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Chapter 73

THE ECONOMICS OF RESALE PRICE MAINTENANCE

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Resale price maintenance involves agreements between manufacturers and downstream distributors that set the downstream price of the product, either at a minimum price or a maximum price. Antitrust law, until recently, condemned these vertical price arrangements as illegal per se. The Supreme Court, recognizing that maximum resale prices may enhance competition and improve consumer welfare, has held that this practice is now to be assessed under the rule of reason for its actual competitive effects. Agreements on minimum prices, however, continue to be subject to the per se rule. Economic analysis reveals the conditions under which resale price maintenance can enhance consumer welfare and where it can harm consumer welfare. Because there are so many circumstances in which resale price maintenance promotes interbrand competition, the practice should be assessed in all situations under the rule of reason, the same way in which nonprice vertical contracts are analyzed.

1. Introduction

A resale price maintenance (RPM) agreement is a contract in which a manufacturer and a downstream distributor (retailer) agree to a minimum or maximum price the retailer will charge its customers (consumers). One might wonder why a manufacturer, having sold a product to retailers, would want to exert any influence over resale prices. It might seem, at first glance, that the manufacturer would want price competition among its retailers to keep markups to a minimum and so promote demand for the manufacturer's product. But there is much more to the story. This chapter explains why a manufacturer might establish and maintain a minimum or maximum retail price and what the consequences are for consumer welfare when this pricing practice is deployed.

It turns out there are several reasons why a manufacturer might try to maintain resale prices. Some of the reasons indicate that RPM enhances consumer welfare; others indicate the opposite. This means any economic assessment of a particular case must interpret the facts in that situation with competing theories in view. The chapter begins with a discussion of procompetitive and anticompetitive uses of RPM to establish retail price floors. Next it describes the tension that exists between the likely economic rationale for using RPM and current enforcement of the antitrust laws. Following this, it comments on the uses of RPM to establish retail price ceilings. The chapter's principal conclusion is that antitrust law should assess RPM under the rule of reason in all situations.

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2. Using RPM to establish a price floor

Manufacturers selling undifferentiated products in perfectly competitive markets would never use RPM as a pricing practice. In such markets, manufacturers have no unilateral influence over prices at either wholesale or retail levels. But in many transactions involving differentiated products, including name brands, RPM can have a constructive role. To understand why, two economic concepts must be understood: (1) consumer demand for a differentiated product can depend on retail "service" as well as the product's price, and (2) retail service can be an occasion for what economic theory calls "market failure."

2.1. Retail services and the free rider

In markets for differentiated consumer products, demand is a function of product features and quality as well as the price of a product. Demand also can be affected by retail service, defined broadly to include presale display, product-specific information, store hours, adequate inventory, postsale service, the reputation of the retailer as a certifier of product quality, and other shopping amenities. Consumers value retail service, so better retail service raises consumer demand. In some instances, an increase in demand caused by increased retail service can increase unit sales and make consumers better off, even if accompanied by a price increase.

If consumers value retail service such that better service raises consumer demand, should we not expect retailers to provide adequate retail service without being nudged by the manufacturer? The answer is "no" where one retailer's service invites a competing retailer to become a free rider. A free rider is someone who enjoys the benefits of someone else's investment without having to pay compensation. The iconic free-riding example in the RPM literature is the high-tech, information-intensive consumer durable good (think of high-end audio equipment), where presale assistance by a knowledgeable salesperson at a retail establishment is required to inform and persuade a consumer of the product's merits.[1] Upon getting the requisite information from the full service retailer, the shopper leaves the store without making a purchase and visits a discount store to buy the product for a lower price. The discount store, which can offer the lower price because it does not employ knowledgeable salespersons, gets a free ride from the full service retailer who incurs costs to promote the product.

The state of affairs just described is unsustainable for the full service retailer. It cannot continue to employ knowledgeable salespersons and still match the discounter's low price. The full service retailer must curtail service to survive. In the end, the free rider prevents consumers from having access to retail services which they value. Those consumers must decide what brand of good to buy, or whether to buy a good at all, with less than optimal information about their choice set. As a result, products that require

1. What is high-tech depends upon the time of reference. In the early days of the automobile industry, Henry Ford used RPM to protect the retail margins of automobile dealers who needed to teach customers how to drive. Economists should be aware that Alfred Marshall's classic text, *Principles of Economics*, was the first product "in the English speaking world to be sold under a scheme of resale price maintenance." William Breit, *Resale Price Maintenance: What Do Economists Know and When Did They Know It?*, 147 J. INSTITUTIONAL & THEORETICAL ECON. 72, 72 (1991).

retail service become less available. The consequences are bad for consumers and bad for the manufacturer.

The possibility that free riders may extinguish retail service altogether in a market without RPM requires that allowable nonprice vertical restraints are not up to the task. It also requires that retailers cannot separate those aspects of retail service that build demand for the manufacturer's product from other retailer activities and "sell" them to consumers, or the manufacturer, on a stand-alone basis. In many instances, transaction costs appear to prevent separate service sales from eliminating all free riding.

