Resale Price Maintenance and the Rule of Reason

Howard P. Marvel

Wayne Woodrow (Woody) Hayes, the longtime football coach of The Ohio State University, famously maintained that "[t]here are three things that can happen when you pass, and two of them are bad." Hayes implemented his aphorism by relying heavily on running plays—his offense was widely known as "three yards and a cloud of dust." The aphorism remains true, but its relevance has declined steadily as football teams, including Ohio State, have come to rely more heavily on their passing games.

Woody's legendary intransigence cannot compare to the conservatism of a Supreme Court dealing with resale price maintenance (RPM). Economists have long recognized three possible effects of RPM, and, as with passing, two of them are bad. RPM can increase the efficiency of distribution and in so doing, it can afford suppliers a powerful tool with which to compete more effectively with rival brands, thereby stimulating interbrand competition. The two bad outcomes involve furthering a cartel, the first at the manufacturer level and the second among retailers. Manufacturer cartels may be facilitated when pass-through retail pricing makes cartel cheating at the supplier level more transparent. Alternatively, retailers may be in position to force a manufacturer to serve as the cat's paw of their cartel agreement.

The probabilities attached to each of these outcomes appear to be changing. Economists have posited an ever-widening set of conditions under which RPM can increase efficiency. The emergence of a panoply of discount retailers means that a supplier who shuns a retail cartel can expect to have available a number of distribution alternatives. The number of cases in which RPM can plausibly be alleged to have facilitated a manufacturer cartel can be counted on one's fingers. These changing assessments of the likelihood of good and bad outcomes yield the conclusion that it makes economic sense to finally convert the per se outcome of *Dr. Miles*[1] into a rule of reason treatment, as the Court did in *Leegin*.[2] No longer are firms subjected to a rule that Judge Richard Posner has characterized as a "sad mistake. There is neither theoretical basis, nor empirical support, for thinking the practice generally anticompetitive."[3]

The task at hand is now to predict how the post-*Leegin* rule of reason should and will be structured. The goal of that rule should be to permit efficiency-enhancing uses of RPM while simultaneously minimizing the damage from RPM used to facilitate either a manufacturer cartel or a dealer cartel. The Court has suggested screens that would help to remove a number of instances of RPM from consideration. But safe harbor screening leaves out the interesting cases in which either a dominant manufacturer employs RPM, a large retailer or a group of retailers insists on margin protection, or RPM is widespread among firms in a particular category. In such cases,

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1 Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

2 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 127 S. Ct. 2705 (2007).

3 Richard A. Posner, Antitrust Law 189 (2d ed. 2001).

the difficulty of obtaining evidence of the efficiency or anticompetitive effects of RPM means that the default rules incorporated in rule of reason assessments will shape case outcomes to an unusual degree.

A presumption that RPM is anticompetitive unless rebutted by a showing of efficiencies will not move the needle far from per se illegality, given the difficulties of conclusively proving efficiencies. In contrast, a default rule requiring proof of anticompetitive impact will also be tough to overcome, mostly because such anticompetitive outcomes appear to be rare. A rule between these polar defaults will be difficult to implement, as comparison periods with and without RPM are unlikely to be available. Indeed, when firms have agreed to drop RPM, the results for interbrand competition have ranged from troubling to disastrous. Without such comparisons, efficiency explanations for RPM run a significant risk of being dismissed as pretextual. If the problem of sorting uses of RPM according to their economic effects is tough, shortcuts can result in very inefficient outcomes. For example, we will see below that the states have continued to espouse an economically inappropriate price effects test.

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At the end of this article, I provide suggestions for dealing with the transition period between illegality and the emergence of an agreed-upon rule of reason framework.

Some Economic Preliminaries

The efficiency-enhancing uses of RPM have the effect of shifting the demand schedule for the product to the right—that is, if the price of the product to consumers remains the same as before, consumers increase the number of units they demand. But such demand promotion is costly. Retail margins, however, are protected from erosion by RPM. Thus as the demand schedule shifts right, the price of the product at retail will rise unless the manufacturer imposing RPM reduces its wholesale price by an offsetting amount. It is thus possible that the price of the product to consumers will rise as a result of RPM enforcement, even when no cartel is present.

