

## 14. Automobile Dealing and Organizational Structure

### *Review of the Theory Of Organization*

Organizational structure responds to transactions costs. On the one hand, shirking is a problem. Shirking is reduced by organizational forms such as independent business units that directly link managerial efficiency and residual profitability. Shirking increases as the organizational structure moves toward complete vertical integration. On the other hand, misalignment of incentives is a transactions costs that operates in the opposite direction. Vertical integration is a way to solve incentive misalignments, while independent business units foster opportunistic behavior. The competitive conditions observed in the marketplace are the result of balancing the relative costs and benefits along this spectrum of organizational forms. The middle ground between complete vertical integration and independent business units is littered with organizational hybrids such as franchise contracts and vertical restraints in the dealing relationship.

The economics of vertical restraints, which includes resale price maintenance, exclusive territories, exclusive dealing, full-line forcing, tying contracts, franchise termination, etc., has received a lot of attention in the past decade or so.<sup>1</sup> The theory in varying degrees of detail links most of these arrangements to a production and distribution process in which the manufacturer attempts to compel its distributors to supply services to customers that enhance the value of the product.<sup>2</sup> The problem is one where these services will not be provided by the distributor based on its own self interest in selling the product of the manufacturer. Because of this, the manufacturer must condition its contracts with distributors to overcome this misalignment of incentives. All of the vertical restraints listed above can reasonably come into play in forming an efficient contract.

Contracting problems arise from the inability of the manufacturer to write a well specified, perfectly enforceable contract that identifies the pre- and post-sale activities the dealer should undertake on the manufacturer's behalf. In the classic example examined by Telser, consumers free ride on the special services provided at one dealership by taking advantage of discount prices offered at another. Contracting costs also result from the fact that these sales activities have differential effects across consumers. Some consumers are more sensitive to promotional activities and service after the sale than others. This encourages some dealers to cream the demand pool, skimming off the promotion-insensitive, informed buyers.

The underlying incentive misalignment is that the manufacturer wants its product marketed in a way that increases overall sales. The seller, however, finds that it can at times increase profits by reducing the supply of these sales inputs. Klein and Murphy argue that the problem revolves around the marketing arrangement between the manufacturer and its dealers.

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<sup>1</sup> Without doing justice to the insights in their contributions a partial list includes: Smith (1982), Marvel (1982), Fisher (1985), Klein and Saft (1985), Marvel and McCafferty (1985), Norton (1988), Sass and Gisser (1989), Brickley, Dark, and Weisbach (1991a & b), Kaufman and LaFontaine (1994).

<sup>2</sup> The manufacturer chooses a dealing relation over integrated production-distribution because independence efficiently minimizes the shirking problem. In the most basic case, the manufacturer's products have a local market so limited that exclusive dealers cannot make a living. See Sass and Gisser. In this case, integration would require that the manufacturer become a conglomerate, multiline production-retailing enterprise.

Consider the case of shelf space. The manufacturer compensates its dealers for the promotional expense of shelf space by giving dealers a high mark up. That is, the manufacturer wholesales the product at a relatively low dealer cost compared to the suggested retail price. By means of this high wholesale markup, the retailer can afford to turn the inventory less often compared to other products of similar retail price. However, the low wholesale price makes discounting the product attractive. Any one seller in this circumstance has an incentive to attract all the informed buyers by cutting the retail price while the other retailers wait on the unsure consumers to make up their minds. Left without a "fair share" of the informed buyers, the full-price retailers cannot support the shelf space. To keep the shelf space at the full-price stores, the manufacturer has to further lower its wholesale price. But this only exacerbates the problem.<sup>3</sup>

#### *A Note on Exclusive Territories*

In addition and as a complement to RPM, manufacturers can use exclusive territories to create efficient distribution networks. Exclusive territories can act like RPM in restricting free riding by cut rate operations on the sales efforts provided by full service stores.<sup>4</sup> With an exclusive territory on a particular product, a retailer can discriminate between customers needing full service and those who know what they want right away.

Producers have a large array of distribution schemes for their products. One decision involves the choice of using exclusive agents or independent jobbers. A producer selling through independent jobbers has its product hawked along with the products of others. The other products distributed by the jobber may or may not be competitive. For instance, most candy is distributed by independent jobbers and is sold along with competitive lines of other manufacturers. On the other hand, independent insurance agents sell different lines of insurance by different underwriters. However, one independent agent will generally handle only one brand of commercial property and casualty, one brand of homeowners, etc.