2.2. RPM induces efficient retail services

Manufacturers with RPM policies that establish retail price floors may be trying to remedy a market failure.[2] That is, by selling its brand to retailers on the condition that each retailer's price not fall below some minimum level, the manufacturer prevents any retailer from taking sales away from another by charging a lower price. Also, by exerting control over the retail price of its brand, as well as the wholesale price, the manufacturer can affect the amount of retail service by providing the necessary retail "margin" to pay for it. With retail price competition for the product thwarted, once prices settle to the minimum level specified in the RPM agreement, retailers compete with each other for sales by offering valuable retail service to consumers.

The free rider problem is not confined to high-tech, information-intensive consumer durables. RPM occurs in markets where goods do not require detailed information, extensive product demonstration, or significant postsale service commitments. Such products include women's fashion accessories, shoes, candy, and designer jeans. In the case of such products, retailers may use RPM-protected margins to invest in retail services like longer hours of operation, more attractive store furnishings, and other amenities that owe little to specialized information. Besides shopping amenities, retailers with reputations for selling high-quality merchandise provide what has been called a "quality certification" service to manufacturers.[3] A manufacturer may use RPM to ensure that reputable retailers—those who help the manufacturer build and maintain a good reputation for its brand—carry its brand by affording those retailers protection from free-riding discounters.

RPM is not a panacea for the manufacturer in every circumstance. If retailers are better informed about retail demand than the manufacturer, an agency problem may interfere with the manufacturer setting the appropriate retail price. If there are retailers who compete in retail markets with different demands, with or without retail services, setting a single minimum retail price for all retailers may not be appropriate. Needless to say, a product whose quality is low cannot survive long in the marketplace just

2. Lester G. Telser offered this explanation for RPM in his path-breaking article on protected retail margins. *See* Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86, 91 (1960); *see also* Lester G. Telser, *Why Should Manufacturers Want Fair Trade II?*, 33 J.L. & ECON. 409 (1990).

3. *See* Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346 (1984).

because it carries a high retail price and appears in reputable retail stores. An RPM policy does not enable a manufacturer to make a silk purse out of a sow's ear.

2.3. RPM reaches beyond the free rider

RPM also may be used to induce efficient retail services when the source of market failure is not a free-riding discounter. Klein and Murphy interpret RPM not so much as a method to foil free riders but rather as a device to make retailers comply with incomplete performance contracts aimed at stimulating and securing retail services that build demand for the manufacturer's product.[4] Economic theory indicates that a manufacturer cannot rely on the retailer to provide optimal retail service when the manufacturer captures some of the benefits of that service. The manufacturer, hypothetically, might enter into a contract with the retailer that specifies exhaustively what services the retailer must provide—for example, how the product is to be displayed, hours of operation, sales presentations, and inventory levels. But incomplete information and monitoring costs make writing and enforcing such thorough contracts problematic.

RPM spares the manufacturer the task of specifying and monitoring the retailer's performance along multiple service dimensions. This is because RPM induces retail services without their being specified exhaustively. The retailer provides the sought-after, but difficult-to-specify, retail services to avoid termination and to capture the protected retail margin. Klein and Murphy's important insight extends the role of RPM well beyond the case of a free-riding discounter.[5]

The motivation of a manufacturer using RPM is not to enable retailers to raise prices and gouge consumers. The economic logic of using RPM to induce efficient retail service is for the manufacturer to impose a price floor to restrain downstream *price* competition in order to foster *service* competition. A manufacturer has no incentive to overcompensate its retailers; doing so would reduce the manufacturer's profits *and* would make the manufacturer's product line less competitive in the marketplace. Instead, the manufacturer wants its retailers to make just enough money to market its brand effectively, and no more.

By redirecting retailers' competitive activities from prices to retail service, RPM limits *intrabrand* competition in prices among retailers. But this limitation can have the effect of enhancing *intrabrand* competition along other dimensions of rivalry among retailers. RPM also can have the effect of enhancing *interbrand* competition among manufacturers and retailers alike for sales of different brands because retail service affects consumers' choices among competing brands. It is interbrand competition that disciplines a manufacturer who has adopted an RPM policy and ultimately establishes retail prices in the marketplace. In this respect, the argument that RPM restrains retail price competition at the expense of consumers is deceiving.

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4. *See* Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988); Frank Mathewson & Ralph Winter, *The Law and Economics of Resale Price Maintenance*, 13 REV. INDUS. ORG. 57, 72 (1998).
5. *See also* Mathewson & Winter, *supra* note 4, at 72.

There is another potentially procompetitive use of RPM that reaches beyond the free rider. This is where retailers must order inventories of a manufacturer's product periodically before demand for the product is known. If retailers are free, once demand becomes known, to raise or lower prices to liquidate their inventories, the result may be substantial price fluctuations. In low-demand periods, prices may fall precipitously. In this environment, Deneckere, Marvel, and Peck show that a manufacturer may use RPM profitably to keep retail prices from falling below some floor during periods of unexpected slack demand.[6] RPM is profitable for the manufacturer here because the "guarantee of a stable market may induce retailers to order larger inventories than they would have had retail markets been permitted to clear."[7] In some instances, consumer welfare would be higher with RPM performing this task even though RPM may prevent the liquidation of inventories. Of course, in other circumstances consumer welfare may not increase with this use of RPM even though the manufacturer's profit does.