This effect is no different than any other investment in demand shifting behavior. A firm that advertises to increase the demand for its products may be able to pass some portion of its advertising cost through to consumers in the form of higher prices. Similarly, a firm that invests heavily in R&D in hopes of improving its product may increase its price if consumers value the resulting improvement. These investments in increasing demand are the same as those of RPM used to increase the competitiveness of a firm's product relative to its rivals. Any of these sorts of increases in interbrand competition may yield higher prices.[4] The two cartel explanations for RPM have the same implication for prices. In each case, a cartel takes actions to increase prices, but since the demand schedule is unchanged, higher prices are coupled with lower volumes. The movement is along a given demand schedule, rather than a shift in demand, but note that the result for prices is indistinguishable from that resulting from efficiency-enhancing RPM. Prices will rise in consequence of a cartel, and may rise in response to RPM. This means that price changes have no value in sorting bad from good outcomes of RPM.

What distinguishes bad from good RPM? The answer is simple: the output effect. A cartel shrinks output, while efficiency-enhancing RPM increases it. Implementing the test is not so simple, as we will see below. In most cases, one would need to experiment with limiting RPM to dis-

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[4] Note that the possibility that prices "may" increase does not mean that retail prices must increase. The effects of RPM on prices will depend on the nature of the demand shift that higher margins elicit. The manufacturer may choose to offset the margin increase by lowering its wholesale price.

cover output effects, harming the brand capital of a manufacturer that was competing by protecting margins.

Nonetheless, simple economics provides the first component of a sensible—that is, economics-oriented—rule of reason for RPM. A trier of fact who sees that with RPM, prices rose, can conclude *nothing* about whether or not RPM was efficiency enhancing. If, in addition to a price increase, consumers bought more of the product, then the demand schedule for the product must have shifted out, and cartel explanations can therefore be rejected.

Previous Rules of Reason for Vertical Restraints

If the history of the treatment of past vertical restraints is a useful guide to forming predictions about the shape of the rule of reason in the post-*Leegin* world, it may pay to consider two previous evolutions from per se to rule of reason treatment for such restraints.

Non-Price Vertical Restraints. The antitrust treatment of non-price vertical restraints is a much compressed mirror of that of vertical price restraints. In 1963, no broad condemnation of non-price restraints was deemed appropriate because "too little was known about the competitive impact of such vertical limitations to warrant treating them as per se unlawful."[5] Apparently, however, this perceived lack of knowledge did not extend to those teaching or trained at Harvard. Within four years, the Court faced a similar challenge to exclusive territories in *Schwinn* and responded with a per se rule against the practice.[6] The arguments for imposition of per se status came from impeccable sources—the Assistant Attorney General for Antitrust, Donald Turner, supported a brief written by a young Harvard-trained lawyer in the Solicitor General's office, one Richard A. Posner. The Court thus was encouraged to endorse "then prevailing thinking of the economics profession [to bear] on restricted distribution."[7]

Posner, benefiting from remedial training at the University of Chicago, soon came to see the errors of the Harvard view, flaws well summarized by Oliver Williamson:

> Alas, what Turner and Posner took to be the then prevailing thinking of the economics profession was deeply confused. . . . [T]he prevailing thinking was self-limiting in three respects: (1) there was little appreciation for the possibility that product differentiation (as opposed to homogeneous product market exchange) might be the source of economic benefits, (2) there was even less appreciation for the possibility that the integrity of a distribution system could be compromised by subgoal pursuit among the parts (in this case, the individual franchisees), and (3) there was a preference for internal organization (hierarchy) over market organization (interfirm contract) if vertical restrictions, for whatever reason, were to be applied.[8]

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[5] State Oil Co. v. Khan, 522 U.S. 3, 11 (1997) (interpreting the result in White Motor Co. v. United States, 372 U.S. 253 (1963)).

[6] United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

[7] Richard A. Posner, Antitrust Law: An Economic Perspective 3 (1st ed. 1997), *quoted in* Oliver E. Williamson, *The Merger Guidelines of the U.S. Department of Justice—In Perspective*, http://www.usdoj.gov/atr/hmerger/11257.htm.

[8] *Id.* It is worth noting that the Harvard view that animated *Schwinn* was derived from the Structure-Conduct-Performance (SCP) view that was coming under strong attack from the Chicago School and elsewhere. Williamson reports that "Turner and Posner were confident that SCP thinking on which they relied for authority was entirely sufficient." It is interesting in this regard to note the extensive reliance of Justice Breyer's dissent in *Leegin* on the work of Professor F.M. Scherer, the author of the canonical treatment of that approach (F.M. Scherer & D. Ross, Industrial Market Structure and Economic Performance 558 (3d ed. 1990)). *Leegin*, 127 S. Ct. at 2729. Breyer also relies on a brief coauthored by Scherer, *see, e.g.*, *Leegin*, 127 S. Ct. at 2730; *see also* Brief for William S. Comanor and Frederic M. Scherer *as Amici Curiae*, Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S. Ct. 2705 (2007) (No. 06-480).

