

Agenda

Advancing economics in business

Ruling within reason: a reprieve for resale price maintenance

As a result of the US Supreme Court's recent overturning of the long-standing 1911 *Dr Miles* decision, which deemed minimum resale price maintenance unlawful per se, this practice is to be judged under the 'rule of reason' in the USA, as has been the case with other vertical restraints. Is it therefore time to change the European approach to vertical price fixing?

In its June 2007 judgement in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, the US Supreme Court ruled that resale price maintenance (RPM) should be judged under the 'rule of reason'.¹ The *Leegin* ruling overturned the long-standing 1911 *Dr Miles* precedent, which held that it is per se unlawful under Section 1 of the Sherman Act for firms to fix the minimum retail price at which retailers may sell goods or services on.²

The outcome of the *Leegin* case has relieved those who support the view that, although under certain circumstances minimum RPM may result in sub-optimal market outcomes, this risk is not sufficient to make the practice illegal per se. The per se prohibition also sits somewhat at odds with economic theory, which suggests that RPM is not very different from other types of vertical restraints in that it can produce efficiency benefits as well as anti-competitive effects. The *Leegin* decision therefore calls for a new debate on whether it is reasonable to maintain the virtual per se outlawing of minimum RPM.

In Europe, Article 81(1) of the EC Treaty prohibits vertical agreements that have as object or effect the restriction, prevention or distortion of competition. Despite the fact that Commission Regulation 2790/1999 exempted some types of vertical agreements, fixed and minimum prices have been classified as 'hard-core' restraints and, as such, cannot benefit from the block exemption 'irrespective of the market share of the undertakings concerned'.³ In the context of the reform of Article 81, in 2004 the Commission advocated a modernised 'economic approach' to the analysis of horizontal and vertical agreements.⁴ However, consistent with Regulation 2790/1999, it has remained suspicious of minimum RPM. In its notice on the application of Article 81(3), this practice was classified as a restriction to competition 'by object'—ie, it was deemed as having:

such a high potential of negative effects on competition that it is unnecessary for the

purposes of applying Article 81(1) to demonstrate any actual effects on the market.⁵

In line with the Commission's approach, in the UK minimum RPM is considered a hard-core practice that 'almost inevitably' infringes Article 81 or the Chapter I prohibition under the Competition Act 1998.⁶ Indeed, the Office of Fair Trading (OFT) has brought a number of high-profile vertical price fixing cases in recent years, as discussed below.

In light of the *Leegin* judgement, is this the time for European competition policy to move towards an effects-based approach to the analysis of minimum RPM?

The *Leegin* case: seeing reason

Leegin designs, manufactures and distributes women's leather accessories, such as belts, handbags and shoes, which it sells to independent boutiques and speciality stores across the USA under its 'Brighton' brand. It has reportedly selected these distribution channels because it aims to offer customers a high-quality sales service.⁷

In 1997 *Leegin* implemented the 'Brighton Retail and Promotion Policy', and subsequently refused to sell Brighton products to retailers that discounted below the suggested retail prices. The justification for such a policy was to provide retailers with a margin that allowed them to offer top-quality customer service. Moreover, the company expressed concern that discounting harmed Brighton's brand image and reputation.⁸ In 1998 it introduced the 'Heart Store Program', through which it incentivised retailers to sell its products at its suggested prices.

However, one retailer—PSKS Inc, which operates the outlet 'Kay's Closet'—discounted below the suggested prices. In 2002 *Leegin* requested Kay's Closet to cease discounting and, after the request was refused, it suspended its supply contract to the retailer. PSKS sued

Leegin in a district court, alleging that, among other claims, Leegin's pricing policy violated antitrust laws by entering into vertical agreements with its retailers to set minimum resale prices. In its defence, Leegin sought to introduce an economist's expert testimony, which concluded that its pricing policy was pro-competitive. The district court, relying on the per se rule established in *Dr Miles*, considered the report to be irrelevant. Leegin was found liable without the need for further inquiry and PSKS was awarded \$1.2m in damages. The district court trebled the damages and reimbursed PSKS for its attorney's costs, such that Leegin's costs escalated to nearly \$4m.⁹