3. When might RPM harm consumers?

Having set forth the standard economic arguments supporting RPM, we now turn to consider conditions where RPM does not increase consumer welfare. Economic analysis suggests three ways in which RPM can contravene antitrust law's fundamental goal of promoting consumer welfare. Two ways in which RPM might have anticompetitive effects involve the formation and maintenance of cartels. In the first instance, the cartel is formed among retailers; in the second, the cartel is formed among manufacturers. The likelihood of RPM being used to fix prices at either stage in an industry with many competitors is not high, absent evidence of formal cartel mechanisms. Where RPM facilitates the organization and operation of a cartel, its use is and should continue to be unlawful under the antitrust laws.

3.1. RPM-induced retailer cartels

In the case of a cartel among retailers, those firms conspire to set retail prices at monopoly levels and get manufacturers to enforce their agreement and prevent opportunistic discounting.[8] Because it is the manufacturer who appears to be setting retail prices, this kind of collusion diverts attention from the collective price setting by the retailers. In this scenario, retailers use the manufacturer's RPM policy as a cover for their own price-fixing shenanigans. Retailers thereby delegate both the implementation and the enforcement of the cartel to the manufacturer. The manufacturer becomes the cat's paw for the retail cartel. Consumers are made worse off, the same as they would be if the cartel were operated directly by retailers without the participation of a manufacturer.

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6. Raymond Deneckere, Howard P. Marvel & James Peck, *Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition*, 87 AM. ECON. REV. 619 (1997).
7. *Id.* at 619.
8. The term "retailers" is used in the following discussion to mean horizontally arranged firms anywhere downstream from the manufacturer. The analysis would not change if we were to use wholesalers or other agents located somewhere in the distribution channel between the manufacturer and consumers.

For RPM to arise in this manner, retailers must possess monopsony power, either unilaterally or by means of a common agency such as a trade association, to make the manufacturer go along, since this practice is likely to reduce the manufacturer's sales and hence its profits. A manufacturer is driven to cooperate with the colluding retailers by the stick of a threatened boycott rather than the carrot of increased sales. The story is easy enough to tell, but finding real world examples is not so easy.

If retailers must get together to coerce manufacturers to engage in RPM, they should leave the same trail of evidence as they would in a direct price-fixing arrangement. The textbook example of an RPM-induced retailer cartel involves retail druggists who, working through a trade association, cajoled a manufacturer of toothpaste to implement RPM. But there is no evidence that retailer cartels held together by RPM are common. One reason is that the retailer cartel story does not account for how retailers could avoid their cartel being undermined by other forms of nonprice competition. Another difficulty facing such a cartel is that manufacturers often have several distribution channels for their products. If retailers in one channel attempted a price increase using RPM, consumers might be easily diverted to other channels. Besides this, a manufacturer may be reluctant to cooperate with retailers' efforts to raise retail prices for its brand because of interbrand competition. This mechanism for cartel enforcement may be undermined by nonprice competition among the manufacturers.

3.2. Manufacturer cartels shored up by RPM

In the usual manufacturer cartel, sellers collude on the price they charge their customers and do not endeavor to set the resale price of their product. For example, in the international vitamins cartel, participants agreed upon the prices they charged but did not try to influence the prices their customers charged.[9] Nonetheless, a cartel of manufacturers might use RPM to help monitor and enforce the cartel's agreement. Once cartelists reach an agreement to raise prices, each of them has a strong incentive to cheat on that agreement by secretly cutting price and expanding output. Incremental sales that stem from furtive discounts can be very remunerative if the cartel has jacked up prices well above incremental costs.

To rein in this kind of cheating, the manufacturers in this scenario agree among themselves to implement RPM policies with retailers to reduce the incentives to cheat. The idea is that it is easier for manufacturers to observe the retail prices of their competitors' products than the prices those manufacturers charge retailers. RPM agreements establish minimum retail prices for every manufacturer's products. If these agreements are enforced, they take away the profitability of secret upstream discounts by manufacturers because retailers are not able to pass those discounts on to consumers in the form of lower retail prices. Without lower retail prices, retailers sell no more of the cheating manufacturer's product than before. By secretly cutting its prices below the

9. *See* Press Release, U.S. Dep't of Justice, F. Hoffmann-La Roche and BASF Agree to Pay Record Criminal Fines for Participating in International Vitamin Cartel; F. Hoffmann-La Roche Agrees to Pay $500 Million, Highest Criminal Fine Ever (May 20, 1999), http://www.usdoj.gov/atr/public/press_releases/1999/2450.pdf.

cartel level, the manufacturer merely sells the same quantity at a lower price, which is not a recipe for making money. The only way the price-chiseling manufacturer could profit from lower prices would be if the firm did not enforce its RPM policy so that its retail price would fall and sales would increase. But this would be more easily detected by the other cartelists than a secret upstream price cut and could elicit an unfriendly response. This is not a recipe for making money either. In short, under this scenario, manufacturers agree to fix prices to retailers and then, to make cheating on that agreement unprofitable or more easily detectable, they agree to fix retail prices as well.