Producers whose products are sold by independent distributors must be concerned with "bait & switch" behavior on the part of these agents. Suppose that the producer spends money on advertising that gets the consumer in the door. Once there, the agent can sell the customer a different product at a lower price but higher markup. The agent thereby expropriates the value of the advertising of the producer. Where both advertising by the producer and sales effort by the jobber are important, the producer will be at risk. Exclusive agents are a solution.

One extreme of dealing with exclusive agents is the case of franchising. Generally the franchisee is an exclusive agent, that is, it does not handle the products of others even non-competing lines. Moreover, the arguments that we developed as an explanation for franchising are all very similar to the arguments for exclusive dealing.

Exclusive territories usually occur along with exclusive dealing in order to insure that the agent that agrees to only deal in the goods of one producer will have sufficient business to make a living. This is arguably the case for insurance agents of the big, exclusive dealing underwriters like

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<sup>3</sup> Klein and Murphy use the example of *Monsanto Co. v. Spray-Rite Service Corp.* 465 U.S. 752 (1984) as a case of a dealer cream-skimming heterogeneous buyers.

<sup>4</sup> Marvel, Howard P. "Exclusive Dealing," *The Journal of Law & Economics*, April 1982, pp. 1-26. Sass, Tim R., and Gisser, Micha. "Agency Cost, Firm Size, and Exclusive Dealing," *The Journal of Law & Economics*, October 1989, pp. 381-400.

State Farm. Gisser and Sass claim that whenever a company is large enough to support an exclusive agent network, it will do so.

### *The Coors Case*

Before the courts stepped in Coors practiced exclusive territories and maximum resale price maintenance among its distributors and minimum resale price maintenance for retailers. It also had distribution termination clauses of five days notice with cause and thirty days without.

Coors beer is nonpasteurized and requires refrigeration from the point of bottling to consumption. Exclusive territories allow distributors to receive an extra profit that they must pay for up front in a franchise fee. They lose this profit flow if they are terminated.

Maximum RPM is a way of stopping the distributor from charging a monopoly price, which it could as a consequence of the exclusive territory. Coors has already decided on the right price and does not want the distributor to reduce sales further. Reducing sales by raising price reduces the revenues flowing to Coors while increasing the profits of the distributor.

Exclusive territories are an efficient mechanism for insuring that the beer is handled correctly at the distribution level but not at the retail level. Minimum RPM is the more efficient device there. Since retailer cannot compete on price, they can only compete on quality which means stock rotation and handling.

### **The Special Case of Automobile Dealing**

Klein and Murphy specifically discuss the case of automobile dealing. They make two points. First, they claim that automobile manufacturers restrict distribution of cars in order to create a dealership network that is larger than the one that would exist in the absence of the manufacturer's intervention. That is, there are supply-side forces in distribution that dictate active oversight of the dealership network by the manufacturer. Second, they claim that manufacturers intervene because of the existence of special-services considerations. This is the manufacturer's demand-side interest. Automobile consumers demand pre- and post-sale service. The manufacturer has an interest in providing these to the consumer.

Klein and Murphy argue that there are substantial economies of scale in selling cars. For one thing, more inventory makes it easier to close any sale. Consumers on the verge of making a purchase can be pushed over the line by providing them with the exact dimensions they desire. If they really want it in red, that's what it takes to make the sale. A large dealership can provide variety for its salespeople at low cost. The large dealership is likely to get both the red demander and the white not just one or the other. Carrying both colors is not redundant, excess inventory. Sales commissions per car are lower. Salespeople sell more per contact hour with customers. Arguably, there are economies of scale in other aspects of the business as well.

Competition translates economies of scale into lower prices. However, the lower prices offered by large automobile discounters create a distribution problem for the manufacturer. Large, relatively remote dealers free ride on the pre- and post-sale services provided by small, more proximate dealers. Warranty work, general maintenance and service, and show-room display are all necessary elements of automobile retailing, and they are all things for which proximity is valuable to the consumer.

It is reasonable to suppose that the abundant display of automobile models to Sunday drivers, stopping by the local car dealership to see what is available, is an important advertising medium for the manufacturer. It is also believable that consumers having found a model to their liking then purchase the car from a distant, discount dealer. The large, relatively remote dealer is free riding on the cars displayed on the local lot.

