Territorialization -- A Reconsideration on the Case of Sealy

Che-peng Lin*

(Received Jan., 1999. Accepted Aug., 1999)

ABSTRACT

Some modern enterprises manage their organizations through contract-type restraints to obtain synergetic advantages and to increase their operation efficiency. However, the arguments of applying these restraints such as exclusive sales (manufacture) territory are controversial. The debate of this issue among previous literatures focused on whether these contract-type restraints will increase consumers' welfare or become a monopoly power. Starting with reviewing a US legal process- the case of Sealy, Inc., this paper substantiates how the illegality of exclusive territory provisions will eventually increase the social costs and negatively impact the economy. It is argued that, in the long run, the restrictions on intrabrand competition among licensees will generate merits to protect free-riding problems and to ensure brand name quality. As a result, the increased interbrand competition among enterprises will bring consumers' welfare towards maximization.

It is suggested that enterprises in other countries such as Taiwan should evaluate their business structures and contract-type restraints from various aspects, in order to promote their overall competitiveness in the long run.

Keywords: Exclusive Territory, Vertical Integration, Contract-type Restraints, Industrial Organization, Management Structure

1. INTRODUCTION

Among those law cases regarding the legality of exclusive geographic territories, the case of a mattress company - Sealy, Inc., is controversial.[1] In 1986, two Sealy licensees: Ohio-Sealy and Michigan-Sealy sued Sealy, Inc. On June 13, 1986, the jury gave a verdict in favor of the plaintiffs and awarded trebled damages approximately $75 and $45 million to Ohio-Sealy and Michigan-Sealy respectively to compensate their potential

---

*Associate Professor, Dept. of Finance, Feng Chia University, Taichung, Taiwan.
The author thanks Professor William Shughart II and two anonymous referees for their helpful comments.

HyWeb

loss under Sealy's territorialization strategy. The issue of this case was surrounded by the arguments of consumer welfare maximization. Sealy, Inc. lost its case under the situation that there was no supportive "rebuttal" to the plaintiffs' evidence. Professor George Stigler, a Chicago School economist who served as an economic expert for Sealy (the defendant), commented that "..eventually, it was all going to have some very dire consequences for both Sealy and the consuming public...".[2] In this paper, I would like to give more thoughts about what the "dire" consequences will be. Will the consumers face these "dire" consequences eventually, or they will benefit from the intrabrand competition after exclusive territories are eliminated. The organization of this paper is as follows. Section 1 introduces the motivation behind this paper. Section 2 describes the background of the Sealy case. Previous litigation process regarding Sealy, the lawsuit between Sealy and Ohio-Sealy and the plaintiffs' evidence/arguments are presented. Section 3 gives reconsideration to the plaintiffs' arguments. Section 4 concludes.

2. BACKGROUND

2.1 Previous Litigation Process regarding Sealy

Sealy Mattress Company, known as Sealy, Inc., was first sued by Federal Trade Commission (FTC) in 1948. The case ended up with the FTC's approval of exclusive sales territories for Sealy in developing its business. In 1964, Judge Austin again approved exclusive sales territories for Sealy. However, this decision was reversed by the Supreme Court in the year of 1967.

As a result, exclusive sales territories were prohibited. But, according to the understanding of Sealy, Inc., some other restraints between Sealy, Inc. and its licensees were conditionally approved. They included: (1) the passover payment, (2) the warranty-repair charge, (3) a board which consists of Sealy licensees, (4) the plant-location provision, (5) the exclusive "manufacturing" (not sales) territory and, (6) the right of first refusal. In here, we may notice that even though the exclusive sales territories were prohibited, the exclusive "manufacturing" territories were allowed from Sealy's perception. This was why the Ohio-Sealy claimed that Sealy, Inc. was "getting around" the Supreme Court's decision during the litigation.