The assumption in this story that retail price cuts are more visible than upstream price cuts is plausible in some situations. But just as real world examples of retailer cartels stitched together by RPM are not common, real world examples of manufacturer cartels that used RPM to curtail cheating are uncommon. Indeed, the economic nexus between cartels and RPM is not robust. Ippolito's study of RPM litigation found that fewer than 10 percent of private cases involve even the *allegation* of collusion among manufacturers or retailers.[10] Kleit's research into cases before the legal status of RPM was clear found no evidence of RPM as a cartelization strategy.[11]

One reason the manufacturer cartel story has limited explanatory power is that cartels work best when manufacturers' products are homogeneous. RPM is used when products are differentiated. Product differentiation engenders all kinds of nonprice competition among the cartel members that would be difficult for a cartel to squash, especially in an environment where contracts cannot be enforced in a court of law.

3.3. RPM-augmented foreclosure

A third theory as to how RPM might have anticompetitive effects is RPM-augmented foreclosure. Since RPM permits a manufacturer to control its retailers' profit margins, this practice might facilitate an implicit contract between the manufacturer and those retailers of the following nature. The manufacturer ensures retailers of an attractive profit margin on sales of its own brand in exchange for their refusing to take on the distribution of competing brands, including brands offered by new entrants.[12] Rather than jeopardize their attractive RPM-protected profit margins on sales of the incumbent manufacturer's product, retailers decline the opportunity to introduce competing products. If the retailers thus bound to the manufacturer via RPM agreements comprise a sufficiently large share of the relevant market, competing manufacturers may find distribution more costly and new entrants may be deterred. This theory cannot apply where manufacturer competitors and entrants retain access to the market via competing retailers or alternative channels of distribution. Nor can it apply where the manufacturer using RPM does not control a large share of the relevant market in spite of using this practice.

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10. Pauline M. Ippolito, *Resale Price Maintenance: Empirical Evidence from Litigation*, 34 J.L. & ECON. 263 (1991).
11. Andrew N. Kleit, *Efficiencies Without Economists: The Early Years of Resale Price Maintenance*, 59 S. ECON. J. 597 (1993); *see also* THOMAS OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE (FTC 1983).
12. *See* BASIL S. YAMEY, RESALE PRICE MAINTENANCE (1966).

The per se rule against RPM, perversely, can thwart new entry or make entry more difficult. For many consumer products, the difficulty a new entrant faces is the marketing advantages large incumbent firms may have in network television advertising (e.g., beverage companies) or through vertical integration into retailing (e.g., clothing chains). To secure entry, a new entrant may seek to gain retail distribution by offering independent retailers protection against discounting, in the hope that margin protection will induce retailers to market and promote the new product. The per se rule against RPM thwarts new entrants and smaller manufacturers from directly using, through contract, this marketing strategy

3.4. RPM pits the interests of consumers against each other

The main economic objections to RPM are when it is used to enable or facilitate cartelization of markets or to foreclose competition. But even where RPM is used to stimulate retail service, the effects on consumers can be mixed. Mathewson and Winter observe that "the general 'service hypothesis' is that the increase in demand resulting from enhanced service, elicited through a protected retail margin, will more than offset a negative impact on demand of a higher . . . retail price."[13] But if RPM raises retail prices to finance enhanced service, and if that service is more valuable to some consumers and less valuable to others, the result may be that some consumers gain when RPM is imposed while others lose.

Although the net effect of RPM on consumers is no doubt positive in many instances, there is no assurance that the net effect is *necessarily* positive whenever a manufacturer finds it profitable to implement RPM. It is possible, hypothetically, that a manufacturer would find it profitable to use RPM to kindle too much retail service. The reason, as Marvel and McCafferty explain, is that "[m]anufacturers, in their desire to maximize profits, focus on the margin, while allocative efficiency incorporates effects on inframarginal customers. . . . The additional customers attracted by the services must be better off as a result of the service provision. But if some of the additional receipts are derived from higher prices charged to inframarginal customers who do not value the services, the benefits to society of the services provided need not justify their cost."[14] In general, market failure—and an attending loss in consumer welfare—can arise whenever the welfare effects of prices, quality, or retail services on the seller's *marginal* consumer are not the same as those on *inframarginal* consumers. This is because the marginal consumer affects the quantity of goods sold without internalizing the effects of her decision on other consumers.

Consider a simple example in which there are two kinds of consumers: those who value enhanced retail service because they are ill informed about the manufacturer's product, and those who are already knowledgeable and do not value enhanced service. If the manufacturer implements RPM to bring about better retail service, and if the retail

13. *See* Mathewson & Winter, *supra* note 4, at 67 (internal footnote omitted).

14. Howard P. Marvel & Stephen McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J. L. & ECON. 363, 370 (1985); *see* A. Michael Spence, *Monopoly, Quality and Regulation*, 6 BELL J. ECON. 417 (1975).

price increases as a result, the beneficiaries of RPM are previously ill informed consumers who now elect to buy the firm's product. Some of these customers might not have bought the product had they remained ill informed, while others might have bought the product but underutilized it for lack of specialized knowledge. Knowledgeable consumers who buy the product are harmed because the price increase is not accompanied by anything they value. In fact, some consumers, whether knowledgeable or not, might be deterred by the price increase.