Consider general maintenance. Automobile purchasers want to be able to have their car serviced when necessary. Proximity of the service facility is valuable; this is the advantage of a local dealership. Even so, car buyers will not necessarily feel compelled to buy from the local dealer. Here, again, they can enjoy the low price afforded by a remote discounter and still take advantage of the local service.

Warranty work is similar and poses an even more serious problem for the manufacturer. In terms of general repairs, the local dealer charges a fee for services provided. For this type of maintenance, the local dealer will probably be willing to accept all customers demanding service. Industry insiders commonly claim that dealership service departments are highly profitable. There may be too few local dealers without manufacturer intervention to limit discount dealing. However, the local dealers that do exist will satisfy the special-services requirements of car purchasers in regard to routine maintenance and owner-compensated repairs. With warranty work, "It ain't necessarily so."

Manufacturers warrant their products against failure of certain systems. When a system fails, the manufacturer promises to provide repair. There are several ways in which this can be done. Most commonly, this warranty work is provided by a dealer.<sup>5</sup> The manufacturer can compensate the dealer for this effort by directly paying the dealer for the repairs. However, the manufacturer faces a knife's edge when it does this. If the manufacturer pays the dealer too little for the work, the dealer has no incentive to do it. If the manufacturer over compensates the dealer, the dealer will fake repairs. Of course, the manufacturer can monitor the warranty work provided by the dealer, but this can never be done perfectly or cheaply. The problems are legendary.<sup>6</sup>

The alternative to paying dealers directly for warranty work is to lower the wholesale price of the autos. In many ways this is a better marketing scheme except for the fact that the manufacturer wants its dealers to provide warranty work for all its car owners, not just the ones who buy from the dealership.

Warranty work paid for by wholesale margin is a doubly big incentive misalignment between the automobile manufacturer and its dealers. No dealer has a perfect incentive to provide warranty work for customers other than the ones who are likely to buy a new car from that dealer. Moreover, the part of the wholesale markup that goes to compensate warranty work is fuel to fire

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<sup>5</sup> There has been some experimentation with satellite service centers operated by dealers away from their car lots. Presumably, this allows the advantages of large selling operations and provides the breath of service outlets sought by the manufacturer. Charles M. Thomas, "Searching For More Profits: Dealers Experiment With Satellite Centers to Make Service Visits More Convenient," *Automotive News*, September 7, 1992, p. 20.

<sup>6</sup> One of our graduate students was a specialist in warranty work for Ford. He went to work for a local dealer and filed warranty repair claims with Ford that recovered over \$250,000 for the dealership in a six month period. These were claims that the dealer had simply written off because the filing process was too complicated. Most of the claims were soon to expire, that is, Ford would not honor them even if filed correctly. Of course, Ford took notice of such an increase in approved claims and audited the dealership's warranty records. The dealership sustained the audit, but one wonders how they are doing now as their warranty specialist moved away.

the growth of large discount dealers.<sup>7</sup> These large, relatively remote dealers free ride on the provision of warranty work that is afforded by the smaller, local dealers.

To solve the agency problems in warranty work recompense and to supply required maintenance, routine repair service, and promotional display of their vehicles to uninformed buyers, manufacturers have an incentive to provide a larger network of dealerships than would develop in the case of unfettered competition among sellers of their product. For this reason manufacturers have an incentive to increase the number of car dealers.

To succeed in this they must somehow restrict the natural forces of competition among their dealers that would otherwise work to drive smaller dealers out of business. Resale price maintenance is one contracting mechanism that could possibly be used to thwart the competitive forces that drive the dealership network toward a few, large, discount automobile dealers.<sup>8</sup> But as Klein and Murphy point out, an alternative scheme is to limit the distribution of cars. Dealers cannot grow large if they do not have the cars to put on the lot. The manufacturer can by fiat increase the number of dealers simply by distributing its cars more widely and by sanctioning cross shipping.

The main tenant in the Klein and Murphy argument is that a viable dealership network depends on the fact that dealerships receive a quasi-rent stream that bonds their behavior in providing the special services desired by the manufacturer. When applied to automobile dealing, there is an additional element to the argument. Manufacturers use high markup and limit the production of automobiles below the level demanded by their largest dealers in order to generate quasi-rents. They reallocate some cars (on which quasi-rents are earned) away from the largest dealers to the smaller ones in order to keep marginal dealers in business. They do this so that these marginal dealers can supply warranty work and other special services in proximate location to car buyers.