Nine years later, the Court fixed its error in *Sylvania*, returning to a rule of reason.[9] Some commentators argued that the *Sylvania* Court did not go far enough—that per se legality was appropriate.[10]

What happened? The answer is provided by the title of Douglas Ginsburg's catalog of post-*Sylvania* decisions, *Vertical Restraints: De Facto Legality Under the Rule of Reason*.[11] Not all non-price vertical restraints are, however, automatically legal.

The treatment of exclusive dealing is the principal exception to the strong presumption that non-price vertical restraints are efficiency enhancing. This exception is sensible, since other vertical restraints typically enable manufacturers to create property rights that protect promotional investments of dealers. More restrictive rights can harm the manufacturer's interest, thereby placing a check on the manufacturer's willingness to define and enforce the right. Exclusive dealing works similarly, but the promotion protected is the manufacturer's own, and the check to providing too expansive a property right is accordingly weaker.

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Maximum RPM: The Post-*Khan *Rule of Reason. Just as for exclusive territories after *Sylvania*, the rule of reason that has emerged for maximum RPM after *Khan* is essentially per se legality. This is sensible, for the harm done by a manufacturer that places a cap on resale prices is not likely to be large, and the benefits to the prevention of double marginalization by retailers can be substantial for consumers. For a rule of reason computation to yield a condemnation of maximum RPM, it would be necessary to have an example of an inefficient outcome arising from a manufacturer-enforced price cap. None has been forthcoming. Indeed, the most noteworthy aspect of the *Khan* decision is how long it took the Court to overturn *Albrecht*.[12]

Part of the reason for the dilatory response to *Albrecht* may have been the relative insignificance of maximum resale price maintenance. A Shepard's citation analysis of *Schwinn* yields twenty-nine decisions that followed the opinion, or approximately three per year for its effective life. In contrast, *Albrecht* was followed seventeen times, or slightly more than one time every two years. But once *Khan* was handed down, similarly to the *Sylvania* outcome, the emergent rule of reason has been virtually indistinguishable from per se legality. For instance, in *Mathias v. Daily News*,[13] in a complaint against a newspaper distribution system raising issues reminiscent of *Albrecht*, the defendant was granted summary judgment on plaintiff's maximum resale price maintenance claim. Maximum RPM of this type is the least likely to find favor in a rule of reason world. Now that newspaper distribution has passed scrutiny, little else is likely to fail.

An Unreasonable Rule of Reason: The States and *Nine West*

The initial skirmish in the coming war over the RPM rule of reason has already occurred. Nine West, a manufacturer of women's shoes, petitioned the FTC to modify an order preventing it from employing RPM. The petition claims that

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[9] In doing so, the Court flip-flopped on its earlier abandonment of the holding in *White*. It is interesting to note that the Court characterized its *Schwinn* opinion, coming four years after *White*, as a "sudden change in position." Cont'l T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 51 (1977). Yet in his *Leegin* dissent, Justice Breyer treats the decision to change a long-established precedent based on dubious economic reasoning as unjustified. *Leegin*, 127 S. Ct. at 2730–34. Had each of these views been adopted, we would have had an emerging "Goldilocks" doctrine of reversing precedent neither too soon nor too late, but only when the time was just right.

[10] Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. Chi. L. Rev. 6 (1981).

[11] 60 Antitrust L.J. 67 (1991).

[12] Albrecht v. Herald Co., 390 U.S. 145 (1968).

[13] 152 F. Supp. 2d 465 (S.D.N.Y. 2001).

> Nine West is at an unfair competitive disadvantage because it is prohibited from entering into minimum resale price maintenance agreements of the kind now available to its competitors under the *Leegin* decision. Continuing to prohibit only Nine West from entering into minimum resale price maintenance agreements that the Supreme Court has acknowledged have procompetitive effects is decidedly not in the public interest and therefore such prohibitions should be vacated.[14]

In a supplemental declaration, Nine West explained that it did not seek a declaration that it could do what it pleases in regard to setting resale prices, but that it merely wished to take its chances in rule-of-reason land instead of the pricing prison it agreed to enter.

> On numerous occasions, Nine West executives have been forced to decide between unilaterally terminating deep-discounting retailers that were harming brand integrity and other service-providing retailers, or abiding the discounters' harmful pricing. In such instances, less extreme measures, such as suspension of—or at least discussion with—the deep-discounting retailer would have been preferable, but would not have been protected under *Colgate*, or permitted by the Order.[15]

RPM was thus offered by Nine West as a less restrictive alternative for structuring distribution compared to the draconian *Colgate* approach.