In a market with lots of knowledgeable consumers and few consumers who are ill informed, RPM can reduce overall consumer welfare. On the other hand, if many consumers are ill informed, RPM can increase overall consumer welfare. Assessing the impact of RPM upon consumers as a whole would seem to involve balancing aggregate gains and losses for different consumer types, which is no easy task.[15]

However, a manufacturer who has competitors to contend with would be unlikely to implement an RPM policy that reduces overall consumer welfare. Unless the manufacturer is a monopolist, consumers continue to have the benefit of *interbrand* competition even if RPM curtails *intrabrand* competition. To the extent one manufacturer's RPM policy induces retailers to provide costly retail service that knowledgeable consumers do not value, an opportunity is created for other manufacturers to sell "plain vanilla" merchandise at lower prices to attract knowledgeable consumers. Consequently, to use antitrust to curtail RPM because of its consequences for inframarginal consumers is a strained application of trade regulation.

Using antitrust to regulate RPM agreements that a manufacturer implements to induce retail services would be similar to using antitrust to govern the firm's advertising and new product introduction policies. Manufacturers who buy media advertising impose costs on customers who are already persuaded; manufacturers who upgrade product features impose costs on customers who prefer (but are no longer offered) the older, less expensive model. But antitrust does not challenge these policies.[16]

Note that assessing the impact of RPM on consumers is easy if the manufacturer's implementation of RPM does *not* increase the retail price of its product but only the quantity of sales. Marvel and McCafferty explain that if the effect of RPM-induced retail service is an isoelastic shift in market demand, and if the cost of providing service is fixed rather than variable in the long run, then the retail price the manufacturer would seek to impose—the retail price that maximizes the manufacturer's profit—is the same as without RPM and enhanced services.[17]

To sum up, the main reason a manufacturer would implement RPM to induce retail service is if the enhanced service increases product sales. The incremental sales come from consumers who value those services, not consumers who gain nothing from them.

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15. *See* William B. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983 (1985); *see also* Don Boudreaux & Robert B. Ekelund, Jr., *Inframarginal Consumers and the Per Se Legality of Vertical Restraints*, 17 HOFSTRA L. REV. 137 (1988).
16. *See* Frank R. Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J. 135 (1984).
17. *See* Marvel & McCafferty, *supra* note 14, at 371.

If putting an RPM policy in place boosts total sales noticeably, this strongly suggests that consumers, on net, have benefited.[18]

3.5. RPM and snobbery

There is a noneconomic argument against RPM, one rooted in what Thorstein Veblen called "conspicuous consumption."[19] This argument attributes to RPM the financing of retail service that appeals to consumers merely because it is expensive and extravagant. That is, RPM-induced service costs a lot of money but does not enhance the instrumental value of the product. This kind of service (so the argument goes) only appeals to consumers who are in search of ways to signal their elite status. Critics of RPM who object to conspicuous consumption might grant the case for RPM when used to sell information-impacted goods like audio equipment but not for status goods such as designer jeans or athletic shoes. If mass merchandisers could sell designer jeans at discount prices in a world without RPM, then consumers purportedly would be better off. What would be lost would be the boost in status enjoyed by those who flaunt expensive clothing in front of people who cannot afford the high, RPM-enhanced prices. Whether this argument has merit is outside the scope of this chapter, since judging the praiseworthiness of different kinds of consumer status is not the task antitrust has assumed.

4. The legal status of RPM

Antitrust law applies to situations where there has been a distortion in market outcomes that harms consumers. In economic parlance, consumer harm means consumer welfare is reduced.[20] For some business practices, the harm to consumers is so transparent that courts consider the conduct to be per se illegal. Economic logic suggests that the per se category of antitrust offense should be for business conduct so

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18. Richard A. Posner considers this to be a key indicator of procompetitive RPM: "If [the defendant firm's] output expanded, the restriction must have made the firm's product more attractive on balance, thereby enabling the firm to take business from its competitors. This is an increase in interbrand competition and hence in consumer welfare, which is the desired result of competition. The increase must exceed any net reduction in intrabrand competition considered in both its price and service aspects. Any reduction in intrabrand competition, viewed by itself, would increase the price to the consumer and hence make the product less attractive to him. If, on balance, the product is more attractive to consumers, as demonstrated by the fact that more of it is sold, the net effect of the restriction on competition must be positive." Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 21 (1981).
19. THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS: AN ECONOMIC STUDY OF INSTITUTIONS (1899).
20. Economists monetize the notion of a consumer's welfare. A consumer's welfare in any purchase is measured as the difference between the *most* the consumer would pay for a product, rather than do without it, and the product's price. By this definition, any reduction in a product's price, *other things remaining unchanged*, adds to the consumer's welfare. Similarly, higher quality and easier availability increase the value of the product to the consumer so that, at the same price, the consumer's welfare increases. To monetize the value of higher quality or easier availability, an economist calculates the price reduction on the unenhanced product that would be necessary to make the consumer indifferent to getting the enhanced product at the original price.

unlikely to ever confer consumer benefits that a full-blown rule of reason inquiry into the practice is not worth the candle.

