto and from the Department of Justice (DOJ) as amicus curiae, the Supreme Court granted certiorari. The petitioners presented three central questions to the Supreme Court. The first two were evidentiary: What evidence is sufficient to infer that nonprice restraints are so connected to an RPM scheme that they should be treated under a per se rather than a rule-of-reason standard, and what evidence is sufficient to infer that a dealer has been terminated as part of a conspiracy to impose RPM? The third question was presented only by the Department of Justice: Should RPM be per se illegal?

On the first question, both Monsanto and the DOJ seized on a statement by the Court of Appeals that *Sylvania* applies to nonprice restraints only if there is no "allegation" that those restraints are part of an RPM conspiracy. Both Monsanto and the DOJ argued that, given the potentially procompetitive benefits from nonprice restraints that the Supreme Court had recognized in *Sylvania*, a "mere allegation" that such restraints were part of an RPM scheme should be insufficient for per se treatment. Even evidence that nonprice restraints have had an effect on price should not be sufficient. As the DOJ's amicus brief pointed out, nonprice restrictions that prevent free-riding and encourage dealers to provide more or higher-quality point-of-sale services can be expected to result in higher retail prices. If the value of those additional services to consumers is greater than the increase in the retail price, however, consumers will be better off and will respond to the increase in both price and quality by buying more of the product. Thus, the critical evidentiary distinction between a procompetitive vertical restraint and an anticompetitive increase in either the manufacturer's wholesale price or the dealer's margin is its effect on quantity: The former results in an increase in the quantity sold, the latter in a decrease.

The Supreme Court disposed of this question in a footnote, stating that the lower court's language could be read to say that a plaintiff must prove, as well as allege, that the nonprice restrictions were in fact part of a price conspiracy. Monsanto had conceded that if the nonprice practices were proved to have been instituted as part of a price-fixing conspiracy, they

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<sup>18</sup>*United States v. Sealy*, 388 U.S. 350 (1967).

would be subject to per se treatment. Since the jury had found that the nonprice practices were created by Monsanto pursuant to a conspiracy to fix resale prices, Monsanto's argument was reduced to the proposition that the jury did not have sufficient evidence to support this finding. Monsanto had failed to make that argument at the Court of Appeals, and, since that court did not address the point, the Supreme Court declined to reach it, stating only that "nothing in our discussion today undercuts the holding of *Sylvania* that non-price restrictions are to be judged under the rule of reason."<sup>19</sup>

A second question, which did interest the Supreme Court, was whether a per se unlawful vertical price-fixing conspiracy could be inferred solely from evidence that a manufacturer had received price complaints from a distributor's competitors and later did not renew the distributor's contract. Monsanto and the DOJ argued that the Appeals Court's holding that "termination following competitor complaints is sufficient to support an inference of concerted action" was incorrect. It undermined the Sherman Act's crucial distinction between collective and unilateral conduct by permitting a jury to infer conspiracy from normal marketplace behavior that was fully consistent with unilateral conduct. Manufacturers routinely terminate distributors unilaterally for being unwilling or unable to promote or service their product in the way desired by the manufacturer. Indeed, one indicator of that failure may be the distributor's pricing strategy. Even a manufacturer that is making no effort to control the resale price may have good reasons for closely monitoring the operations of price-cutting dealers. In doing so, the manufacturer is likely to be helped by complaints from rival dealers, especially if those dealers believe that they are losing sales because the price-cutting dealer is free-riding on their efforts. Neither parallel desires nor evidence of communication, by themselves or in combination, provides sufficient evidence to imply collusion between a manufacturer and one or more dealers. Further, the practical effect of a "termination that follows complaints" standard for inferring collusion could be virtually to immunize dealers from terminations once a competitor had complained.

The Supreme Court began its approach to the evidentiary standard in *Monsanto* by reiterating the two central themes of the legal approach to vertical restraints—the distinction between concerted and independent action, and the distinction between concerted action to set prices and concerted action on nonprice restrictions. The Court acknowledged that the economic effects of vertical arrangements, whether concerted or unilateral, price or nonprice, are often similar or identical. The Court did not, however, proceed from this observation to conclude that these distinctions were invalid as the basis for choosing between a rule-of-reason or a per se standard. The Court concluded that for the per se approach of vertical price restraints,

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<sup>19</sup>465 U.S. 752, 761, fn. 6 (1984).