In a response to the Nine West Petition, twenty-seven states joined in asserting that "Nine West's activities are 'inherently suspect' because they raise prices for consumers and violate the antitrust laws because nothing in the Petition justifies those higher prices."[16] The states argued that when they confronted Nine West with the per se illegality club and demanded "your money or your life," Nine West forked over its wallet to the tune of $34 million, $31 million of which was contributed to the women's charity of choice in each state. The states apparently considered it churlish that when the threat of the club is gone, Nine West no longer considers the contract it signed under considerable duress to be valid.

The states argued that "Minimum vertical price-fixing is a restraint that usually raises prices for consumers—the very opposite of consumer welfare. Because Nine West's activities did that to the tune of $45.7 million, Nine West's activities should be deemed 'inherently suspect' under the *PolyGram* framework."[17] But note that the approach of the states would gut the *Leegin* decision. Interpreting the states' concern about prices as instead regarding margins, it is clear that no imposition of RPM for purposes of preventing free riding would pass muster under this unreasonable rule of reason. As we discussed above, acceptance of the states' position requires that economics be consigned to the same irrelevance that it occupied under the per se standard.

A simple example will illustrate why. Years ago, before Marshall Field & Co. was swallowed by Macy's, Field's was widely considered to be a leading arbiter of taste for Chicagoans. But inspection of the Maxwell Street flea market located conveniently to the University of Chicago campus often yielded merchandise that bore the Field's imprimatur. Indeed, one could obtain speaker systems that still had Field's packaging and stickers affixed. Such merchandise was typically offered in close proximity to vendors selling like-new tires conveniently pre-mounted on wheels (another

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[14] Petition to Reopen and Modify Order, Nine West Group Inc., FTC Docket No. C-3937 (Nov. 6, 2007), http://www.ftc.gov/os/caselist/9810386/071106petition.pdf (Nine West Petition).

[15] Supplemental Memorandumat 5–6, Nine West Group Inc., FTC Docket No. C-3937 (Feb. 11, 2008), http://www.ftc.gov/os/caselist/9810386/080208ninewestsuppmemo.pdf.

[16] Amended States' Comments Urging Denial of Nine West's Petition at 2, Nine West Group Inc., FTC Docket No. C-3937 (Jan. 17, 2008), http://www.ftc.gov/os/comments/ninewestgrp/080117statesamendedcomments.pdf.

[17] *Id.* at 5–6.

instance of nearly free riding). The author can attest that the prices at which the Field's-labeled speakers were available were substantially below those for identical merchandise at the Field's State Street emporium located not far to the north. The consumers who purchased at bargain prices appeared to find their welfare enhanced by their ability to do so.

The states simply argue that a supplier whose price rises in response to RPM is conferring a benefit on its dealers that provides no benefit to consumers. According to the most basic law of demand, this will reduce the amount of the product that consumers purchase. If they wish to maintain this position, the states should at least be required to show some reason why the supplier wishes to impose RPM that is not in its interest. Even if a full output test is not required, there should at least be a requirement that it is plausible that the supplier somehow benefits by selling less of its product as it receives the same or a lower wholesale price owing to higher dealer margins.

[T]he states' proposed rule of reason is unreasonable because it is incapable of distinguishing between procompetitive and anticompetitive uses of RPM.

As a fall-back, the states then argue that even if RPM works, it may not be the most efficient way to generate promotional services. So what are the alternatives? We could tell the manufacturer to avoid RPM, which suppresses distributor price competition, encouraging the manufacturer instead to establish exclusive territories that eliminate all intrabrand competition. Less restrictive? No. Legal? Likely, yes.

Another alternative is to tell the manufacturer to pay retailers for services rendered. The plan would work something like this: The supplier identifies a fancy chain store as a trendsetter, and the hole-in-the-wall discounter down the street as of no particular value in encouraging consumers to buy its product. So it offers the fancy chain store a lower price than the shoestring discounter. Not only does this require considerably more monitoring than RPM (the fancy store can pocket any payments and not push the product), but it also is rather cavalier about the Robinson-Patman issues raised.

Nine West suggests that the next best alternative is one of keeping RPM in place through adherence to the *Colgate* doctrine. Terminating dealers who discount one's products is not a less restrictive approach than encouraging them to continue to sell the products at the preferred price.

In the end, the states' proposed rule of reason is unreasonable because it is incapable of distinguishing between procompetitive and anticompetitive uses of RPM. It will be nearly impossible to distinguish the two with pricing evidence. We will need a standard based on economics. Unfortunately, that will be difficult to provide because, as we shall see in the next section, it is not an easy task to evaluate whether an efficiency explanation for RPM is to be credited.