### *Legal Background*

The organizational structure of automobile retailing has been the focus of numerous studies analyzing the manufacturer-dealer relationship.<sup>9</sup> That automobile dealing is not vertically integrated with manufacturing seems reasonably to result from the fact that dealer independence efficiently controls shirking. However, the contracting problems associated with the attempt to correctly align the incentives of the manufacturer and the independent dealers has long been an arena of legal confrontation between dealers and manufacturers.<sup>10</sup>

A common dispute is the complaint by dealers that the manufacturer will not send them enough of the right kind of cars. This point was made emphatically by Honda's experience when executives of American Honda Motor Co. were caught taking kickbacks from dealers to ship cars

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<sup>7</sup> Not all of the wholesale markup goes to recompense warranty work. Moreover, the full cost of warranty work is not paid by wholesale margin. Manufacturers use both wholesale price and direct payment schemes to compensate dealers for the warranty work they provide.

<sup>8</sup> Klein and Murphy question its efficiency in this application because of the idiosyncratic dealing with each buyer that seems to be a large part of the automobile selling process. They suggest as is amplified later in the text, that limitations on distribution is a more potent tool.

<sup>9</sup> C. M. Hewitt, *Automobile Franchise Agreement* (1956). B. P. Pashigian, *The Distribution of Automobiles: An Economic Analysis of the Franchise System* (1961). L. J. White, *The Automobile Industry since 1945* (1971).

<sup>10</sup> Every state now has some law limiting the arrangement that can be entered into between automobile manufacturers and their dealers. An excellent review of these issues is found in Smith (1982).

that the dealers would not have gotten under normal circumstances.<sup>11</sup> The bribery ring was uncovered because of a civil suit brought by one Honda dealer who alleged that he went out of business because he could not get cars while his cross-town rival did by means of payola.

The opportunity for Honda executives to extort kickbacks from dealers occurs because Honda leaves some the quasi-rents flowing from the sale of Honda motor cars with the dealers so that it is profitable to be a Honda dealer. The standard explanation for Honda's beneficence is that quasi-rents enjoyed by the dealers are a way of assuring their performance in promoting the brand name of the line.<sup>12</sup> The extension of this argument in regard to automobile distribution is that manufacturers value an expanded network of dealers. To achieve this, manufacturers restrict the number of cars they produce relative to the wholesale price they charge. The cars are valuable commodities. (This is evidenced by the kickback money paid to the American Honda executives for car allocations.) The manufacturer seeks to distribute these quasi-rents in a way that expands the dealership network.

The Honda experience does not necessarily demonstrate Honda's interest in an expanded dealership network except to the extent that the Honda dealers who paid the kickbacks would not have gotten the cars without paying. In other words, if the dealers paying the bribes would have gotten the cars anyway, the executives were simply extorting quasi-rents from those dealers. On the other hand, if the dealers that received the cars would not have gotten them anyway, then the executives were expropriating quasi-rents from the dealers for whom the cars were intended but who did not receive them. There is some evidence supporting this latter view. Only 30 to 40 of the 550 Honda dealerships were involved in the kickback schemes.<sup>13</sup> Also, the dealer who originally exposed the extortion did so because he claimed he was not getting car allotments originally promised him. Numerous lawsuits have followed the criminal convictions alleging that dealerships lost profits and in some cases went out of business because they did not get their "fair share" of cars.<sup>14</sup>

At the same time that manufacturers restrict the number of cars that they send to some dealers, they retain the right to send cars at will to dealers. Toyota has been the object of numerous lawsuits that allege Toyota both underships and overships cars to its dealers. A major legal dispute is on-going between the southeast regional Toyota distributor and its dealers. One of the points of dispute is that the distributor will not send cars to dealerships that request them. Another point is that the southeast distributor forces dealers to take cars under threat of opening new dealerships nearby. The issue is more than misalignment of incentives between Toyota and its

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<sup>11</sup> See Lindsey Chappell "Web of Shame at Honda," *Automotive News*, March 21, 1994, p. 1, and John O'Dell, "2 Ex-American Honda Executives Convicted," *Los Angeles Times*, June 2, 1995, Orange Co. Ed., p. D1. Charges brought against executives and some dealers allege that kickbacks were paid by dealers to American Honda executives for automobile allotments, dealerships, and phony advertising campaigns. Some of the defendants claimed that Honda Motor Co. of Japan knew about and thereby sanctioned the kickbacks, but no sworn testimony of complicity was presented into evidence.