On April 2, 1975, Ohio-Sealy filed a lawsuit against Sealy and there was a jury verdict. According to Sealy's explanation, the jury made no determination. This explanation was not agreed by Ohio-Sealy. On January 18, 1977,[3] Judge Parsons made a decision. This decision was explained

HyWeb

by Ohio-Sealy as: the Judge "did not grant any equitable relief". But on the other hand, was explained by Sealy as: he "approved a bunch of things".[4] In October of 1978, its controversial situation brought the argument to the 7th Circuit Court of Appeals. In May of 1979, Sealy voluntarily eliminated three restraints.[5] On September 11, 1979, Mr. Howard Hass of Sealy, Inc. wrote a letter to Ohio-Sealy. He mentioned that Sealy would invalidate the contract which prohibited Ohio-Sealy to acquire non-Sealy plants. In May of 1980, Ohio-Sealy bought Pacifica to develop Ohio-Sealy's business in the west coast.

2.2 The Lawsuit between Sealy and Ohio-Sealy

Ohio-Sealy became a Sealy licensee in 1924 and is one of the largest mattress company in the world currently. In 1950s, in planning to expand its business outside of its assigned territory, Ohio-Sealy once marketed Form-Rite mattresses - a non-Sealy brand mattress. The business of Form-Rite was disapproved by the other Sealy licensees and was cut out later due to the decision of an arbitration. To continue the attempt of business expansion, Ohio-Sealy changed its strategy and bought a Sealy license in Browning, Texas, a plant in Puerto Rico and a Sealy plant in Ft. Worth, Texas during the period of 1956 to 1967. However, its efforts in acquiring the other Sealy licensees in the 1960s and 1970s (either before or after the jury verdict in 1975) were hindered by Sealy Inc. which exercised the right of first refusal based upon a "12% rule".[6] In 1979, the Sealy, Inc. eliminated the prohibition for Ohio-Sealy in acquiring a non-Sealy mattress company, Pacifica.[7] However, from Ohio-Sealy's view point, this elimination still implied a distortion of equal competition. Ohio-Sealy claimed that mattress business needs a brand name but Pacifica was a "no-name" mattress company. In the lawsuit against Sealy, Ohio-Sealy argued that these 'unreasonable' restraints disabled itself to develop its business and to compete effectively in the market, especially in the west coast. As a result, the total sales and profits of Ohio-Sealy were decreased. Consumers who lived in the west coast paid higher prices to buy Sealy mattresses. Ohio-Sealy emphasized the importance of 'intrabrand competition' which may increase the welfare of both Ohio-Sealy and the consumers.

This case was heard in court based on the rule of reason.[8] Different from other manufacturer/distributor cases, every Sealy licensee was not simply a distributor but also a manufacturer and had the capacity to produce Sealy mattress under Sealy's restraints. This licensee's manufacturing power complicated the situation when the most 'powerful' Sealy licensee- Ohio-Sealy

HyWeb

tried to expand its own business outside its assigned territory.

Ohio-Sealy was not satisfied with the right of first refusal and the exclusive-manufacturing-territory restraints set by Sealy. Believed by Ohio-Sealy, these restraints made it incapable to compete effectively. Mattress industry was a local business. The transportation costs would be increased if Ohio-Sealy was not allowed to acquire other Sealy licensee/plants or to produce Sealy mattresses by using non-Sealy plant outside its territory. According to Ohio-Sealy, the invalidity of this exclusive manufacturing territory would enhance the intrabrand competition and, consequently, increase the consumers' welfare.

2.3 Plaintiffs' Evidence

The court/jury made their decision in favor of the plaintiffs based upon the evidence provided by Dr. Willard Mueller [9] who served as the economic expert for Ohio-Sealy in this case. The evidence was described as "unassailable evidence" on "Sealy's dramatic surge" in output under intrabrand competition.[10] Here, the evidence provided by Ohio-Sealy regarding how the consumers' welfare could have been increased during a certain time period is presented.

2.3.1 The Quantitative Data

The quantitative data provided by the plaintiffs was observed between the years 1976 and 1985.[11] The followings address the major points which disadvantaged Sealy's restraints.

(1) The mattress business was a local business. In the year 1983, 88% of the sales were made within 300 miles.

(2) The mattress industry was highly concentrated. In 1983, the top four brands occupied approximately 63% of the whole market.