Affirmative Cases for Efficiency

Nine West has argued that its inability to enter into RPM agreements with its dealers prevents it from competing successfully with other shoe manufacturers. There are a number of such competitors. Defining the market as women's footwear sold through department and national chain stores, Nine West reported its own market-leading share as 10.4 percent. *Brown Shoe* ranked second at 6.2 percent, with reported shares of ten other rivals accounting for a collective share of just under a quarter of the market.

These shares are not strikingly large, but in the aggregate, resale price maintenance is a widely practiced tactic in selling shoes. According to Nine West:

> I am told by Nine West executives that they believe that Coach, Inc., Deckers Outdoor Corporation, C&J Clark International Limited, Born Footwear, Ecco and Brown Shoe Company all use some type of minimum resale price maintenance. Also, Coach, Merrell, Born, Ecco, Sofft, Clarks, Kate Spade, UGG

> and BCBG/BCBG Max Azria are all competitor brands that have been excluded from department store point-of-sale coupons, based on a review of fine-print exclusions in Macy's, Bloomingdale's and Lord & Taylor's point-of-sale coupons appearing in publications such as *The New York Times*, the *Stamford Advocate*, and direct mail promotions.[18]

Does this parallel behavior mean that the manufacturers are colluding? Not likely—many of them market different lines through discounters.

Shoe manufacturers that are more significant in other segments also appear to employ RPM. Keds, primarily a producer of children's sneakers, was stepping out in the early 1990s, but the Keds brand peaked at that point.[19] Why? It could be coincidence that in 1993, Keds "agreed to pay $7.2 million to settle sneaker price-fixing suits brought by 50 states, the Federal Trade Commission and the District of Columbia. . . "[20] Reebok, at the time the second largest athletic shoe company, has also paid an RPM settlement.[21] Reebok's decline to number 3 in the athletic shoe market likely began prior to its RPM settlement and derived from a variety of factors, but one is particularly relevant: "in the last few years Reebok has been unable to increase shelf space with retailers."[22] Prospective Air Jordan purchasers are apt to conclude that Nike has a good grasp of the *Colgate* requirements.

Nine West focuses on the widespread use of RPM to sell shoes as evidence that its consent order places it at a competitive disadvantage. But in terms of the application of a rule of reason to RPM for shoes, the widespread use of the practice could indicate either that shoe retailers are powerful enough to force manufacturers to enforce a dealer cartel, or, alternatively, that the manufacturers adopt RPM for purposes of increasing enforcement of their own cartel scheme.

For shoe marketing, neither of these anticompetitive alternatives seems plausible. Does the Foot Locker chain dictate to Nike and rivals? Nike does not sell shoes through Target stores, but it certainly could. A manufacturer cartel is even less likely than a retailer cartel. If there were an agreement to maintain retail shoe prices in order to ease policing of a supplier cartel, Nine West would be legally obliged to cheat on the cartel—not an undesirable outcome.

If Nine West were required to prove that its RPM is efficiency enhancing, it would face a considerable challenge. Consider the services that it identifies as necessary to its success: "desirable location, hours, floor space, etc." Will a customer partake of the location offered by a retailer only to purchase at a discount elsewhere? If a store has convenient hours, will a customer shop at times when a discounter is closed while deferring a purchase until the discounter opens? These services are not subject to free riding and are, in any event, difficult to prove. It is clearly possible to free ride on the reputation of a highly regarded retailer, identifying the brands that the

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[18] Supplemental Declaration, Nine West Group Inc., FTC Docket No. C-3937 at 4 (FTC Feb. 11, 2008).

[19] Shawn Neville, President of the Keds Corporation, told shareholders in 2007 that "We believe that that young 20 year old consumer is so important, and it was very important for us when the brand peaked in the early 90s . . ." Collective Brands Inc. Shareholders Meeting—Final FD (Fair Disclosure) Wire, Sept. 27, 2007. Keds shoes have moved down the price/value distribution, and now sell for lower prices and margins than the sneakers of rival firms. But the company is trying hard to increase both prices and margins as part of a drive to increase its "premium-ness" (Neville's term).

[20] *Keds to Pay to Settle Suits*, N.Y. TIMES, Sept. 28, 1993, *available at* http://query.nytimes.com/gst/fullpage.html?res=9F0CE4DE1F3AF93BA1575AC0A965958260&sec=&spon=&pagewanted=print.