Although Leegin appealed the decision, its arguments were rejected by the appeals court. However, the US Supreme Court subsequently considered whether minimum RPM should continue to be deemed unlawful per se, and eventually overruled *Dr Miles*, establishing that vertical price restraints should be judged under a 'rule of reason'. The Supreme Court recognised the potential for minimum RPM to give rise to a number of anti-competitive effects, but it concluded that it could:

not state with any degree of confidence that resale price maintenance 'always or almost always tend[s] to restrict competition and decrease output'.¹⁰

Is minimum RPM always bad?

Somewhat out of line with the legal approach to minimum RPM, economic theory has long shown that this practice can have a number of efficiency benefits as well as negative effects on market outcomes.

A simple hypothetical example can illustrate these positive and negative effects of minimum RPM. Resound is a manufacturer of music players, which distributes its products through two retailers, The Moon and The Rocket. Resound requires retailers to sell its product at no less than €300 per unit, eliminating 'intra-brand' competition (ie, competition between Resound units at different retailers).

On the positive side, RPM may have a demand-expansion effect. In addition to price, there are a number of determinants of consumer demand, including awareness of a product or brand, convenience of store location, and quality of in-store customer support both before and after acquiring a product. On the demand side, making these services available to customers could reduce their search costs. For example, if the product has complex features, consumers may first wish to be informed about those features, or to see a demonstration. With an enhanced pre-sale customer service, they may be able to obtain enough information from one store to buy the Resound product there.

On the supply side, by allowing retailers to earn a higher margin, RPM incentivises them to provide the required pre-sale service (see below). Furthermore, although minimum RPM might reduce intra-brand competition, competition between products or brands (ie, inter-brand competition) could increase as the investments in retail services strengthen the position of Resound compared with its rivals.¹¹

In economic terms, minimum RPM promotes retailers' investments in customer services by making it more difficult for discounters to 'free-ride' on the customer support activities offered by other retailers.¹² Taking the above example, suppose that retailers make a profit margin of 5% if they sell the Resound music player for €300. The Rocket invests this retail margin in value-added customer services, including improved showrooms for Resound's music players, product demonstrations, and in-store training for customers on how to use the product. In contrast, The Moon does not make any such investment, and can therefore offer Resound's products at €285 (at a 0% margin).

In this situation, The Rocket would run the risk of customers visiting its stores to learn about Resound's product, but subsequently buying it more cheaply at a nearby outlet of The Moon. Although, in the short run, discounters such as The Moon would benefit consumers, in the long run, The Rocket may be deterred from engaging in investments aimed at improving pre-sale customer services, and the overall level of these services might then become sub-optimal (from the perspective of the manufacturer, but also, possibly, for consumer welfare as a whole).

In contrast, with Resound imposing a minimum resale price of €300, the free-riding problem may be avoided by preventing discounters from undercutting retail prices.¹³ Although price competition between The Rocket and The Moon would be reduced, competition in other product attributes related to retail services may increase. (In this regard it is worth noting that another vertical restraint preventing such free-riding would be to impose exclusive territories on retailers of Resound.) In addition, Resound's strategy may induce other music player manufacturers to follow suit and encourage retailers to make the necessary retail investments to promote their brands, which could result in increased inter-brand competition.

As the Supreme Court notes in the *Leegin* case, even in the absence of free-riding, minimum RPM may be the more efficient way of giving retailers the incentives to undertake certain investments, and to use their initiative and experience to provide the services in question. For example, to achieve the benefits of RPM, Resound could integrate downstream and sell its music player directly to

final consumers (which would be unusual for manufacturers). However, its distribution costs might be higher than those of The Rocket and The Moon because it would need to invest in training personnel to provide the same customer service that firms specialising in the retail sector would provide. Higher distribution costs may be passed on to final consumers in the form of higher retail prices. Furthermore, vertical integration may be more likely to affect intra-brand competition than RPM.

