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### *Leegin*, The Political Backlash

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### I. INTRODUCTION

In 1911, the Supreme Court addressed resale price maintenance (“RPM”) for the first time.<sup>2</sup> Although RPM is a vertical price restraint, the Court treated it as a horizontal restraint and found RPM to be illegal per se. This, we believe, was an error that went uncorrected for nearly 100 years. Finally, in 2007, the Court got it right and made RPM subject to rule of reason analysis.<sup>3</sup> Now, several states legislatures are trying to roll back the clock and restore the per se illegality of RPM. This, we argue, is a mistake based on faulty economic reasoning. We support our contention by explaining briefly pro-competitive as well as anticompetitive uses of RPM. We then examine the antitrust treatment of RPM and the states’ reactions to the current antitrust status of RPM.

### II. RESELL PRICE MAINTENANCE

Resale price maintenance is a vertical price restraint: A manufacturer will sell its product to a distributor only on the condition that the product not be resold at a price below some minimum specified by the manufacturer. If the distributor agrees to abide by the manufacturer’s resale price provisions, there is an agreement as that term has meaning in antitrust. Section 1 of the Sherman Act forbids agreements—contracts, combinations, and conspiracies—in restraint of trade. Since RPM plans are price restraints and involve agreements, they may provoke §1 of the Sherman Act. But only unreasonable restraints are unlawful and, therefore, one must examine the reasonableness of RPM to determine whether it is unlawful. The guide for determining reasonableness should be based on the competitive effect of the RPM plan under consideration. If RPM is anticompetitive, it will result in higher prices and reduced sales. In that event, the RPM agreement would appear to be unreasonable and, therefore, unlawful. On the other hand, if RPM is pro-competitive, price will rise, but output will expand rather than contract and the agreement arguably would be reasonable.

It has been argued that RPM can be used to support a horizontal price-fixing agreement among manufacturers.<sup>4</sup> Such an agreement would lead to an increased price and a reduced output, which is clearly anticompetitive. The bane of every cartel is cheating by greedy cartel members. This is where RPM comes in. The fixed wholesale prices are hard to monitor, so the manufacturers agree to employ RPM agreements with their customers because their customers’ prices are visible. To the extent that the distributors cannot reduce price to expand volume, it reduces a would-be cheater’s incentive to reduce its wholesale price. In this context, RPM has no independent competitive significance since its purpose and effect (if successful) is to support an

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<sup>1</sup> Department of Economics, University of Florida. Neither of us has a role in any current RPM dispute. Right or wrong our views are entirely our own.

<sup>2</sup> *Dr. Miles Medical Co. v John D. Park & Sons Co.*, 212 U.S. 575 (1911).

<sup>3</sup> *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S.Ct. 2705 (2007).

<sup>4</sup> Lester G. Tesler, *Why Should Manufacturers Want Fair Trade?* 3 J. L. & ECON. 86 (1960), explains the use of RPM to aid the effectiveness of a manufacturer cartel.

already anticompetitive horizontal agreement on price. The appropriate antitrust remedy is to attack the horizontal cartel rather than the vertical price agreement. As we will see below, the existence of an RPM agreement is not *prima facie* evidence of a horizontal cartel.

It has also been argued that RPM can be used to support a horizontal agreement among distributors to fix prices.<sup>5</sup> Again, there will be an incentive to cheat on the cartel agreement. RPM comes to the rescue, so the story goes, by enlisting the aid of the manufacturers. The manufacturers are expected to impose an RPM agreement and enforce it to prevent cheating. This, of course, is contrary to the manufacturer's interest. In any event, RPM again has no independent competitive significance.

In the event of a manufacturer cartel or a dealer cartel, the focus of antitrust enforcement ought to be on the horizontal cartel rather than on the RPM agreement. Now, if all RPM agreements were used invariably to support horizontal cartels that would collapse without them, then attacking a visible vertical agreement rather than an elusive horizontal agreement would make some sense. But RPM can be used as a promotional device that does not deserve antitrust attack.