(3) The mattress business is a brand business. According to the data in 1984, the estimate of the Sealy brand share of total mattress purchases in the LA area was 40%; in southern California and Portland area, the Sealy brand accounted for 19% and 23% of the total mattress purchases.

(4) Sealy made a lot of efforts to differentiate its products. By 1984, the advertising fee for Sealy was about 7.5 million dollars which represented 43% of the advertising expense for the whole mattress industry.

(5) The intrabrand competition could increase the sales performance and lowered the sale price.

a). After the year 1980, both out-of-area sales and out-of-area sales as a percent of total sales of Ohio-Sealy increased substantially.

b). The average out-of-area sales was 30% in the east and 7% and in the west for the year 1984. In northern California and Portland, there were no out-of-area sales in 1984. This indicated a complete shortage of intrabrand competition.

c). The other Sealy licensees retaliated against Ohio-Sealy by selling mattresses in Ohio-Sealy's territory with lower prices.

d). From 1980 to 1984, both 'within territory' and 'within plus out-of-area' sales for northern California and Portland areas (which represented the areas with no intrabrand competition) decreased 3%. While for Ohio-Sealy (whose business teritory represented the area with intrabrand competition), the 'within territory' sales increased 4% and the 'within plus out-of-area' sales increased 35%.

e). Between 1978 and 1984, the average price increment for northern California and Portland areas was much higher than the one in Phoenix which had 30% out-of-area sales in the year of 1984.

2.3.2 The Plaintiffs' Arguments

According to the above quantitative data, the plaintiffs' arguments can be summarized as followings:

First, the mattress business was a local business. It was possible that customers paid a higher price for a certain brand mattress because of the lack of intrabrand competition in that area. Therefore, policies that discouraged the local competition should not exist. For example, when Sealy applied its right of first refusal and rejected Ohio-Sealy to acquire other Sealy licensees, this action prevented Ohio-Sealy from attaining its economic scale and providing merchandises at lower prices to consumers who lived in other territories.

Secondly, the mattress industry was highly concentrated and lacked sufficient interbrand competition. The limitation on intrabrand competition made the mattress market remaining high concentration and impaired the consumers' welfare.

Third, Sealy mattresses were brand name products. Without intrabrand competition, local Sealy licensees would produce Sealy mattresses at low costs but still charge consumers relatively high prices.

In short, from plaintiffs' perception, Sealy's exclusive-manufacturing-territory and the right of first refusal clauses unreasonably restricted intrabrand competition. According to the 'evidence', intrabrand competition could have increased the consumers' welfare.

3.RECONSIDERATION

The 'evidence' provided by the plaintiffs

HyWeb

ignored some unforeseen effects which might negatively impact the overall consumers' welfare in the long run. The very issue here was: would the intrabrand competition eventually increase the consumers' welfare when the restraints applied on Ohio-Sealy were relaxed? To make a proper conclusion, "whether or not intrabrand competition is harmful should not be based only on evidence of price and quantity effects, especially when data are available only for a limited time horizon".[12] The following subsections state my reconsideration regarding the plaintiffs' arguments.

3.1 Potential Decline of Economic Efficiency

Sealy was a small mattress company in the beginning. In order to develop its mattress business, Sealy licensed various small manufacturers to produce Sealy mattresses under certain rules in the early 1920s. To meet Sealy's standards and specifications, the licensees were given exclusive territories in return. The licensees did their very best in developing the~~ir~~ own business and in selling Sealy mattresses within their pre-assigned territories. In order to enhance sales performance, different tasks such as establishing relationship with the local retailers, introducing Sealy's mattress to the local people and providing post-sale services were conducted by every licensee. This exclusive territory clause not only protected the local manufacturer's interest, but also served as a low-cost method to control free-riding problems and to maintain the quality of Sealy mattresses. Sealy had survived in the mattress industry since 1920 and became the No.1 mattress company. We should not ignore that the exclusive territory strategy had been economically efficient for Sealy Inc. to cope with the interbrand competition.