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something more than evidence of complaints is needed. There must be evidence that tends to exclude the possibility that the manufacturer and non-terminated distributors were acting independently. . . . The antitrust plaintiff should present direct or circumstantial evidence that reasonably tends to prove that the manufacturer and others “had a conscious commitment to a common scheme designed to achieve an unlawful objective, . . . a unity of purpose or a common design and understanding, or a meeting of minds in an unlawful arrangement.”<sup>20</sup>

The Court thus rejected the Court of Appeal’s evidentiary standard of termination following complaints. The new standard, however, was not enough to save Monsanto. Applying the new standard to the facts of this case, the Court concluded that “there was sufficient evidence for a jury to have concluded that Monsanto and some of its distributors were party to an ‘agreement’ or ‘conspiracy’ to maintain resale prices and terminate price cutters” and affirmed the judgment of the lower court.<sup>21</sup>

The third question presented to the Court in the DOJ’s amicus brief was potentially the most important: Should RPM be per se illegal? The amicus brief argued that the Court should take this opportunity to do what it had never done: analyze RPM in terms of its actual economic effects. It pointed out that a manufacturer who wished only to raise the resale price could and would do so simply by raising its own price to the distributor and that preserving or increasing the downstream margin may be a more efficient way to achieve procompetitive effects than various nonprice restraints judged under a rule of reason. The brief went on to cite control of the free-rider problem as a major beneficial effect of RPM and argued that the evidence in *Monsanto* pointed to this as the explanation for Monsanto’s conduct. Finally, the brief argued that the conditions under which any adverse competitive effects (i.e., a manufacturer or dealer horizontal cartel) from RPM might occur are readily ascertainable.<sup>22</sup>

While some of the justices showed a keen interest in the question during oral argument, the Supreme Court’s opinion ducked the question, stating only in a footnote that:

Certainly in this case we have no occasion to consider the merits of this argument. This case was tried on per se instructions to the jury. Neither party argued in the District Court that the rule of reason should apply to a vertical price-fixing conspiracy, nor raised the point on appeal. In fact, neither party before this Court presses the argument advanced by amici.

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<sup>20</sup>465 U.S. 752, 764 (1984).

<sup>21</sup>465 U.S. 752, 765 (1984).

<sup>22</sup>Necessary conditions for RPM to facilitate manufacturers’ collusion include high concentration, barriers to entry, and industrywide use of the practice. Necessary conditions for RPM to be a disguised dealer cartel include market power by dealers in the resale market and some price inelasticity for the product of the manufacturer or group of manufacturers coerced by dealer pressure.

We therefore decline to reach the question, and we decide the case in the context in which it was decided below and argued here.<sup>23</sup>

Justice Brennan, in a concurring decision, did, however, provide one explanation by stating that,

As the Court notes, the Solicitor General has filed a brief in this Court as amicus curiae urging us to overrule the Court's decision in *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911). That decision has stood for 73 years, and Congress has certainly been aware of its existence throughout that time. Yet Congress has never enacted legislation to overrule the interpretation of the Act. Because the Court adheres to that rule and, in my view, properly applies *Dr. Miles* to this case, I join the opinion and judgment of the Court.<sup>24</sup>

The history of Congress's views of RPM is a long and complex one. The amicus brief for the United States argued that Congress's views on RPM had varied over the years, that in repealing the broad per se legality afforded by the Fair Trade Laws (the Miller-Tidings and McGuire Acts) in 1975 Congress did not specify that RPM be treated as per se illegal, and that determination could properly be assumed by the Court.

But Congress had made its recent views extremely clear in resolutions, committee hearings, and, most strikingly, in passing a statute to prohibit the Justice Department from urging in its oral argument before the Court in *Monsanto* that the per se treatment of RPM be altered.<sup>25</sup> The Court was surely aware of these views.

## AN ECONOMIC ANALYSIS OF MONSANTO

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Turning now to economic diagnostics, can we discern from the available evidence the "true" reason and effects of Monsanto's actions? For all practical purposes, the answer is yes. But the ability of the Court or any observer to diagnose this case correctly is severely hindered by the legal structure under which it was brought.