There are circumstances in which a manufacturer may find it more efficient to rely on its distributors to perform promotional services that will benefit the manufacturer than to perform them itself. When consumers can obtain the promotional benefits at one location and buy the product elsewhere, there is an incentive for some distributors to perform no promotional services, avoid the costs of performing those services, and sell at a discount to attract customers. For example, bricks-and-mortar stores provide display and demonstration services that are costly while online stores offer only deep discounts. RPM helps to preserve sales for the bricks-and-mortar stores that are providing the services.<sup>6</sup> RPM prevents the discounting and thereby compels all distributors to provide the level of promotions that the manufacturer deems optimal. In this case, the use of RPM leads to increased demand for the product as it is more valuable to consumers with the promotions than without them. The result is higher prices and higher *outputs*. At least in this sense, RPM is pro-competitive. If RPM is forbidden, consumers have an incentive to buy from the discounters. Eventually, no distributors will provide promotions and demand will fall. In many cases, this will make consumers worse off.

### III. ANTITRUST TREATMENT OF RPM

Dr. Miles Medical Company had written contracts with its authorized wholesalers and retailers. One of the explicit provisions required the distributors to adhere to an RPM plan. John D. Park & Sons Company, an unauthorized wholesaler, induced some of Dr. Miles' authorized distributors to breach their contracts and Dr. Miles sued. When the suit reached the Supreme Court in 1911, the Court ruled that the contracts were invalid as they were not in the public interest. Thus, *Dr. Miles* held RPM to be illegal per se. Prior to the *Leegin* decision, every time a case involving RPM reached the Court, the per se rule was confirmed.<sup>7</sup> In some cases, the Court did not find RPM<sup>8</sup>, but where it was found, it was illegal.<sup>9</sup> This changed when the weight of

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<sup>5</sup> *Id.*

<sup>6</sup> For an extended analysis, see Roger D. Blair & Jessica S. Haynes, *Leegin and The Plight of Online Retailers: An Economic Analysis*, ANTITRUST BULL., forthcoming 2010.

<sup>7</sup> See *Simpson v. Union Oil*, 396 U.S. 13, (1969); *United States v. Parke Davis*, 365 U.S. 125, (1961). Also, see *GTE Sylvania v. Continental T.V.*, 433 U.S. 36, (1977).

<sup>8</sup> See *Colgate v. United States*, 488 U.S. 833, (1988) and *Business Electronics Corp. v. Sharp Electronics Corp.*, 487 U.S. 717, (1988).

<sup>9</sup> See *Monsanto v. Spray-Rite Serv. Corp.*, 465 U.S. 752, (1984).

scholarly criticism convinced the Court to take a fresh look at the wisdom of *Dr. Miles*. In 2007, the Supreme Court decided *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*<sup>10</sup> which appeared to involve the promotional use of RPM. There was no evidence of either a manufacturer cartel or a dealer cartel. In *Leegin*, the Court overruled *Dr. Miles* and thereby made RPM subject to the rule of reason. Since RPM is neither invariably anticompetitive nor invariably pro-competitive, a rule of reason analysis seems appropriate.

A rule of reason analysis is designed to separate unreasonable and, therefore, unlawful uses of RPM from reasonable and, therefore, lawful uses of RPM. This is precisely what we should want from antitrust enforcement.<sup>11</sup>

#### IV. THE STATES STRIKE BACK

The *Leegin* decision resulted in a storm of protest from disparate sources. The *New York Times* reported considerable discontent among states and justices with the decision.<sup>12</sup> The *Times*, terming resale price maintenance “anti-price-cutting agreements,”<sup>13</sup> conveyed this displeasure with quotes from the New York solicitor general.