But, what about the lower prices and the intrabrand competition argued by Ohio-Sealy? Did consumers really benefit from intrabrand competition? For a certain time period, especially during the years when Ohio-Sealy free-rided other licensees' previous efforts,[13] the answer might be a yes. However, when all the licensees were lack of incentives in making efforts within their own specific territories, it would become harder for any Sealy licensee (including Ohio-Sealy) to develop business outside of its pre-assigned geographic area. That is, it would cost more for Ohio-Sealy (or any other licensee) to make out-of-area sales. These costs, such as doing its own sale analysis, developing local sale strategies for a particular area, establishing relationship with the local retailers/customers and etc.; would reduce Sealy's overall economic efficiency and impair their ability to compete with other brands eventually. In the long run, the lack of economic

HyWeb

efficiency caused by the intrabrand competition will undermine its interbrand competition.

3.2 Interbrand and Intrabrand Competition

Generally, consumers' welfare is enhanced by competition among manufacturers. In this case, the plaintiffs argued that the introduction of intrabrand competition enhanced consumers' welfare. Their argument was supported by a series of quantitative evidence. However, it was the interbrand competition benefited the consumers' welfare but not the intrabrand competition. The economic theories indicate that while the vertical restraints reduce/eliminate intrabrand competition, they generally promote interbrand competition. The real competition for Sealy should be with other brands like Simmons, Serta, ...etc. It is true that this intrabrand competition lowered the price of Sealy mattress at a short period of time, but the ability of Sealy as a whole to compete with other brands in mattress industry would be affected negatively. The mattress business was already a highly concentrated industry as reported by the plaintiffs. Whether the consumers' welfare would be enhanced through introbrand competition was questioned when Sealy lost its interbrand competitiveness and the mattress industry became more concentrated. Introducing intrabrand competition at the expense of loosing interbrand competition, from my view point, was not a wise decision.

3.3 Free-riding Problem

In his early paper, Telser [14] pointed out that a free riding problem will arise when there is no restraint on intrabrand competition. In the Sealy's case, there could be two major concerns. First, the quality of Sealy trademark was maintained through the exclusive territory policy. That is, when territory restraints were applied, every Sealy licensee had to meet certain standards in producing Sealy mattresses and then received exclusive territory in return. The right to sell Sealy brand merchandises effectively controlled the quality of Sealy mattresses. Without the restraint, some Sealy licensees may manufacture degraded or poorer quality mattresses at lower costs.

In this case, Ohio-Sealy could have free-rided on other Sealy licensees' previous efforts after exclusive sales territory restraint was relaxed. The plaintiff claimed that intrabrand competition increases the sales for both Ohio-Sealy and other Sealy's licensees for the years between 1976 to 1985 when exclusive sales territory was eliminated. They further showed a substantial growth on Ohio-Sealy's sales performance after the year 1980. However, as mentioned by

HyWeb

Eckard [5], this evidence did not firmly support Ohio-Sealy's arguments that the subtantial growth was completely generated from the relaxation of the exclusive 'sales' territories.

Exclusive territory protection had given Sealy licensees the motivation to make efforts (e.g. pre- and post-sale services) in developing their business within their own territories since 1920s. After the exclusive 'sales' restraint was relieved, Ohio-Sealy came in the market with lower prices and free-rided on the efforts of other Sealy licensees who had contributed to the mattress market in the previous years.

Ohio-Sealy was the world's largest mattress company. With its economic scale, it was able to offer relative low prices to local retailers and 'grabbed' the business originally belonged to the other licensee of that territory. This free-riding action was the cause of the substantial sales growth of Ohio-Sealy during 1980 to 1984 when Ohio-Sealy aggressively developed its out-of-area sales after Judge Parsons' order. To decide whether consumers' welfare is enhanced, the unforeseen negative effects generated from free riding should be carefully measured. The sales growth of Ohio-Sealy after only few years of relaxing restrictions did not sufficiently prove the merits of intrabrand competition.