First, Monsanto was not appropriately an antitrust case at all: If anything, this was a contract dispute between a manufacturer and a distributor that was transformed into an antitrust case by the combination of a per se standard and the prospect of treble damages. In general, the ability of

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<sup>23</sup>465 U.S. 752, 762, fn. 7 (1984).

<sup>24</sup>465 U.S. 752, 769 (1984).

<sup>25</sup>"None of the funds appropriated . . . may be used for any activity the purposes of which is to overturn or alter the per se prohibition against resale price maintenance in effect under Federal antitrust laws." Public Law No. 98-166 (1983), sec. 510. This law was passed after the DOJ had submitted its written amicus brief but before the DOJ's oral argument before the Supreme Court in *Monsanto*.

courts to resolve such contract disputes efficiently requires that the parties provide information on explicit or implicit contracts and address any violations directly. Costuming such disputes as antitrust claims leaves some valid contract claims unaddressed while other efficient contracts are heavily penalized, thus reducing the incentives of firms to enter into efficient contracts.

To this author's knowledge, Spray-Rite never asserted that Monsanto had violated an explicit or implicit contract. In general, however, distributors' legal claims of violations of implicit contracts by a manufacturer may be economically defensible. For example, Spray-Rite could have reversed the free-rider argument against Monsanto by asserting that it (Spray-Rite) had invested a considerable effort over ten years in building up an understanding and acceptance of Monsanto's products among a group, however small, of major customers; that as a result, sales of Monsanto products to these customers had become a highly profitable business; and that Monsanto's decision to terminate Spray-Rite was simply a naked seizure of Spray-Rite's investment. Termination would allow Monsanto to appropriate that investment directly by making those sales through its vertically integrated sales system. Alternatively, Monsanto could assign such highly profitable customers to its other distributors, extracting in return either additional distributor services or a lower average distributor margin. Thus, instead of Spray-Rite's free-riding on the efforts of Monsanto or of other distributors, Monsanto was attempting to free ride on Spray-Rite.

Second, even if this were appropriately an antitrust case, the application of the per se rule meant that only by accident would a court discover the cause and effects of Monsanto's decision to terminate Spray-Rite. If *Monsanto* had been judged under a rule-of-reason standard, it would not have been sufficient to show that Monsanto had agreed with other distributors to impose a minimum distributor margin and had terminated Spray-Rite for price cutting. Under the *Sylvania* standard, Spray-Rite would have had to show that RPM by Monsanto had an anticompetitive effect. Under a per se standard, however, all that mattered was whether Monsanto had done the deed, not why or with what effect.

The absence of any incentive for Spray-Rite to establish the cause or effect of RPM by Monsanto placed Monsanto in a dilemma. Monsanto, of course, vigorously denied ever engaging in RPM—a response that could only be expected but one that may also have prevented much valuable information from ever appearing. As the DOJ's amicus brief later put it,

It is true that Monsanto has denied engaging in resale price maintenance; but the per se unlawful status of that practice has been universally assumed by courts for so long and the consequences of being adjudged to have engaged in the practice are so severe—treble damages and possible

felony prosecution—that few antitrust defendants can be expected to concede participating in such an agreement, a concession that is necessary as a matter of litigation strategy if they wish to argue that the practice was procompetitive. For 70 years, then, it has been unlikely that the per se status of resale price maintenance would be placed directly in issue by an antitrust defendant.

Monsanto did, of course, go to some efforts to argue that its real goal was to improve dealer education and increase customer services. The strategy, however, appears to have been more to provide an explanation for Monsanto's behavior that might be taken by the jury to be an alternative to—or even perhaps mutually exclusive with—RPM, rather than an attempt to justify RPM.

The per se treatment of RPM thus forced both parties to adopt litigation strategies under which a number of important factual questions were neither asked nor answered. Nevertheless, a great deal is clear beyond a reasonable doubt. First, both of the standard anticompetitive scenarios—dealer collusion and manufacturer collusion—can be ruled out. With respect to dealer collusion, there was evidence that other distributors complained to Monsanto about price cutting by Spray-Rite. As noted, however, such dealer complaints are both routine and explicable on other grounds. There was no evidence of any concerted effort by a group of distributors to force Monsanto to raise the retail margin against its will. It might be argued that an explicit agreement among distributors would not be essential if a few large distributors each accounted for a large proportion of the sales of one or more relatively small and powerless manufacturers. But the large number of actual or potential distributors, the absence of any entry barriers into distribution, and the enormous size discrepancy between manufacturers and distributors of herbicides would render incredible any scenario of unilateral threats by dealers against an unwilling manufacturer. The evidence from both structure and conduct show clearly that any RPM in this case was inspired and enforced by the manufacturer.