“Price is different,” Ms. Underwood said .... “this court has said that price competition is the central nervous system of the economy.” Overturning the rule would be “a drastic change in the longstanding, settled interpretation of the Sherman Act.”<sup>14</sup>

The *Wall Street Journal* also complained.<sup>15</sup> The article similarly asserts that RPM agreements have increased prices and thereby caused harm to consumers. Price is of course only part of the story. Maryland quickly passed legislation<sup>16</sup> and Congress began an inquiry.<sup>17</sup>

The focus of all this criticism is on the effect of RPM on retail prices. The sentiment seems to be that if RPM leads to higher consumer prices, then it should be unlawful. But this makes no sense. RPM is supposed to lead to higher prices. After all, an RPM agreement forbids discounting below some specified minimum price, which means that prices will be higher than they would have been in the absence of the RPM program. A price test would condemn every RPM program that is even minimally effective, but the Court could not have intended that result. If it had, then it could simply have left the *Dr. Miles* rule intact. The focus of the current criticism therefore is misplaced.

<sup>10</sup> *Leegin*, *supra* note 3.

<sup>11</sup> There can be substantial difficulties in conducting a rule of reason analysis, but that challenge must be met. See Roger D. Blair, *The Demise of Dr. Miles: Some Troubling Consequences*, 53 ANTITRUST BULL. 133 (2008).

<sup>12</sup> Linda Greenhouse, *Justices Hear Arguments About Pacts on Pricing*, N.Y. TIMES, (March 27, 2007).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> Joseph Pereira, *Price-Fixing Makes Comeback After Supreme Court Ruling*, WALL ST. J. ONLINE, (August 18, 2008). The first line of the article is “Manufacturers are embracing broad new legal powers that amount to a type of price-fixing....”

<sup>16</sup> In 2009 two bills passed by Maryland’s legislature, S.B. 239 and H.B. 657, amend the Maryland Antitrust Act to include the following statement:

For purposes of subsection (a)(1) of this section, a contract, combination, or conspiracy that establishes a minimum price below which a retailer, wholesaler, or distributor may not sell a commodity or service is an unreasonable restraint of trade or commerce.

<sup>17</sup> “On May 14, 2008, thirty-five state attorneys general submitted to Congress a letter strongly supporting the passage of S. 2261, Discount Pricing Consumer Protection Act, introduced by Senator Kohl in the 110th Congress.” Alan M. Barr, *State Challenges to Vertical Price Fixing in the Post-Leegin World*, Federal Trade Commission: FTC Hearings on Resale Price Maintenance, May 21, 2009, <http://www.ftc.gov/opp/workshops/rpm/may09/docs/abarr.pdf>.

The *Leegin* decision did not render RPM per se lawful. It is subject to the rule of reason, which means that it is unlawful when it is unreasonable, but lawful when it is a reasonable restraint. The test of reasonableness cannot be whether price is higher than it would be otherwise because all RPM plans lead to higher prices. Thus, we are left with an output test. As we have seen, promotional uses of RPM led to higher output while anticompetitive uses of RPM reduce output.

It would appear that the easy solution is to employ an output test: If RPM leads to higher output, it is reasonable; if RPM leads to lower outputs, it is unreasonable. Unfortunately, nothing about RPM seems to be easy. It has been shown that an output test is not dispositive.<sup>18</sup> An output test works well in distinguishing between RPM plans that support horizontal cartels and those that are promotional. But promotional uses of RPM can reduce consumer welfare (at least in theory). A sound argument can be made for holding all promotional uses of RPM lawful. The ambiguity in the impact of consumer welfare is not confined to RPM. All promotions and even quality changes may have ambiguous welfare effects, but none of these are subject to antitrust condemnation.

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<sup>18</sup>F.M. Scherer, *The Economics of Vertical Restraints* in ANTITRUST POLICY IN TRANSITION: THE CONVERGENCE OF LAW AND ECONOMICS (eds. E.M. Fox & J.T. Halverson, Chicago: ABA Press (1984); William B. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions and the New Antitrust Policy*, HARV. L. REV. 983, (1985); and Roger D. Blair & James M. Fesmire, *The Resale Price Maintenance Policy Dilemma*, 60 S. ECON. J. 1043, (1994).