Leegin, the Use of RPM, and Antitrust Liability

by James F. Nieberding

THE SUPREME COURT'S DECISION in Leegin[1] has generated much commentary in the antitrust community as well as the general press.[2] In it, the Court overturned its previous decision in Dr. Miles,[3] a nearly 100-year-old rule, by holding that minimum resale price maintenance ("RPM") between a manufacturer and its downstream dealers/retailers ("distributors") now must be analyzed under the rule-of-reason standard, and no longer be judged as an automatic violation of the Sherman Antitrust Act. RPM, also known as "vertical minimum price fixing," refers to a manufacturer's commercial practice of controlling the downstream price of its merchandise. Now that RPM is to be evaluated using the rule-of-reason approach under federal antitrust laws, a court needs to balance the pro- and anti-competitive aspects of this pricing policy to determine, on a case-by-case basis, whether it unreasonably restricts competition. While *Leegin* brings the economic analysis of RPM into sync with other "non-price" vertical restraints used by manufacturers (e.g., territorial restrictions, exclusive dealing), it does not make RPM *per se* legal.[4] As noted by the *Leegin* Court, RPM can be abused by a powerful manufacturer or retailer, and may be anticompetitive under a rule-of-reason analysis if it facilitates horizontal collusion at either the manufacturer or distributor level, or enables a dominant firm (manufacturer or distributor) to abuse its market power.

The change in the legal treatment of RPM at the federal level presumably will provide manufacturers more flexibility to establish such agreements with distributors. However, several factors exist that likely will add to the uncertainty for businesses that adopt such pricing policies. For example, as some commentators have noted, *Leegin* does not necessarily change state law on RPM.[5] Duncan and Guernsey (2008) note that thirteen states may explicitly prohibit RPM under their own antitrust or consumer protection statutes (one of which is Ohio under the Valentine Act). Also, while the FTC and the DOJ argued in *Leegin* that the *per se* treatment of RPM should be abandoned in favor of a rule-of-reason approach,[6] thirty-seven state attorneys general (one of which was Ohio's AG) submitted an *amicus* brief urging the Court to maintain the *per se* prohibition against RPM.[7] In fact, the NAAG Vertical Restraint Guidelines, although published prior to *Leegin*, still call for treating RPM as *per se* illegal.[8] Moreover, on October 30, 2007, Senators Kohl (D-WI), Biden (D-DE), and Clinton (D-NY) introduced the Discount Pricing Consumer Protection Act (S.B. 226). The stated goal of this legislation is to "correct the Supreme Court's mistaken interpretation of the Sherman Act in the *Leegin* decision."[9] Last, the Court in *Leegin* offered little practical guidance for implementing the new treatment of RPM, and recognizes that case law in this regard needs to be developed.

The Business Justification for Leegin to Impose RPM

The *Leegin* decision came from a dispute between Leegin Creative Products, Inc., a California firm that designs and manufacturers women's accessories under the Brighton® brand name, and PSKS, owner of the retail shop Kay's Kloset in Flower Mound, Texas. In 1997, Leegin entered into an RPM agreement with its downstream retailers by instituting the "Brighton Retail Pricing and Promotion Policy" under which Leegin refused to sell to retailers that discounted Brighton® goods below suggested prices. When Leegin terminated Kay's as a retailer for its apparent violation of the RPM agreement, PSKS sued Leegin for illegal price fixing. The jury, under the *Dr. Miles' per se* rule against RPM, awarded PSKS \$3.6 million in damages and \$375,000 in attorney fees. The 5th U.S. Circuit Court of Appeals affirmed which the Supreme Court reversed. As discussed below, the Court's decision in Leegin acknowledged that the law regarding RPM needed to reflect modern economic analysis. Specifically, the Court recognized that manufacturers (such as Leegin), through the use of RPM, have an interest in creating property rights for retailers to combat "retailer free riding" due to the provision of costly pre-sale services, as well as for reasons related to "quality certification,"

> Leegin adopted the policy to give its retailers sufficient margins to provide customers the service central to its distribution strategy. It also expressed concern that discounting harmed Brighton's brand image and reputation.[10]