It is also clear that any RPM was imposed unilaterally by Monsanto. Again, no evidence was introduced, nor any allegation made, that Monsanto imposed RPM as part of an agreement among manufacturers aimed at facilitating oligopolistic price coordination. Collusion among herbicide manufacturers would not be implausible. The available data showed that in 1968, both the corn and the soybean herbicide markets were highly concentrated.<sup>26</sup> But there was no evidence of the kind of pricing behavior that RPM is alleged to prevent: retail price shading that induces retaliatory wholesale price cuts by manufacturers. Most important, there was no evidence or

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<sup>26</sup>All indications are that corn and soybean herbicides are separate product markets. Even using only the available market share data, the HHI was over 5125 in corn herbicides and over 2822 in soybean herbicides.

allegation that RPM was being imposed industrywide or even by a group of firms with a sizable share of the market.<sup>27</sup> Moreover, Monsanto was apparently the least likely instigator of any attempt at collusion. In 1968, Geigy dominated the corn herbicide market, while in soybean herbicides Monsanto's 3-percent market share made it a fringe firm in that market. Resale price maintenance seems to have appealed more to small fringe firms than to the large firms that might be expected to have had an interest in "stabilized prices."

The ease with which the only two anticompetitive scenarios can be dismissed allows us to rule out any potential for an anticompetitive effect from the use of RPM by Monsanto and should have been enough to dismiss the case under a rule-of-reason analysis. But both Monsanto and the DOJ argued that the available facts in *Monsanto* not only demonstrate the absence of the necessary conditions for an anticompetitive effort but also provide considerable positive evidence that Monsanto's vertical practices were procompetitive and beneficial to consumers.

The most dramatic evidence is the very large increase in Monsanto's share of the market between 1968 and 1972, from 15 percent to 28 percent in corn herbicide and from 3 percent to 19 percent in soybean herbicide. With much of those increases coming at the expense of the leading firms, concentration fell significantly in both markets.<sup>28</sup> Unfortunately, we do not know how much of the increase in Monsanto's market shares to ascribe to Monsanto's introduction of its "third-generation" herbicide, LASSO, in 1969.

Monsanto could also point to a significant fall in the relative prices of its products. Between 1967 and 1979, while an index of Monsanto herbicide prices rose by 23 percent, prices of all agricultural chemicals increased by 53 percent, the CPI rose by 119 percent, and the overall indexes of prices received and paid by American farmers rose by 147 percent and 149 percent, respectively. Again, however, little if any of this fall in Monsanto's relative prices could be ascribed to Monsanto's new distribution policies. A number of critical patents expired after 1975—notably Geigy's Atrazine patent in 1976 and AmChem's Amibem patent in 1978—and some price cutting to deter postexpiration entry was expected by 1972.

Both Monsanto and the DOJ as amicus argued that the relevant model was Telser's "free-riding on special services" model. Indeed, Monsanto appeared to provide almost a textbook example of the free-rider scenario: a complex product, where the provision of complete and accurate presale information is crucial, sold by a discounting broker. Curiously, however, to this author's knowledge no evidence was ever presented of

<sup>27</sup>One Monsanto document reported that "Stauffer, DuPont, and Elanco have sold on a Fair Trade policy. Elanco [the division of Eli Lilly that produced Treflan] dropped Fair Trade in about 1968." (Monsanto's Corn/Soybean Product Area Business Plan 1970–1975. Plaintiff's exhibit 13a.) Of these three, only Treflan accounted for a sizable market share.