3.4 Comparison Based on Different Time Periods

The plaintiffs showed quantitative sales data based on the years during 1980-1984. Although a comparison of sales performance for the periods before and after the introduction of intrabrand competition was presented, it was a problematic comparison. The growth of sales performance could be accounted for by various factors including the economic cycle and so forth. The total sale performance of Sealy might be still outstanding without the elimination of exclusive sale territory constraint. It would be fairer if the plaintiff could estimate sales performance for the years from 1980 to 1984 under the situation that the exclusive sales territory restraint was not eliminated, and then compare the estimation with the sales performance when the constraint was out.

Furthermore, the evidence provided by the plaintiffs only described the situation during the years from 1976 to 1985. This historical record could not guarantee the intrabrand competition would eventually advance the consumer welfare in the long run.

3.5 Potential Problem of Excess Capacity

Without the protection of exclusive

HyWeb

territories, Sealy licensees would have been forced to compete in the market out of his territory. These licensees had to make estimation about their new rivals. This enhances the possibility that extra plants will be built and excessive mattresses will be produced. The overall social costs thus increased. From the view of a whole economy, the increase of social costs would decrease the consumers' welfare.

3.6 Influence on Future Management Decision

The final verdict of the Sealy case has an impact on the economy as a whole. In the Sylvania case, it was decided that the non-price vertical restraints would be judged on the rule of reason case by case.[14] In the Sealy case, non-price vertical restraints such as the exclusive territory and the right of first refusal were prohibited. This verdict discouraged other corporations to conduct economically efficient restraints. In order to avoid litigation costs, corporate decisions might be limited to less efficient choices. The invisible loss of economic efficiency among various types of industries followed by the Sealy case may be one of the "dire consequences" inferred by Dr. Stigler.[15]

4. CONCLUSION

The Sealy case in 1986, as mentioned in the first part of this paper, was in favor of the plaintiffs. The jury's verdict was made based upon a set of quantitative evidence. The evidence provided by the plaintiffs seemed to be explicit and convincing. However, the determination of consumer welfare maximization is difficult and implicit. In this paper, I argue that those quantitative data did not sufficiently support the conclusion that intrabrand competition would maximize consumers' welfare in the long run. To a contrary, interbrand competition may be damaged by the increased intrabrand competition and the consumers' welfare will be impaired eventually.

The prosperity of Ohio-Sealy from 1980 to 1984 should not be attributed only to the intrabrand competition. It was highly possible that this substantial growth came from Ohio-Sealy's free-riding on other licensees' previous efforts. Besides, other economic factors might have contributed to its total sales growth.

It was a problematic method to compare the sales performance by separating the periods into 'before' and 'after' the introduction of intrabrand competition. An estimation of the sales performance under exclusive sale territory restraint for the period 1980-1984 was not provided, which biased the jury's decision.

Non-quantitative effects were not considered carefully in this case. The

HyWeb

merits of exclusive territory restraints were ignored. These restraints were designed originally by Sealy with considerations of economic efficiency. They possibly promote the interbrand competition and enhance the consumers' welfare in the long run.

The final verdict of the jury prevented other business entities from future utilization of non-price vertical restraints. To avoid potential litigation problem, firms will channel themselves into a situation with less efficient choices. This would retard the economic efficiency as a whole. As a matter of fact, recent studies indicate that exclusive territories have a 'commitment value' (see Alexander and Reiffen [1]) and when these contracts are applied on some specific industries, they 'increase demand and enhance welfare by stimulating the provision of dealer services.' (see Sass and Saurman [12]).

In summary, the benefit of intrabrand competition in the long run is still controversial. The determination of what really maximizes consumers' welfare needs to be considered from many different aspects. Unfortunately, the present legal system has to make that decision with limited available evidence. This paper presents the Sealy case in the States, and proposes possibilities that the illegality of the exclusive territory provisions will eventually increase the social costs and generate negative impacts on the economy in the long run. It is hoped that, through the reconsideration of this Sealy case, enterprises in other countries such as Taiwan will carefully evaluate their business structures and contract-type restraints, in order to maintain their overall competitiveness in the long run.

HyWeb

FOOTNOTES

1 Ohio-Sealy et al. v. Sealy, Inc., Civ. No. 76C810 et al., U.S. District Court, Northern District of Illinois, Eastern Division (Chicago).