4.1. Squaring price and nonprice vertical arrangements

At one time, a number of vertical contracts between manufacturers and retailers were thought to be so unlikely to generate consumer benefits that they were considered per se violations of antitrust law. RPM agreements are an example, but so were agreements that assigned dealers to exclusive geographic territories.[21] Exclusive territory agreements prevent a dealer in one territory from undercutting the prices of a dealer in a nearby territory and curtail free riding and promote downstream services. As courts discovered the procompetitive benefits associated with exclusive territories, this practice was removed from treatment under the per se rule and made subject to the rule of reason. The decision by the Supreme Court that accomplished this move was *Continental T.V. v. GTE Sylvania Inc.*[22] Efficiencies the Court cited in *GTE Sylvania* included facilitating new entry by helping manufacturers incentivize retailers to promote new products and enabling established manufacturers to induce retailers to engage in marketing efforts that consumers value. The Court also mentioned the role of vertical arrangements to promote service and repair of a manufacturer's product. Summing up, the Court wrote: "The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called 'free rider' effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did."[23] Today, all nonprice vertical arrangements are subject to rule of reason scrutiny, leaving only price-related vertical arrangements like RPM in the per se bin.

The legal status of RPM has vacillated between a strict proscription and explicit tolerance. The antitrust case that left the longest-lasting imprint upon trade regulation and RPM is *Dr. Miles Medical Co. v. John D. Park & Sons Co.*[24] Here, a manufacturer of patented medicine entered into contracts with hundreds of wholesalers and thousands of retailers that specified minimum resale prices. The Supreme Court ruled in this case that an agreement on price between a manufacturer and a retailer "can fare no better" under the Sherman Act than an agreement on price among competitors, and thereby put vertical price fixing on the same plane as horizontal price fixing.[25] The Court in *Dr. Miles* contended that RPM agreements were invalid because they contravened the common-law rule against restraints on alienation. This allowed RPM to prevail if the manufacturer did not pass title of the goods to retailers (e.g., goods sold on consignment

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21. United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).
22. 433 U.S. 36 (1977).
23. *Id*. at 55. In the process, *Schwinn* was overturned.
24. 220 U.S. 373 (1911).
25. In Europe, RPM also is generally condemned "as being particularly serious" and seldom would "produce any beneficial effects." *See* EUROPEAN COMMISSION, DG COMPETITION, GLOSSARY H (2003) (definition of "Hardcore Restrictions"), http://ec.europa.eu/comm/competition/general_info/h_en.html#t117. However, the European Commission allows various work-arounds for manufacturers to implement RPM short of direct contract.

to retailers). But the Court in *Dr. Miles* did not simply recite common-law doctrine. It described the price agreements that Dr. Miles had with downstream vendors as "a combination between the manufacturer, the wholesalers and the retailer to maintain prices and stifle competition . . . . That these agreements retrain trade is obvious."[26]

Dr. Miles established RPM as a per se antitrust offense. Later, the Miller-Tydings Act (1937)[27] and the McGuire Act (1952)[28] ushered in the "fair trade" era by removing RPM contracts from the reach of the Sherman Act if such contracts were valid under state laws. These laws were intended to protect independent retailers from the price cutting by large chain stores. In 1975, these acts were repealed, effectively returning the law to the pre-1937 status quo.[29] The Court's opinion in *Dr. Miles*, over 90 years ago, remains the taproot for the per se rule against RPM. This rule is at odds with the economic theory of vertical relationships that has developed over the 90 years since.

Economic analysis makes clear that vertical price fixing, unlike horizontal price fixing, can remedy market failure and promote consumer welfare. Yet, thus far, the Supreme Court has not placed RPM (for minimum price arrangements) under the rule of reason. Prominent antitrust commentary has suggested such a change. The Areeda-Hovenkamp antitrust treatise concludes: "To the extent that *Dr. Miles* rests on the false categorical propositions that resale price maintenance never benefits manufacturers and always has the same effects as an illegal dealer cartel, its ruling is ripe for reexamination the Supreme Court has never given it."[30] Posner's antitrust treatise concludes: "The per se rule against resale price maintenance remains. It is a sad mistake. There is neither theoretical basis, nor empirical support, for thinking the practice generally anticompetitive."[31]

If prevailing antitrust law governing nonprice vertical arrangements is properly calibrated, this means that a per se rule against RPM fails to apply the economic logic of *GTE Sylvania* to price-related vertical arrangements. In other words, if the per se rule is reserved for conduct that is nearly always anticompetitive, then why should it apply to RPM? Just as economic analysis is required to distinguish those circumstances when territorial restraints reduce or increase consumer welfare, it also is required to tell when RPM reduces or increases consumer welfare. The economics of RPM does not warrant the presumption that RPM nearly always causes antitrust injury.