<sup>28</sup>The HHI fell from over 5125 to over 3488 in corn herbicides, and from over 2822 to over 1886 in soybean herbicides.

even one uninformed farmer or dealer who had been educated in the benefits of Monsanto's product by a full-service distributor and who then purchased Monsanto herbicides from Spray-Rite at discount prices. Perhaps there were instances of such postservice but presale switching, but Monsanto decided not to introduce them at trial for fear of emphasizing the pricing aspects. Thus, while the standard free-riding story cannot be entirely dismissed because we cannot be certain that no significant postservice/presale switching occurred, it seems dubious at best.

What does emerge clearly is Monsanto's concern that Spray-Rite was selling too little rather than too much and in particular was refusing to attract new, smaller customers in its area of primary responsibility. Monsanto's criteria for renewal, its partial vertical integration into distribution, its shipping policies, and its complex pricing and payment system for distributors all point to a concern with the intensive margin and a concerted effort to increase Monsanto's market share by pushing distributors to develop new customers and expand purchases by past customers.

Why was this necessary? Why could not Monsanto simply establish a wholesale price and sell to anyone interested in buying? Why could Monsanto not rely on competitive downstream distributors and dealers to make the same decisions Monsanto would have if it were vertically integrated and controlled those decisions directly? In other words, why did the price system fail? The usual reason given is Telser's free-riding story. But the free-riding story does not fit this particular set of facts very well.

The concern with and attempts to influence decisions by competitive downstream firms appears almost ubiquitous among manufacturers who have "market power" or even just a differentiated product, even if presale services are not priced separately or are easily free-ridable. This points to a much broader market failure than free-riding. Simply put, whenever an input or intermediate product is sold at a price above marginal cost, an inefficiency can arise because socially incorrect information and commands are being provided to the downstream market. There is a considerable literature on the effects of upstream pricing above marginal cost when market power is also exercised independently downstream. Such "successive monopoly" conditions give rise to incentives for vertical integration or for partial forms of vertical control such as setting maximum resale prices. The result is an increase in joint profits and a decrease in prices to consumers. Thus, vertical control under successive monopoly conditions is unambiguously socially beneficial.<sup>29</sup> In addition, even when the downstream stage is competitive, if the monopolized input can be used in variable proportions with competitively supplied inputs, the upstream firm has an incentive to integrate vertically (or use other vertical practices, such as tying arrangements) to control the input proportions decision.<sup>30</sup> In these models, the competitively

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<sup>29</sup>For a review of that literature, see Warren-Boulton (1978).

<sup>30</sup>See Vernon and Graham (1971), Hay (1973), Schmalensee (1973), Warren-Boulton (1974, 1978), Mallela and Nahato (1980), and Westfield (1981).

supplied inputs and the monopolized inputs are net substitutes, and the upstream firm's problem is that when it sets its price above its marginal cost, independent downstream firms are induced to use too much of the competitive inputs relative to monopolized inputs.

In the manufacturer-distributor context, however, inputs provided at successive stages appear to be net complements. When the manufacturer of a differentiated good sets the wholesale price above marginal cost, the independent distributor or retailer will "underprovide" complementary downstream services, whether those services are shelf space for breakfast cereal or blue jeans, or complete inventories and presale information to customers in the case of agricultural herbicides.

The manufacturer has several alternatives. First, it can vertically integrate downstream into retailing and provide those enhanced services directly. Second, it can establish complex nonlinear pricing and subsidy schedules that raise the return to the dealer at the margin without raising the average dealer return (i.e., lower the inframarginal return and raise the marginal return). Third, it can make an all-or-nothing offer: Either the dealer provides specific services (e.g., to small herbicide customers in its area of primary responsibility) that would not be profitable by themselves to the dealer, or the dealer is terminated. Of course, the threat to terminate is meaningful only if termination would preclude profitable sales to other customers—perhaps that dealer's share of large and well-informed herbicide users in the dealer's area of primary responsibility, to whom large sales can be made at relatively low cost and at resale margins protected by the manufacturer through threats of dealer termination.<sup>31</sup> All three strategies have the same effect, and Monsanto appears to have tried all three, searching for the most effective and least-cost combination.

Whichever form or combination of forms of vertical control is used to achieve the manufacturer's goal, both consumer and total welfare from such an expansion of downstream services would appear to be substantially greater. Even in the short run, the manufacturer and marginal consumers clearly gain, while, given the endogeneity of the wholesale prices, inframarginal consumers—the large and well-informed purchasers—may gain or lose. The effects seem to be analogous to first-degree price discrimination. In the long run, given the *ex ante* competitive conditions that are likely to prevail at the research and development stage, any increase in potential manufacturer profits will be dissipated in the form of additional expenditure on research and development, leading to a large number and variety of such products.