<sup>12</sup> In recent empirical work, Kaufman and LaFontaine show evidence that McDonald's passes along substantial quasi-rents to its franchisees. However, the Honda case is itself dramatic evidence that Honda Motor Co. intended for there to be substantial quasi-rents enjoyed by its franchisees.

<sup>13</sup> According to statements by Assistant U.S. Atty. Michael J. Connolly who prosecuted the case. See Greg Johnson, "8 Officials Plead Guilty in Honda Bribery Case," *Los Angeles Times*, March 15, 1994, Orange Co. ed., p. A1.

<sup>14</sup> Don Lee, "Ex-Honda Dealer Sues Company Alleging Fraud," *Los Angeles Times*, June 8, 1995, Orange Co. ed., p. D1.

southeast distributor. This same point has been the focus of other law suits between Toyota itself and dealers in regions where Toyota distributes directly to its dealers.<sup>15</sup>

In their attempt to control the breadth of their dealership networks, manufacturers have run afoul of antitrust laws. In the court record in these cases manufacturers have defended their behavior by claiming that vertical restraints are necessary to achieve an optimal dealership network. The basic legal hurdle has been the Sherman Act.<sup>16</sup> The act prohibits concerted action in restraint of trade and the vertical restrictions employed by automobile manufacturers often give that appearance. Sanctions imposed by the manufacturer on one of its dealers result from the interplay among many dealers in the network. Hence, the actions of the manufacturer appear to be and often are the result of the combined decision making of the manufacturer and a group of dealers. In fact, there is no reported case where an aggrieved dealer suffered adverse unilateral action on the part of the manufacturer; there has always been some indication that other dealers encouraged or actually carried out objectionable acts. However, the issue of the sufficient conditions for combined actions on the part of the manufacturer and some dealers against other dealers is in flux.<sup>17</sup>

The application of the Sherman Act hinges on whether the manufacturer's actions in attempting to control its distribution system are considered a *per se* violation. If *per se*, the auto manufacturer is prevented from arguing that its actions promote inter-brand competition and, hence, should be allowed even though they seem to restrict intra-brand competition. A landmark case in this regard is *U.S. v. General Motors*.<sup>18</sup>

In *General Motors*, the court found that GM pressured its dealers to stop selling cars to discounters. Store-front discounters in Los Angeles sold cars at prices well below the full-service dealers in the area. The discounters obtained their cars by cross shipments from remote dealers—dealers outside of the Los Angeles market. The discounters had no stock and would only buy a car for resale after a customer placed an order. The discounters carried no inventory and performed no warranty work. Hence, they were free riding on display, service, warranty work of local dealers by means of the cross-shipping arrangement with remote dealers.

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<sup>15</sup> See Patrick Lee, "Distribution Dispute Pits Magnate Against Toyota," Los Angeles Times, July 11, 1990 p. D1; Lindsay Chappell, "Storm Gather Over Moran Empire: Lawsuits Allege Independent Toyota Distributor Wrecked Dealers," Automobile News, August 12, 1991 p. 1; Warren Brown, "Carmaker to Cut Out Middleman: Toyota Plans to Sell to Area Dealerships," The Washington Post, June 29, 1990, p. 1; Charles M. Thomas, "Jury Slams Toyota Over Allocations," Automotive News, January 22, 1990, p. 1; David Versical, "Toyota: Official Get Earful: Better Distribution, Floorplan Assistance," Automotive News, February 1990, p. 68; Helen Kahn, "Dealerships Investor Sues Southeast Toyota," Automotive News, July 29, 1991, p. 22; Lindsay Chappell, "Several Toyota Dealers Battle Southern Giant," Automotive News, December 2, 1991, p. 4; Helen Kahn, "Dealers Claim Toyota Distributor Caused Store's Demise," Automotive News, June 10, 1991, p. 24; Lindsay Chappell, "Ex-dealer Asks State to Banish SE Toyota," Automotive News, October 7, 1991, p.3; Lindsay Chappell, "Toyota Distributor Pleads Case to Dealer," Automotive News, August 26, 1991, p. 4; Edward Lapham, "Toyota Supports Distribution," Automotive News, November 4, 1991, p. 49; Dorn M. Cobbledick, "State Franchise laws May Backfire on Dealers," Automotive News, September 28, 1992, p. 14.