2 Antitrust Law and Economics Review (1989) Vol.21, No.1, P.5.

3 In the Federal District Court in Chicago.

4 Antitrust Law and Economics Review (1989) Vol.21, No.1, P.22 and P.54. Judge Parsons said: "I decline to enjoin the use of its operation, the exclusive manufacturing territories provision. The exclusive manufacturing territory provision prevents excess capacity from occurring in such area. I am convinced that to permit a licensee a total unconstrained right to develop manufacturing plants anywhere throughout the country it chooses is tantamount to permitting it to appropriate to itself the property of the licensor".

5 These are: passover payments, warranty repair charge, and the plant location clause.

6 Antitrust Law and Economics Review (1989) Vol.21, No.1, P.39.

7 A non-Sealy plant located in San Diego.

8 After the Continental TV v. GTE Sylvania, 433U.S.36 (1977) case, the current rule is that non-price vertical restraints will be judged under the rule of reason.

9 Antitrust Law and Economic Review (1989) Vol.21, No.1, P.61.

10 Ibid., P.5.

11 Ibid., P.61-94.

12 Ibid., P.5.

13 See Subsection 3.3 for further discussions on the free-riding problem.

14 See Footnote 8.

15 See Introduction Section and Footnote 2.

HyWeb

REFERENCES

[1] Alexander, C. R. and Reiffen, D. (1995), "Vertical Contracts as Strategic Commitments: How Are They Enforced?" Journal of Economics and Management Strategy, 4, 4, pp.623-649.

[2] Asch, P. (1970), Economic Theory and the Antitrust Dilemma, John Wiley & Sons, Inc.

[3] Blair, R. D. and Kaserman, D. L. (1985), Antitrust Economics. Richard D. Irwin, Inc., Homewood, IL 60430.

[4] Brace, F. F. (1989), "Closed Territories and People Who Won't Obey The Law," Antitrust Law and Economics Review, 21, 1, pp.9-26.

[5] Eckard, W. E. Jr. (1994), "An Empirical Test of the Free Rider and Market Power Hypotheses: A Comment," Review of Economics and Statistics, 76, 3, pp.586-589.

[6] Grieson, R. E. (1986), Antitrust and Regulation, Lexington Books, D.C. Heath and Company, Lexington, MA.

[7] Joslin, R. D. (1989), "Free-Riding and Licensee Insurrection: The Plan To Capture Sealy," Antitrust Law and Economics Review, 21, 1, pp.33-48.

[8] Kamien, M. I. (1989), "Product Differentiation and Market Definition: Sealy's Submarket and The 30% Higher Price," Antitrust Law and Economics Review, 21, 1, pp.95-110.

[9] Monz, J. (1991), Industrial Organization, Economics and the Law, The MIT Press, Cambridge, MA.

[10] Mueller, W. F. (1989), "Intrabrand and Interbrand Competition in the'Brand' Industries: The Sealy Case (II)," Antitrust Law and Economics Review (1989), Vol.21, No.1,pp.61-94.

[11] Mueller, W. F. and Geithman, F. E. (1991), "An Empirical Test of the Free Rider and Market Power Hypotheses," Review of Economics and Statistics, 73, 2,pp.301-308.

[12] Sass, T. R. and Saurman, D. S. (1996), "Efficiency Effects of Exclusive Territories: Evidence from the Indiana Beer Market," Economic Inquiry, 34, 3, pp.597-615.

[13] Shughart, W. F. II (1990), The Organization of Industry, Irwin, Boston, MA 02116.

[14] Telser, L. G. (1960), "Why Should Manufactures Want Fair Trade?" Journal of Law and Economics, 3, pp.86-105.

[15] Webb, D. K. (1989), "Territorialization and Suppressed Price Competition: The Des Moines and Canada Sealy Violations," Antitrust Law and Economics Review, 21, 1, pp.27-32.

[16] Wildman, M. E. (1989), "Interbrand Competition and Product Quality: The Fight With Simmons and Serta," Antitrust Law and Economics Review, 21, 1, pp.49-60.

HyWeb