This is a far cry from a practice that invariably has a pernicious effect on competition and lacks any redeeming competitive virtue for which the rule of *per se* illegality was intended. Clearly, in the history of antitrust cases brought against anticompetitive practices, *Monsanto*, and, almost

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<sup>31</sup>See Klein and Murphy (1988).

without exception all cases involving resale price restraints unilaterally imposed by a manufacturer, are false positives.

Unfortunately, while the first and the second strategies are generally legal by themselves, under legal current doctrine attempting the third can expose a manufacturer to the possibility of very large penalties. This is a triumph of form over function.

The uncertainty and arbitrariness of such a legalistic distinction between price and nonprice forms of vertical control have imposed large transaction costs on society, including the legal costs of the many manufacturer-dealer contract disputes transformed into RPM cases. But the major cost must be the cost of acts committed and the forgone benefits of acts not undertaken by those threatened by such sanctions. In the former category is a bias toward nonprice forms of vertical control, such as vertical integration—surely a paradoxical result of a legal standard apparently motivated in part by a political desire to protect small business. In the latter category are the downstream services not provided and the output not produced and sold or perhaps not even developed.

## THE LEGACY OF MONSANTO

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In *Monsanto*, a jury found sufficient evidence to conclude that Monsanto had been conducting an illegal RPM program, and the Court of Appeals and then the Supreme Court both affirmed. The plaintiff won, and RPM continued to be condemned as a per se violation of Section 1 of the Sherman Act. Yet, ironically, *Monsanto* has come to be considered a substantial victory for the defendant's bar.

This paradoxical outcome stems from the standard of proof that the Supreme Court enunciated in its opinion: "Permitting an agreement to be inferred merely from the existence of complaints, or even from the fact that termination came about 'in response to' complaints, could deter or penalize perfectly legitimate conduct. . . . Thus, something more than evidence of complaints is needed."<sup>32</sup> The Court found enough "more" in *Monsanto* to affirm the jury's conclusion, but the standard itself tightened the criteria that had been used by the Court of Appeals. In addition, subsequent to the decision a number of dealer termination cases, in which RPM allegations were based largely or solely on evidence of complaints followed by termination, were dropped by the plaintiffs. And in 1988 the Supreme Court in *Sharp*<sup>33</sup> extended even further the evidentiary burden on plaintiffs in RPM cases.<sup>34</sup>

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<sup>32</sup>465 U.S. 752, 763, 764 (1984).

<sup>33</sup>*Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988).

<sup>34</sup>*Sharp* held that termination of a dealer following complaints about such dealer's pricing is not per se illegal absent evidence that the manufacturer and the nonterminated distributor agreed to set or maintain prices at a specific level.

The decade following *Sharp* was a relatively quiet one for antitrust policy with respect to RPM. Despite congressional expressions of displeasure with the Supreme Court's tightening of the evidentiary burdens on plaintiffs in *Monsanto* and *Sharp*, no legislation overturning these decisions was ever passed.

In 1997, however, the Supreme Court reversed course with respect to *maximum* RPM. In *State Oil Co.*<sup>35</sup> the Court unanimously declared that maximum RPM should be judged under a rule-of-reason standard, overturning the per se standard for maximum RPM that it had established in the 1968 *Albrecht* case.<sup>36</sup> Though the Court indicated that this decision did not change its per se rule for minimum RPM, this new flexibility shown by the Court may eventually inspire it to revisit the RPM question more broadly and adopt a broader rule-of-reason approach.

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<sup>35</sup>*State Oil Co. v. Khan*, 66 L.W. 4001 (1997).

<sup>36</sup>*Albrecht v. Harold*, 390 U.S. 145 (1968). A number of amicus briefs in *State Oil Co.* (including a joint brief by the DOJ and the FTC) urged the Court to adopt a "rule of reason" standard for maximum RPM; opposing amicus briefs urged the court to maintain its per se standard even for these cases (apparently fearing that this might be an opening wedge for the Court eventually to apply a rule of reason standard in all RPM cases).

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