<sup>16</sup> Sherman Antitrust Act Sec. 1, 15 U.S.C. sec. 1.

<sup>17</sup> Unilateral action by a manufacturer is not actionable; *United States v. Colgate*, 250 U.S. 300 (1919). Moreover, complaints from other dealers, followed by a manufacturer's termination of the transgressing dealership, without more, is insufficient as a matter of law to show a combination or conspiracy; *Monsanto v. Spray-Rite Corp.*, 465 U.S. 752 (1984).

<sup>18</sup> 384 U.S. 127 (1966).

The local dealers, understandably annoyed, encouraged GM to stop the cross-shipping and thereby put the store-front discounters out of business. The local full-service dealers met and agreed to petition GM to revoke the franchises of the cross shippers because of a violation of the locational clause in their contracts. Local dealers accompanied GM to meetings with the cross shippers. After what were apparently strong-arm tactics by GM, the discounting stopped.

In analyzing the suit, the Supreme Court specifically refused to consider whether the locational clause in the dealers' franchise contracts was valid.<sup>19</sup> Nor did the Court consider whether GM's interest in stopping the discounting was pro-competitive vis-à-vis other brands of cars. The Court held that:

We have here a classic conspiracy in restraint of trade: joint, collaborative action by dealers, the appellee associations, and General Motors to eliminate a class of competitors by terminating business dealings between them and a minority of Chevrolet dealers and to deprive franchised dealers of their freedom to deal through discounters if they so choose.<sup>20</sup>

The Court went on to conclude that “[e]limination, by joint collaborative action, of discounters from access to the market is a *per se* violation of the [Sherman] Act.”<sup>21</sup>

It is clear that GM was interested in preserving its dispersed dealership network in order to promote inter-brand competition. Discounters, who provide no showroom, no pre-sale prep, and no warranty work, free ride on the efforts of the full-service dealers. Even so, the court ruled that its hands were tied because of the *per se* nature of the case against GM in sanctioning remote dealers supplying the Los Angeles store-fronters. The elements of this case that made it a *per se* violation are that 1) it was designated a horizontal conspiracy and 2) it involved the elimination of certain traders from the market.<sup>22</sup>

The horizontal nature of the actions in *General Motors* was immoderate. GM was slow to react to the harm done to its full-service Los Angeles dealers by the discounters. This prompted the concerted action of the full-service dealers. Even though these dealers had little ability to compel the cross shippers, once they became actively engaged in attempting to limit their behavior, the action became horizontal, which is a virtual Rubicon on the road to a *per se* violation of Sherman. On the other hand, the court has not been overly strict in defining the sufficient conditions for horizontal combinations. In *Spray-Rite* the court ruled that a manufacturer's termination of a transgressing dealership prompted by nothing other than complaints from other dealers does not constitute a combination or conspiracy between the manufacturer and the other dealers.<sup>23</sup> Thus, the termination itself is a vertical rather than horizontal restraint. This view has been reinforced in other decisions discussed below.

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<sup>19</sup> The Court stated “[w]e need not reach these questions concerning the meaning, effect, or validity of the ‘location clause’ or any other provision in the Dealer Selling Agreement, and we do not.” *U.S. v. General Motors*, 384 U.S. at 139.

<sup>20</sup> *Id.* at 140.

<sup>21</sup> *Id.* at 145.

<sup>22</sup> The Court held that “[e]limination by joint collaborative action of discounters from access to the market is a *per se* violation of the Act.” 384 U.S. at 145. The Court went on to conclude that the discounters lowered price, and the eliminating the discounters indirectly increased price. *Id.* at 147.

<sup>23</sup> *Op. cit.* note 17. In *Spray-Rite*, the Court emphasized two key distinctions. First, is there a concerted or independent action. Independent action is not proscribed. Second, is there concerted action to set price or only non-price restrictions. If the action is directed at price, then *per se* analysis applies; if non-price, then rule of reason is employed. *Id.* at 761.