[21] Kenneth N. Gilpin, *Reebok Settles Price-Fixing Case and Will Pay $9.5 Million*, N.Y. TIMES, May 5, 1995, *available at* http://query.nytimes.cim/gst/fullpage.html?res=990CE4D8133CF936A35756C0A963958260.

[22] "In the last few years" could well refer to 1995–1999. *See* Sharon R. King, *Sisyphus of the Sneaker Makers*, N.Y. TIMES, Dec. 11, 1999, *available at* http://query.nytimes.com/gst/fullpage.html?res=9D07E5D61531F932A25751C1A96F958260&sec=&spon=&pagewanted=all.

retailer carries and then purchasing them elsewhere at a store that is distinguished only by its low price point. But such a service is intangible—how is the manufacturer to prove that it sells more shoes due to the willingness of the high-reputation dealer to carry its products? It is hard to see how proof can rise beyond assertion by the manufacturer's marketing managers. It will be even tougher to establish an efficiency explanation based on free riding, though inventory and intangible services arguments are each plausible.

The FTC's Decision

On May 6, 2008, the FTC granted Nine West's request to permit it to enter into RPM agreements with dealers. Nine West was not required to demonstrate the existence of procompetitive efficiencies. The Commission focused instead on the possibility that RPM could have anticompetitive consequences, a possibility that was dismissed summarily: "Nine West has demonstrated that it lacks market power and that Nine West itself is the source of the resale price maintenance."[23] The willingness to dismiss the possibility of a manufacturer cartel is somewhat surprising, given the widespread use of RPM in conjunction with the sale of women's shoes. Likewise, Nine West's interest in employing RPM was taken to be enough to rule out the possibility of its knuckling under to retailer pressure. It would appear that any firm willing to enforce a *Colgate* RPM scheme would likely be able to demonstrate that it was acting in its own interests, not that of retailers.

The unanimous decision by the Commission was particularly surprising in view of Commissioner Harbour's previously expressed view that "Vertical minimum price fixing is almost always harmful to consumers . . . it typically leads to higher prices without bestowing countervailing benefits."[24] The Commission's sensible threshold inquiry made it unnecessary for Nine West to embark on the difficult task of proving, rather than merely suggesting, that its RPM would yield efficiencies. But the future will likely hold tougher challenges, including cases with large-share suppliers and/or very significant retailers. The *Nine West* outcome is encouraging, but far from the final word on the RPM rule of reason.

Coping with a Rule of Reason World

Proving Efficiencies. The difficulty with proving efficiencies is that the strongest proof will be available after your client goes belly-up. The hearing aid manufacturers that agreed to drop their use of exclusive dealing disappeared within a year. The channel within which they operated shrank substantially and would have disappeared had not one manufacturer chosen to fight. Interbrand and interchannel competition was crushed.[25]

Levi, Strauss fared better after eschewing RPM. Its sales and profits rose, albeit briefly, as its distribution expanded and prices fell. But the company lost the top end of the market to the fashion jeans brands that stepped into the upscale void that resulted. Its short term success eroded and was followed by a lengthy decline. The Gap, Levi's' nemesis, emerged as an integrated marketer/retailer, converting from a free-rider to a strictly limited distribution alternative effective in an era hostile to RPM. Levi's tried the same tactic, but the dual distribution it employed proved unwieldy.

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[23] Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000, at 17, Nine West Group Inc., FTC Docket No. C-3937 (May 6, 2008), *available at* http://www.ftc.gov/os/caselist/9810386/080506order.pdf.

[24] *See* Commissioner Pamela Jones Harbour, An Open Letter to the Supreme Court of the United States (Feb. 26, 2007), *available at* http://voluntarytrade.org/downloads/Harbour_ExParteLetter.pdf.

[25] *See* Howard P. Marvel, *Vertical Restraints in the Hearing Aids Industry*, *in* Impact Evaluation of the Federal Trade Commission Vertical Restraint Cases (Ronald N. Lafferty, Robert H. Lande and John B. Kirkwood eds., 1984).

Firms that did not adjust to the anti-RPM world, like Arrow Shirt, the long-time leader in men's shirts, simply crumbled. Vertical integration in place of RPM showed up in department stores as well, as they increasingly relied on private brands.

The carnage has continued. When the states attacked Salton's RPM and exclusive dealing, the company ruled segments of the small appliance market. No more. By 2005, the company was described by *Business Week* as "on the ropes."[26] Were prices lower once Salton dropped RPM? An Internet search suggests that the answer is yes: Salton's George Foreman grills are now much cheaper than competing versions from Cuisinart. Notice, however, that the low prices of the George Foreman grill have been associated with the demise of the company. It is difficult to argue that such low prices benefit consumers who no longer choose to purchase Salton's products.