Resale price fixing can be particularly useful to entrant manufacturers since it may help them to position their brands and products. As a result of RPM, retailers would have the incentives to invest in making the entrant's product or brand better known to consumers. If this is the case, dynamic efficiency would increase.¹⁴ Furthermore, RPM can provide incentives to ensure efficient stocking by retailers. By allowing The Rocket and The Moon to earn a given margin over the wholesale price, Resound could ensure that the retailers make the necessary investments to facilitate an adequate level of stocks of music players to meet demand, without running the risk that, for whatever reason, the product proves unpopular and is then rapidly discounted by all retailers before their initial stocks are depleted.

The balancing act ...

The above is not to say that minimum RPM should always be considered pro-competitive. There are also circumstances where it may lead to inefficient market outcomes. It is therefore necessary to strike a balance, as with other types of vertical restraint, rather than opting for a *per se* prohibition.

The economics literature shows that minimum RPM may promote and maintain collusion both at the manufacturer level (ie, between Resound and other music player manufacturers) and at the retail level (between The Rocket and The Moon and other retailers).¹⁵ One reason for this is that minimum RPM can assist companies in identifying price-cutters. For example, if there were a cartel between Resound and other music player manufacturers, it would not be possible for any manufacturer to pass on a price reduction to retailers without also lowering the controlled retail price. In addition, by making it more likely that changes in retail prices are the result of a manufacturer deviating from the agreement, RPM would reduce the uncertainty about the source of observed variations in retail prices. Hence, since Resound and other manufacturers of music players would not be able to cheat on the agreement without being discovered, RPM may reduce manufacturer price competition and help sustain coordination.

RPM may also be initiated by retailers in order to form a downstream cartel. For example, The Rocket and The

Moon might collude to fix prices, and put pressure on Resound to set prices. The retailers could then use RPM to prevent more efficient retailers from entering the market. RPM would be a barrier to entry because retailers with a lower cost structure or a wider distribution network would not be able to discount the prices set by Resound. RPM would then be a manifestation of the incumbent retailers' monopsony power—otherwise they would not be able to compel the manufacturer to aid a downstream cartel through RPM.

So how to strike the balance? This will often depend on the facts of the specific case, and there are few bright-line tests. One indication of the strength of the negative competition effects of RPM could be the degree of concentration in the upstream market (the greater the concentration, the more likely it is that the collusive effect will prevail). Likewise, as has been noted by a number of scholars,¹⁶ and now by the Supreme Court in the *Leegin* case, the extent to which minimum RPM may have a negative effect on consumer welfare depends on the (pre-existing or resulting) market power of the firms engaging in the practice.

A different outcome?

There have been a number of high-profile vertical price fixing cases in Europe in recent years. In the UK, Hasbro, a toys and games supplier, was fined nearly £5m after the OFT found that it had entered into retail price fixing agreements with ten distributors.¹⁷ Heavy fines were also imposed on Umbro (£5.3m) and a number of its resellers (eg, JJB Sports, £6.3m and Manchester United, £1.5m) after the OFT established that they had entered into agreements fixing the retail price of Umbro's licensed replica shirts of Celtic, Chelsea, and Manchester United football clubs and England's national football team.¹⁸

In both cases, the OFT concluded that the agreements had as the 'object and effect, the prevention, restriction or distortion of competition in the relevant downstream markets. Hence, the agreements were in breach of the Chapter I prohibition'.¹⁹ In reaching the decision, the OFT did not assess the potential impact on competition that the agreements could have—ie, it applied a *virtual per se* approach.