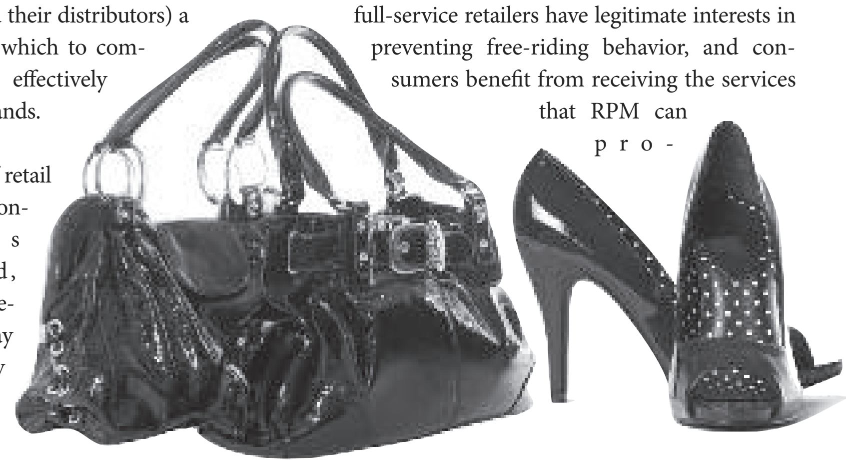
Many upstream manufacturers (like Leegin) distribute their merchandise through a network of independent downstream retailers. Such manufacturers want their retailers to exert maximal sales effort to promote and sell their products. These efforts can take many forms depending on the merchandise being sold. For example, retailers selling high-end branded consumer goods (e.g., clothing, electronics, patio furniture) often invest time and money to hire and train a knowledgeable sales staff, offer high-quality customer service both pre- and (perhaps) post-sale, provide an attractive venue stocked with quality merchandise, carry sufficient inventory, and conduct advertising. While these retailer services are intended to increase the demand for the manufacturer's merchandise, such pre-sale efforts and activities are costly to retailers. Retailers providing such services must recover these costs, generally through the markup over their wholesale cost. If competing retailers also sell the manufacturer's merchandise, but do not make available the same pre-sale efforts (thereby avoiding their costs), such discount retailers will be in a position to undersell full-service retailers.

Manufacturers generally encourage pre-sale efforts by their retailers to increase the demand for their products. However, a retailer's incentive to provide costly pre-sale services is undermined when a competing discount retailer (which may be internet-based) offers a lower price because it does not incur the costs associated with pre-sale services. The prospect of lower prices from such discount retailers entices consumers away from full-service retailers. As a result, retailers who choose to provide pre-sale services are exposed to the risk that consumers might acquire pertinent product knowledge at their stores, but then switch to a discounter for their final purchase. In other words, a no-frill retailer can "free ride" on the pre-sale efforts of full-service retailers. This retailer free-riding (also called "dealer free-riding") poses a problem for the manufacturer, as well as for retailers providing the pre-sales effort who are unable to retain those customers that their efforts have generated.[11]

Manufacturers have an interest in creating property rights for retailers that invest in value-added pre-sale services because manufacturers benefit from the resulting increase in demand for their products. By doing so, manufacturers encourage the provision of the optimal level of retailer pre-sale efforts on their behalf, while also allowing full-service retailers to internalize the benefit of their sales efforts in that lower-priced, free-riding retailers are precluded from appropriating their sales. One well-recognized method for controlling this retailer free-riding is RPM where a manufacturer sets a minimum price for retailers.[12] Since under such an agreement retailers may not compete on price, incentives are created for retailers to compete along non-price dimensions such as sales effort and customer service. Such a price policy channels competition among retailers toward sales effort which the manufacturer hopes will increase demand for their products, as well as addressing retailer free-riding. RPM used in this manner can increase the efficiency of distribution by giving manufacturers (via their distributors) a means with which to compete more effectively with rival brands.

Over time, if retail free-riding continues unchecked, full-service retailers may lose so many sales that they will no longer earn a sufficient return on their pre-sale investments, and will reduce (or eliminate) such activity. The risk to a manufacturer is that its retailer network will provide fewer of the demand-enhancing pre-sale services than is optimal (from the manufacturer's point of view). That is, to the extent that a retailer who promotes a given manufacturer's products cannot reap the full benefit of their promotional activity, the retailers will have an incentive to reduce those efforts to the detriment of the manufacturer. Because these retail services are demand-enhancing, a reduction in their level is harmful to the manufacturer. And since retailer free-riding reduces the incentive of retailers to promote the manufacturer's product, the manufacturer has an incentive to try to prevent this.