Nine West's market share used to be 20 percent. It is now 12.5 percent. There is no easy way to determine whether these figures are commensurate. Even if Nine West's share has fallen with its inability to protect quality certifying retailers, one cannot tell with a sample size of one whether a Nine West decline stems from the absence of RPM, from marketing incompetence, or from poor product design. Nor do we know if the consumers simply tired of George Foreman commercials at 3:00 a.m. But as the number of cases mounts, it becomes apparent that at least in some such cases, antitrust policy has substantially impaired competition.

It is, however, difficult to prove that a particular instance of RPM is efficiency enhancing. An efficiency explanation risks being judged a pretext for some other nefarious goal. Some examples can illustrate the problem.

- When Levi's was charged with RPM, the company's experts sought services that they could argue that RPM would protect. The search yielded two candidates, fitting rooms and inventory. Neither of these was a very attractive candidate. Would a customer try on jeans in a fancy department store fitting room and then buy at the Gap store? Did the Gap fail to provide so much as a closet? And would a customer try on a pair of hard-to-find 60″ waist, 22″ inseam Levi's in a department store and then free ride on that inventory elsewhere? If the free-rider avoided the inventory cost of the jeans, then how could the customer find those odd jeans more cheaply at the discounter?

We now understand that Levi's might well have wanted to obtain and protect the intangible services of high-fashion stores whose very decision to carry Levi's provided consumers with certification of the quality and stylishness of their jeans purchases. In addition, it is now apparent that Levi's expressed desire to foster inventory holdings does rationalize its RPM, even though the mechanism is not through protection against free riding. But the explanations provided at the time of the RPM litigation do, indeed, appear to have been pretextual—or, at a minimum, poorly understood.

- Starter Sportswear offers an illustration of a free-rider explanation for its no-transshipment policy allegedly aimed at maintaining high retail prices, which was accepted by a court even though it was likely pretextual. Here, as in Levi's, there was an efficiency-enhancing explanation for its distribution policy, but a more likely impetus for the policy is that Starter was attempting to induce its retailers to hold a broader range of its products than those retailers preferred. Trans Sport, a wholesaler, was shipping inventories between retailers, in the process undoing Starter's preferred inventory holdings. Once again, as in Levi's, the inventory holdings of Starter retailers were not subject to free riding.[27]

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[26] Elizabeth Woyko, For Salton, A Sea of Debt, Bus. Wk., June 13, 2005, http://www.businessweek.com/magazine/content/05_24/c3937013_mz003.htm.

[27] Trans Sport, Inc. v. Starter Sportswear, Inc., 964 F.2d 186, 188 (2d Cir. 1992).

Justifications for RPM thus must be formulated with considerable care and must conform to the facts of the market in question. It is useful to think about RPM well in advance of the threat of litigation. Here are some suggestions for initiating such a process.

Judge Frank Easterbroook has provided a clear statement of the problem of proving that a business practice is efficient:[28]

> It is easy for a judge to find an efficient rationale to be either pretextual or unpersuasive. "Not persuaded" is a common answer. Many times there are no satisfactory explanations. Their development comes too late. Other times the explanation is very difficult. Even when people know why business practices work—which is not very often—the explanation is hard to convey. It may entail some fancy theory or complicated econometrics. What can be conveyed in the academic seminar or the corporate board room is hard to articulate in a trial, when the judge and jury lack economic training and business expertise. The explanations may show how cooperative practices (or practices that exclude or harm rivals), which appear at first glance to be restrictive, will have longer-run benefits in competition. Such explanations meet hostile reactions.
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> The response "not persuaded" is natural when a judge is presented with a novel and difficult explanation of complex behavior. The benefits will not be precisely measurable. What evidence would suffice? The benefit of any arrangement is its improvement over the next-best method of obtaining the same objective. If it is hard to find what a given practice does, it is impossible to determine the difference in efficiency between a known practice and some hypothetical alternative.

Note that the skepticism can take either the form of "not persuaded," or an assertion of "pretext"; since the business people need not understand why a practice works—it need merely prove effective—an economic explanation can easily be found pretextual.

But experience with the prohibition of vertical price restraints teaches that their absence is often catastrophic for the firms in question. This experience suggests that a rule of reason should appropriately place a burden (and not simply a market power screen) on those who attack such restraints to provide a plausible explanation for how they might adversely affect competition. Because the Court in *Leegin* appears to accept that such adverse effects are to be expected at most through facilitation of a dealer or supplier cartel, it seems likely that the emerging rule of reason should require a cartel component.