The question that arises is: would the OFT's decisions have remained the same if it had adopted a rule of reason approach? In these two cases, the answer to this may well be 'no', due to the strong market position of the manufacturers and/or retailers involved in the vertical price fixing cases. Indeed, in the Hasbro case, the OFT noted that:

Although there may be circumstances, which will be limited, in which price fixing agreements may

not have an appreciable effect on competition, this is clearly not the case *given Hasbro's strong position in the market.* (emphasis added)²⁰

would probably advise them that the legal risk is low if they do not have a strong market position. The internal assessment of the legal risk of RPM practices then becomes the same as for any other vertical agreements in which manufacturers engage with retailers. Ultimately, this may be of benefit to consumers too.

What seems clear is that if RPM were no longer outlawed per se, manufacturers may be expected to engage in this practice more frequently, since their competition lawyers

¹ Supreme Court of the United States (2007), *Leegin Creative Leather Products, Inc. v. PSKS, Inc. (DBA Kay's Kloset)*, Certiorari to the United States Court of Appeals for the fifth Circuit, No. 06.480. Argued March 26th 2007. Decided June 28th 2007.

² *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

³ In contrast to minimum RPM, maximum and recommended prices are covered by the block exemption (see Commission Regulation (EC) No 2790/1999 of December 22nd 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, para 10). Although minimum RPM can qualify for individual exemption under Article 81(3), the EC guidelines make it clear that this would be unlikely.

⁴ European Commission (2004), 'Guidelines on the Application of Article 81(3) of the Treaty', OJ C 101, 27.04.2004.

⁵ *Ibid.*, para 21.

⁶ Office of Fair Trading (2004), 'Vertical Agreements: Understanding Competition Law', *Competition Law*, December, p. 22. .

⁷ In effect, Leegin noted that 'at least for its products, small retailers treat customers better, provide customers with better services, and make their shopping experience more satisfactory than do larger, often impersonal retailers'. Supreme Court of the United States (2007), *op. cit.*, p. 2.

⁸ Supreme Court of the United States (2007), *op. cit.*, p. 3.

⁹ *Ibid.*, p. 4.

¹⁰ *Ibid.*, p. 14.

¹¹ In this regard, as Mathewson and Winter (1998) note, a manufacturer would be willing to engage in minimum RPM only if the positive effect that the practice has on demand expansion more than compensates for the negative impact that higher prices might have. See Mathewson, F. and Winter, R. (1998), 'The Law and Economics of Resale Price Maintenance', *Review of Industrial Organization*, **13**, pp. 57–84.

¹² In addition to free-riding on investments aimed at improved customer services, there may be free-riding on retailers' certification of products as high quality. See Marvell, H.P. and McCaffery, S. (1984), 'Resale Price Maintenance and Quality Certification', *Rand Journal of Economics*, **15**, pp. 346–59.

¹³ There is no guarantee that, under minimum RPM, all retailers would invest the higher margin in value-added services. For example, The Moon could invest part of the margin and still rely on The Rocket's efforts. As a result, inefficient entry would still be promoted while efficient players would be prevented from taking advantage of their superior performance.

¹⁴ Supreme Court of the United States (2007), *op. cit.*, pp. 10–11.

¹⁵ See, for example, Posner, R.A. (2001), *Antitrust Law*, Chicago: Chicago University Press; Mathewson, F. and Winter, R. (1998), *op. cit.*; and OECD (1997), 'Resale Price Maintenance', OECD/GD(97)229.

¹⁶ See, for example, Vickers, J. (2007), 'Competition Law and Economics: A Mid-Atlantic Viewpoint', The Burrell Lecture of the Competition Law Association, March 19th, London.

¹⁷ Decision of Director of Fair Trading No. CA98/18/2002, Agreements between Hasbro UK Ltd and distributors fixing the price of Hasbro toys and games, November 28th 2002.

¹⁸ Decision of the Office of Fair Trading No. CA98/06/2003, Price-fixing of Replica Football Kit, Case CP/0871/01, August 1st 2003.

¹⁹ Decision of Director of Fair Trading No. CA98/18/2002, Agreements between Hasbro UK Ltd and distributors fixing the price of Hasbro toys and games, November 28th 2002, p. 1.

²⁰ *Ibid.*, para 45, p. 15.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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