In the early days of antitrust, RPM was viewed as nothing more than an attempt to fix retail prices at monopoly levels. This doctrine was especially perverse in the case of "maximum RPM," where the manufacturer imposes a price *ceiling* on its retailers. Precisely why a self-interested manufacturer would want to constrain retailers to raise

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26. *Dr. Miles*, 220 U.S. at 400.
27. Act of Aug. 17, 1937, Pub. L. No. 314, ch. 690, Title III, 50 Stat. 693 (1937) (amending 15 U.S.C. § 1), *repealed by* Consumer Goods Pricing Act of 1975, Pub. L. No. 94-145, 89 Stat. 801.
28. Act of July 14, 1952, Pub. L. No. 543, ch. 745, 66 Stat. 631 (amending 15 U.S.C. § 45), *repealed by* Consumer Goods Pricing Act of 1975, Pub. L. No. 94-145, 89 Stat. 801.
29. Consumer Goods Pricing Act of 1975, Pub. L. No. 94-145, 89 Stat. 801; *see also* OVERSTREET, *supra* note 11, at 7 (providing an historical account of the legal treatment of RPM).
30. *See* 8 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 217 (2d ed. 2004).
31. RICHARD A. POSNER, ANTITRUST LAW 189 (2d ed. 2001) (footnote omitted).

retail prices instead of just setting wholesale prices at profit-maximizing levels (and relying on intrabrand competition among retailers to set the retail price) was a question that went ignored. The common-law doctrine against restraints on alienation also helps account for the early hostility to RPM. RPM agreements never were given the opportunity to be assessed on the basis of their effects on consumers. To square the status of RPM with that of other vertical practices, RPM should be subjected to a rule of reason inquiry like nonprice vertical arrangements.

A rule of reason inquiry need not be an expensive, time-consuming task for the court deliberating about a manufacturer's use of RPM. Unless there is independent evidence of collusion among retailers and that a manufacturer's RPM agreements are involuntary and not motivated by retail services, the retail cartel theory of RPM should be discounted. This theory casts RPM in a supporting role played by a reluctant manufacturer. The lead role is the retail cartel itself.

Similarly, unless there is independent evidence that a manufacturer using RPM is colluding with its rivals, each of whom also uses RPM, the manufacturer-cartel theory of RPM should be discounted. Finally, where a manufacturer does not possess enough market power to trigger concerns about the exclusion of rivals (i.e., where there is abundant interbrand competition), the RPM-augmented foreclosure theory should be discounted.

When a manufacturer's RPM agreements are motivated by retail service provision, there should be a presumption that those agreements are procompetitive. Interbrand competition among manufacturers renders pricing and service outcomes that promote consumer welfare with or without RPM. Marvel and McCafferty state that "[i]f a manufacturer chooses voluntarily to impose RPM to ensure that services are provided, welfare will almost certainly rise as a result."[32] Mathewson and Winter go so far as to say that "[e]ven in a market where there is a monopoly—where there is no chance of enhancing interbrand competition—restricting the firm to lower service levels through a prohibition on resale price maintenance is not generally welfare increasing."[33]

4.2. Unilateral RPM

Notwithstanding the per se illegality of RPM agreements, the Supreme Court in 1919 recognized a manufacturer's unilateral right to implement RPM in *United States v. Colgate & Co*.[34] The *Colgate* doctrine affords a manufacturer the option to announce a take-it-or-leave-it policy of selling only to downstream vendors whose retail price adheres to the manufacturer's *suggested resale price* (SRP). In particular, *Colgate* allows a manufacturer to enforce its SRP policy by refusing to do business with retailers who undercut that price, as long as there is no "agreement" under the antitrust laws with the retailer as to the price the retailer will charge.

The *Colgate* doctrine appears to be a technical artifact of Section 1 of the Sherman Act, the statute in the United States that governs RPM, since Section 1 applies only to

32. Marvel & McCafferty, *supra* note 14, at 372.
33. Mathewson & Winter, *supra* note 4, at 81.
34. 250 U.S. 300 (1919).

"contracts," "combinations," and "conspiracies." Unilateral action is not within Section 1's purview. The reason a manufacturer may implement RPM unilaterally is that such a policy does not comprise an *agreement* between the manufacturer and its retailers, or the retailers among themselves.

The fact that a group of retailers behaves in the same way does not mean they have collectively agreed to behave that way. Parallel behavior is not necessarily collective behavior. The distinction between a coincidence of action and an agreement is prominent in economic theory and is a basic principle of antitrust analysis.[35] In the economic model of perfect competition, sellers all charge the same price, but not as the result of an agreement. The same holds in other theories of price determination where firms' products are homogeneous. Economists call this the "law of one price." In similar fashion, when a manufacturer unilaterally announces its intention to terminate retailers who do not abide by its retail price requirement, and retailers unilaterally follow suit, this result is not due to an agreement.

Historically, courts have been hostile to the *Colgate* doctrine. As a result, to implement an RPM policy under the *Colgate* doctrine the manufacturer must take care to avoid any appearance of conduct that could be taken as evidence of an agreement as to any constraints on the prices the retailer will charge. Most importantly, the manufacturer cannot "forgive" a violation of its SRP policy by a retailer on the commitment of the retailer not to violate the policy again. The conventional wisdom is that once a retailer has violated the manufacturer's SRP policy, the manufacturer has no choice except to terminate the retailer.

A variety of methods have emerged to make it easier for retailers to adhere to a manufacturer's SRP policy. These include using buy-back deals to purchase unsold inventory, markdown allowances offered to retailers whenever demand is unexpectedly low, meeting competition price guarantees to retailers, printing SRP on packaging or sales tags, and making use of buydowns and slotting allowances, all to influence downstream retail prices. If antitrust law acknowledged that explicit minimum price RPM agreements, without indications of a horizontal conspiracy, are mainly procompetitive, many such work-arounds would fade away.