Economists and other antitrust practitioners recognize the pro-competitive aspect of RPM when it has the effect of inducing retailers to provide desired pre-sale services, as retailer free-riding can adversely affect competition by leading to sub-optimal levels of demand-enhancing efforts.[13] In the jargon of antitrust economics, the elimination of retailer free-riding allows the manufacturer to engage more effectively in "interbrand" competition by restricting "intrabrand" competition.[14] The effect of the increase in interbrand competition, due to the increased provision of desired retailer pre-sale efforts, tends to increase sales of the manufacturer's product. This increase in output is pro-competitive and will increase social welfare. Because manufacturers and full-service retailers have legitimate interests in preventing free-riding behavior, and consumers benefit from receiving the services that RPM can pro-



[1] *Leegin Creative Leather Products, Inc v PSKS, Inc.*, 127 S Ct 2705 (June 28, 2007), available at http://www.supremecourtus.gov/opinions/06pdf/06-480.pdf. The Court's decision was 5-4 with Justices Kennedy, Roberts, Scalia, Thomas and Alito in the majority; and Justices Breyer, Stevens, Souter and Ginsburg dissenting.

[2] See, e.g., Edward D. Cavanagh, "Vertical Price Restraints After Leegin, The Berkeley Electronic Press, available at http://works.bepress.com/edward_cavanagh/2 (2008); Marie L. Fiala & Scott A. Westrich, "*Leegin Creative Leather Products:* What Does the New Rule of Reason Mean for Resale Price Maintenance Claims?," Antitrust Source, available at http://www.abanet.org/antitrust/at-source/07/08/Aug07-Westrich8-6f.pdf (August 2007); Michael J. Lockerby, "Franchising After *Leegin*: A License to Fix Prices?," 27 Franchise L.J. 112 (Fall 2007), available at http://www.foley.com/files/tbl_s31Publications/FileUpload137/4410/Lockerby.pdf; and, "Price-Fixing Makes Comeback After Supreme Court Ruling," The Wall Street Journal, August 18, 2008, at A1.

[3] *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911). Eight years later in 1919, however, the Court provided a loophole via the *Colgate* doctrine whereby a manufacturer could refuse to do business with distributors who sold below a suggested retail price, provided there was no agreement with distributors about what those prices might be.

[4] A decade prior to *Leegin*, the Court reversed the *per se* ban on maximum RPM in *State Oil Co. v. Khan*, 522 U.S. 3 (1997). "Vertical restraints" refer to the variety of contracts, agreements, or understandings between a manufacturer and downstream distributors that specifies the ways in which the manufacturer and distributor can operate in marketing and selling the manufacturer's product. Vertical restraints can be used to address various problems that inhibit the efficient distribution of goods throughout a vertical supply chain, and can help align the incentives of manufacturers and their downstream distributors. In 1977, the Court overturned the *per se* rule for non-price vertical restraints. (Cont'l T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 57–59 (1977)).

[5] See, e.g., Richard A. Duncan and Alison K. Guernsey, "Waiting for the Other Shoe to Drop: Will State Courts Follow Leegin?" Franchise L. J., Volume 27, No. 3 (Winter 2008), available at http://www.faegre.com/pdf/pdf_35470.asp; and, M. Russell Wofford, Jr. & Kristen C. Limarzi, "The Reach of *Leegin*: Will the States Resuscitate Dr. Miles?," Antitrust Source (October 2007), available at http://www.abanet.org/antitrust/at-source/07/10/Oct07-Wofford10-18f.pdf.

mote, economists (and the courts) have been willing to accept reductions in intrabrand competition due to a vertical restraint where there is a corresponding increase in, or no effect on, interbrand competition.

In addition to ameliorating retailer free-riding with respect to pre-sale efforts, economists also recognize that RPM can be used to prevent free-riding among retailers on quality certification services. That is, a retailer by choosing to carry a particular manufacturer's product, may in effect certify the high quality of that product based on the retailer's – not the manufacturer's – reputation by cultivating its image as a "high-end" establishment. Consumers, believing that a certain retailer is high-end, depend on that retailer to certify the quality of the merchandise it carries. However, like in the provision of pre-sale services, it is costly for a retailer to cultivate and maintain a high-end profile. More importantly, quality certification services are subject to free-riding just as in the case of pre-sale services. That is, a discount (or internet) retailer can benefit by carrying the same merchandise as a high-end retailer but without making the same investments in quality certification. And, as with pre-sale services, discount (or internet) retailers will be in a position to undersell the high-end retailers as they did not incur the costs that quality certification entails.