Generally non-price vertical restraints are subject to the rule of reason.<sup>24</sup> When a manufacturer's efforts in controlling the tendency of the dealership network to become highly concentrated are couched in terms of vertical and non-price restraints, then the court can consider whether the whole scheme is actually pro-competitive on an inter-brand level. The court seems willing to accept that an auto manufacturer's product allocation scheme is a non-price restraint. In *National Auto Brokers*, the Court held that the plaintiff had the burden to show that GM's allocation scheme, as a non-price vertical restraint, was unreasonable.<sup>25</sup> The plaintiff sued GM and some of its dealers alleging violation of the Sherman Act based on the assertion that the defendants refused to sell cars to National Auto Brokers (Nabcor). Nabcor was organized as a large brokerage system that would seek customer orders for cars and then attempt to buy the cars from dealers at a deep discount. Nabcor would seek to buy the cars from the dealers' fleet allotments. Nabcor carried no inventory, had no store fronts, and provided no service. The trial court directed a verdict for the defendants. The appellate court upheld on the grounds that the plaintiff had failed to prove that the defendants acted in concert, and even if they had and the allotment of cars available to Nabcor was restricted, that conduct was not shown to violate the rule of reason. The Court appealed to long standing precedent by citing language from *Chicago Board of Trade*, which held that the reasonableness of the conduct must be judged by its holistic effects on competition.<sup>26</sup>

Manufacturers must have a way to allocate their cars. A scheme used by Subaru in deciding how to distribute to its regional distributors is called the "earned share system." In *Jim Forno*, the district court held that the earned share system applied by the distributor to the dealers was a non-price, vertical restraint subject to analysis under rule of reason in spite of the fact that there was some evidence that the dealer-distributor scheme was "informal and subject to abuse."<sup>27</sup> In this case, a dealer sued the manufacturer and regional distributor for misapplication of cars based on false sales reports. The earned share system allowed for cars to be allocated based first on unfilled customer orders and then on turnover. The plaintiff argued that the distributor allowed some dealers to falsify sales reports to earn a higher share.<sup>28</sup> In spite of this, the court held that the earned share system was a reasonable method of allocation.

GM has used numerous systems to control automobile allocation including: 1) limiting the allocations to the discount dealers "based on some measure of market potential in the dealer's Area of Primary Responsibility"; 2) limiting allocation based on "dealer's facilities"; and 3) limiting sales to the dealer's "Area of Primary Responsibility".<sup>29</sup> These policies have been the

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<sup>24</sup> *Continental T.V., Inc. v. Sylvania, Inc.*, 433 U.S. 36 (1977).

<sup>25</sup> *National Auto Brokers v. General Motors Corp.* 572 F.2d 953 (2nd Cir. 1978) cert. den. 439 U.S. 1072 (1978). The appeals court cited *Continental T.V., Inc. v. Sylvania, Inc.*, 433 U.S. 36 (1977), that held that non-price vertical restraints were subject to the rule of reason approach.

<sup>26</sup> *National Auto Brokers* citing *Chicago Board of Trade v. United States*, 246 U.S. 231 (1918). The court held that the plaintiff had the burden "to show GM's distribution system was unreasonable in view of 'the facts peculiar to the business to which the restraint is applied; the conditions before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable.' "

<sup>27</sup> *Jim Forno's Continental Motor, Inc. v. Subaru Distributors Corp.*, 649 F.Supp. 746 at 748 (N.D.N.Y. 1986).

<sup>28</sup> The fact that the dealer-distributor scheme was informal and subject to abuse relative to the manufacturer-distributor earned share system is another instance where quasi-rents that the manufacturer intended to go to smaller, more dispersed dealerships were diverted.

<sup>29</sup> *Lovett v. General Motors Corp.*, 769 F. Supp. 1506 at 1512 (D. Minn. 1991). The term "Area of Primary Responsibility" (APR) will be discussed below.

subject of much litigation. In one series of cases, GM's allocation of cars was the center piece of the dispute.<sup>30</sup> There the GM-dealer relationship was described as follows:

Dealer Sales and Service Agreements govern the relationship between GM and each of its dealers. Under the agreements, GM assigns dealers an area of primary responsibility (APR) for the purpose of evaluating performance. Dealers agree to sell and service product lines effectively and to promote new vehicle sales in their APR's through their own advertising and sales promotions. Dealers must maintain an adequate sales force and provide presale information to consumers. Dealers can sell to any customer, located anywhere, at any price, but must service GM vehicles regardless of where they were purchased. For its part, GM agrees to distribute vehicles in a fair and equitable manner and to explain its distribution method to dealers. GM has final discretion on accepting orders and distributing vehicles. One factor that affects distribution is sales potential in a dealer's APR.<sup>31</sup>