Note, however, that this cartel evidence requirement will not come into place easily. The states recently extracted a settlement from Herman Miller over its alleged RPM as applied to the company's iconic Aeron chairs. But Herman Miller cannot collude in a market defined to consist solely of its own chair, and it is implausible to imagine that retailers as a group could force the company to undertake distribution restraints that were not in its interest.[29]

RPM Advice for the New Rule of Reason World.

1. Ask your clients to explain why they want to impose RPM. The answer may be because its use lets them compete more effectively with rivals in some manner. Such an answer will be unlike-

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[28] Frank Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1, 8 (1984). Judge Easterbrook is broadly skeptical about the ability of courts to apply rules of reason successfully.

[29] *See* Complaint, New York v. Herman Miller, Inc., No. 08-02977 (S.D.N.Y. Mar. 21, 2008); Stipulated Final Judgment and Consent Decree, New York v. Herman Miller, Inc., No 08-02977 (S.D.N.Y. Mar. 25, 2008) (hereinafter *Consent*).

While the Aeron chair has achieved iconic status, there are a number of rival offerings. Moreover, the consent order covers only sales by the Herman Miller for the Home division, which accounts for only about two percent of Herman Miller sales. Given the relatively small amount that Herman Miller agreed to pay ($750,000) and the express permission in the injunction for a *Colgate* program (*Consent*, § IV, D, at 5), the company may have determined that presenting a case for RPM in the post-*Leegin* world was unlikely to be worth the expected cost. Thus despite the apparent availability of an efficiency defense and the low likelihood that the States could have shown a tangible anticompetitive impact, the States were able to prevail on what appears to be a charge related only to price effects.

ly to be enough to carry the day should litigation emerge. Further reflection is suggested. Do not underestimate the importance of RPM as a competitive tool, but recognize that it carries considerable legal risks in the near term.

2. Listen carefully to what those with marketing responsibility consider important. The answer may be something like the need to obtain adequate floor space or inventory at leading retailers. Since these factors are not subject to free riding, it makes sense to document their success in obtaining distribution, and to document cases where their efforts have fallen short. If litigation does loom, do not immediately embrace the first pre-sale service that comes to mind as an explanation for RPM.

3. Does your client believe that it can unilaterally adopt its distribution restraints? "I cannot control my distribution unless my rivals also do so" is an answer that should trigger considerable investigation into the alternatives available to RPM use. If RPM is employed, it is particularly important to document its procompetitive effects.

4. RPM is just one way of many to structure distribution. Alternative vertical restraints are safer, and may be worth trying even if RPM appears more effective. Have your clients considered direct payment for services or inventory holdings? These payments can be problematic, as 3M discovered in *LePage's*, but evidence that the alternative has been investigated may be useful. If these have been considered and rejected, the investigation should be documented. It may be that RPM is in fact less restrictive than alternative restraints. Documentation on this point will likely be valuable in the event of litigation.

5. Be wary of too much success. Sadly, the antitrust laws have long tended to punish firms that come to dominate their market segments. The tendency may have atrophied somewhat elsewhere, but it remains alive and well in the RPM area. The experience of firms that have lost their ability to structure distribution and have shortly thereafter fallen on hard times should be both a cautionary tale and an inducement to consider other restraints as substitutes for RPM, even if they are less effective.

The* Colgate *Approach. It may seem attractive to advise clients to continue to announce price policies and to terminate retailers who deviate, relying on the absence of a contract with dealers to protect against RPM charges. Courts have been hesitant to find contracts due to their need to work around the per se rule. With that rule gone, manufacturer-dealer relationships no longer need to be viewed though *Colgate*-tinted glasses. The willingness of courts to tolerate implicit agreements will be increasingly difficult to maintain.

Conclusion

We do not know the shape of the rule of reason that will emerge for minimum RPM, but it is unlikely to be as lenient as those that appeared for other vertical restraints. RPM is a powerful tool for improving the effectiveness of distribution. For market-leading firms, its use will remain legally problematic for some time. It will be difficult to obtain appropriate recognition that price effects are not useful for the evaluation of RPM.

The past treatment of vertical restraints has been characterized—accurately, in my view—as "an intellectual failure of imposing dimensions."[30] But we know from the difficulty of overturning *Dr. Miles* that old intellectual errors die hard. The emerging rule of reason should reflect our understanding of the potential efficiency gains available from RPM. The difficulty of establishing those gains in particular settings suggests that caution should be exercised in embracing those gains. ●

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[30] Richard A. Posner, Antitrust Law, *supra* note 3, at 188.