The Uncertain Treatment of RPM in a Post-Leegin World

Antitrust authorities and the courts have used *Leegin* both to support and rebut the legality of RPM agreements. For example, on May 6, 2008, relying on *Leegin*, the FTC granted Nine West Group's request to permit it to enter into RPM agreements with its dealers, revising an existing FTC consent order against Nine West from doing so.[15] In another instance, citing to Leegin, the Third Circuit reversed a district court that had granted summary judgment in favor of a truck manufacturer (Mack Trucks) relating to an allegation by one of its truck dealers (Toledo Mack) of an illegal RPM practice.[16] Pertaining to state enforcement, Herman Miller, Inc. entered into a Consent Decree on March 21, 2008 with the attorneys general of New York, Michigan and Illinois to settle allegations that it had entered into illegal RPM agreements involving one of its products,[17] perhaps indicating that states will still aggressively pursue RPM agreements post-*Leegin*. And recently antitrust authorities have increased their efforts with respect to investigating whether manufacturers are engaging in minimum advertised price ("MAP") requirements that illegally prevent retailers from offering discounts.[18] In an effort to address post-*Leegin* uncertainty about the legality of RPM agreements, the FTC has announced a series of public workshops planned for early 2009 to explore the distinction between pro-and anti-competitive uses of RPM.[19] While the paucity of case law regarding the rule-of-reason treatment of RPM (and related practices like MAP) continues to provide manufacturers and their antitrust lawyers with imperfect guidance and uncertainty, the *Leegin* decision nonetheless has brought some economic sense to antitrust policy regarding this sales practice. ■

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[6] See http://www.ftc.gov/os/2007/01/070122Leegin06-480amicusPDC.pdf. FTC Commissioner Harbour has published a dissenting view (http://www.ftc.gov/speeches/harbour/070226verticalminimumpricefixing.pdf).

[7] See http://www.naag.org/assets/files/pdf/amici.leegin.states.pdf.

[8] See National Association of Attorneys General (NAAG), *Revisions to the National Association of Attorneys General Vertical Restraints Guidelines* (Mar. 26, 1995), available at http://www.naag.org/assets/files/pdf/at-vrest_guidelines.pdf.

[9] See http://www.govtrack.us/congress/bill.xpd?bill=s110-2261. This Bill remains before the Senate Judiciary Committee.

[10] 127 S.Ct. at 2707.

[11] Free riding is a problem because retailers generally are not compensated *separately* for their sales efforts. Instead, they are compensated for promoting a manufacturer's product only when they sell that product. For example, full-service retailers do not generally charge customers for services provided by showrooms even though consumers gain valuable information from them. Instead, they are compensated for expenses related to their showrooms when they make final sales to customers.

[12] Although there exists a variety of economic explanations as to why manufacturers might wish to impose vertical restraints such as RPM on retailers who sell their products, one which finds a great deal of support in the economics literature is that they can help combat retailer free-riding.

[13] See, e.g., the *amicus* brief in *Leegin* filed by numerous well-known economists arguing for the abolishment of the *per se* treatment of RPM, available at http://www.abanet.org/antitrust/at-committees/at-df/pdf/knowledge-database/economists-amicus-brief.pdf. See also, the ABA Section of Antitrust Law, Antitrust Law and Economics of Product Distribution, (2006), Chapter II ("Resale Pricing Issues"). The *Leegin* majority noted that the economic literature was "replete with procompetitive justifications" for the use of RPM. (127 S. Ct. at 2714-15.)

[14] Interbrand competition relates to competition between different manufacturers of a given product. Intrabrand competition refers to competition among multiple retailers selling a single manufacturer's product. The Court in *Leegin* emphasized this point ("The antitrust laws are designed primarily to protect interbrand competition from which lower prices can later result.").

[15] See http://www.ftc.gov/opa/2008/05/ninewest.shtm. As noted by the FTC, its modification does not affect the various agreements Nine West entered into with several states for violations of state antitrust laws.

[16] "A Key Decision On Resale Price-Fixing, Post-Leegin," Competition Law360, July 17, 2008.

[17] Herman Miller Press Release, March 25, 2008, at http://www.herman-miller.com/CDA/SSA/News/Story/0,1585,a7-c1181-n597,00.html

[18] See, e.g., "Instruments, Audio Gear Scrutinized in Price Probe," The Wall Street Journal, October 23, 2008, at B1.

[19] See http://www.ftc.gov/opa/2008/10/rpmwksp.shtm.