In *John Peterson Motors*, the plaintiff claimed that its practice of selling cars for \$49.00 over invoice caused other GM dealers to convince GM to reduce the Plaintiff's supply of cars. GM admitted to reducing Plaintiff's supply of cars based on Plaintiff's \$49.00 over invoice strategy. The issues were 1) whether GM's actions should be judged by a *per se* or rule of reason standard and 2) if the rule of reason applied, whether the allocation strategy of GM was reasonable.

The first question hinges on whether the combination was horizontal or vertical. The trial court decided that the defendants' acts were primarily horizontal because the agreement reached was among competitors, with GM merely becoming involved in the conspiracy later.<sup>32</sup> Since the trial court concluded that the agreement was horizontal, the trial court applied a *per se* approach.

The Court of Appeals dismissed and held that the alleged agreement was vertical. Accordingly, GM's allocation strategy was evaluated under the rule of reason approach. The Court concluded that GM's action was a non-price vertical restraint because it was an effort of a manufacturer to control its dealers and not an effort by other competitors to eliminate competition. In light of *National Auto Brokers*, the plaintiff in *John Peterson Motors* had the burden of showing GM's allocation system was unreasonable. This the plaintiff did not do, and GM successfully asserted that its allocation system was reasonable and pro-competitive on an inter-brand level.

GM's defense was well rooted in the theory that a broad dealership network that can provide pre- and post-sale service is most beneficial to GM. The Court summarized GM's argument:

GM asserts that [John Peterson Motors'] "\$49.00 over" plan conflicts sharply with its marketing strategy. GM believes that it is in its pro-competitive interest to establish a network of local businesses which can provide potential customers convenient access to sales and service. GM asserts that the nature of cars and trucks as costly, complex, mobile products requires larger capital investment at the retail level, sophisticated pre- and post-sale servicing, promotion and consumer education. Accordingly, it states that the number, location, and size of the dealerships are determined by analysis of each

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<sup>30</sup> *John Peterson Motors v. General Motors* 613 F. Supp. 887 (D. Minn. 1985). This first District Court case spawned a number of subsequent cases: *Lovett v. General Motors Corp.*, 769 F. Supp. 1506 (D. Minn. 1991), *Lovett v. General Motors Corp.*, 975 F.2d 518 (8th Cir. 1992); and *Lovett v. General Motors Corp.*, 998 F.2d 575 (8th Cir. 1993) cert. den. 114 S.Ct. 1058 (1993). In the subsequent cases, Lovett was John Peterson Motors' trustee in bankruptcy.

<sup>31</sup> *Lovett v. General Motors Corp.*, 998 F.2d 575 (8th Cir. 1993)

<sup>32</sup> *Lovett v. General Motors Corp.*, 796 F. Supp. 1506 at 1517 (D. Minn. 1991). See also, *Arnold Pontiac GMC, Inc. v. General Motors Corp.*, 700 F. Supp. 838 (W.D. Pa. 1988).

marketing area, and that it allocates vehicles produced at its factories among its dealers to accomplish its overall marketing strategy. GM asserts that JPM, with its “\$49.00 over” strategy, takes a “free ride” on the full service dealer’s service, promotion, and marketing expenditures.<sup>33</sup>

The Court of Appeals went on to state that:

[t]he availability and quality of service and repair affect a manufacturer’s goodwill and the competitiveness of the manufacturer’s product. Accordingly a manufacturer can take action against a price-cutting dealer without fear of antitrust liability if the action is the product of the manufacturer’s independent decision that the price-cutting dealer undermines the well-being of the manufacturer’s dealer network, even though the manufacturer learns about the price-cutting dealer’s behavior from dealers whose principal or perhaps only concern is with protecting their prices.<sup>34</sup>

The theory of organization discussed in the previous section argues that GM was correct about the pro-competitive effects of a broad dealership network, and the court agreed.

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<sup>33</sup> John Peterson Motors, Inc. v. General Motors Corp., 613 F.Supp. 887 at 890 (D. Minn 1985).

<sup>34</sup> Lovett v. General Motors Corp., 998 F.2d 575 at 578 (8th Cir. 1993).