4.3. Consignment arrangements

Because using RPM exposes a manufacturer to antitrust liability, the manufacturer may try to control the retail price of its product through consignment arrangements with retailers. Since these arrangements do not involve actual sales to retailers, it is unnecessary to reach an agreement on the "resale" price. This tactic may enable a manufacturer to avoid antitrust oversight without forfeiting control over retail prices.[36] But the practice of consigning rather than selling products to retailers is not a safe harbor from antitrust oversight for manufacturers.

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35. *See* 6 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 59-66 (2d ed. 2003).
36. In *United States v. General Electric Co.*, 272 U.S. 476 (1926), General Electric's consignment system to control the retail price of incandescent light bulbs was unanimously upheld.

If a consignment arrangement is a sham or subterfuge, its use to maintain retail prices will be seen as an unlawful agreement.[37] For example, if retailers bear conventional risks of ownership over the manufacturer's products, the practice will not be considered unilateral. Because they do not remove all risk of antitrust liability, and because they often involve monitoring costs and other transaction costs that make them less efficient than RPM agreements, consignment arrangements provide scant comfort to manufacturers who have procompetitive reasons for implementing RPM.

4.4. Problems with the current legal status of RPM

The inadequacy of the *Colgate* doctrine and agency arrangements as substitutes for enforceable straightforward agreements to induce retail services, and the asymmetric treatment of RPM and nonprice vertical arrangements both augur for changing the legal status of RPM. Antitrust law reserves the category of per se offense for business practices that nearly always create antitrust injury. RPM does not qualify for per se treatment by this criterion. If RPM were to come under the rule of reason, many benign applications of RPM could go unchallenged and the procompetitive effects of RPM would not have to be achieved by other means.

There is probably no starker example of antitrust diverting a company from an efficient marketing strategy than Coors. Coors once purchased very little media advertising. Instead, the company used RPM and exclusive territories to preserve the freshness of its nonpasteurized beer and to induce downstream promotion and regular product rotation by its distributors. When the Federal Trade Commission successfully attacked Coors for these distribution arrangements,[38] Coors had more difficulty ensuring product freshness—something that was not as great a concern to its major rivals, which pasteurized their beer. In the end, Coors altered its product differentiation strategy and turned to media advertising, as its major rivals.

5. "Maximum" RPM

For years, under *Albrecht v. Herald Co*.[39] the Supreme Court treated minimum and maximum resale price agreements with the same lack of enthusiasm. It should be evident, however, that using RPM to establish a downstream price *floor* is quite different than using RPM to establish a downstream price *ceiling*. Although the presumption of harm to competition will rarely be justified for RPM-imposed price floors, it is even more likely that prohibiting "maximum" RPM—the imposition of a retail price

37. In *Simpson v. Union Oil Co*., 377 U.S. 13 (1964), the Court struck down Union Oil's practice of consigning gasoline to dealers because it had "no legitimate purpose" and was only implemented to fix retail gasoline prices. *Id*. at 21.

38. Adolph Coors Co., 83 F.T.C. 32 (1973), *enforced in part and vacated in part*, 497 F.2d 1178 (10th Cir. 1974), *order modified*, 85 F.T.C. 187 (1975).

39. 390 U.S. 145 (1968). Albrecht was a distributor for a newspaper who had an exclusive territory for his delivery route. According to Albrecht's contract with the newspaper, he would be terminated if he charged his customers a price greater than the paper's advertised price. He did just that. When he was terminated, Albrecht sued, and the Court affirmed that fixing *maximum* prices also violated § 1 of the Sherman Act.

ceiling—could harm consumers. The most compelling explanation for a manufacturer restraining retailers from charging high retail prices is one that couples consumers' interests with those of the manufacturer.

When a manufacturer distributes its product to consumers via a perfectly competitive retail market, competition among retailers will keep retail prices as low as possible, given retailers' costs and the manufacturer's wholesale prices. In fact, it is the dependability of price competition among retailers that gives rise to a manufacturer's using "minimum" RPM to prevent price competition from extinguishing efficient retail service. If retailers who distribute the manufacturer's product have substantial market power, whether localized or over an extensive geography, the manufacturer cannot rely on competition to discipline retail prices. The imposition of price ceilings keeps such retailers from raising retail prices and reducing quantities sold at the manufacturer's expense.

In 1997, the Supreme Court overturned *Albrecht* and held that maximum RPM agreements were to be assessed under the rule of reason. In explaining this change in direction, Justice Sandra Day O'Connor, writing for a unanimous Court in *State Oil Co. v. Khan*,[40] stated that "we find it difficult to maintain that vertically imposed maximum prices could harm consumers or competition to the extent necessary to justify their per se invalidation."[41]

The plaintiff Khan, a retail gasoline dealer, challenged its wholesale gasoline distributor State Oil's supply contracts. In effect, State Oil's supply contract established the maximum retail prices at which Khan could sell premium and regular gasoline. It did so by pegging the margin between the wholesale and retail price. For example, if Khan were to raise its pump price $0.02 per gallon on premium gasoline, but not on regular, State Oil would raise its wholesale price on premium gasoline the same amount. Maximum RPM was important to State Oil in order to deter its gasoline dealers from changing the relative prices of premium versus regular gasoline by raising the price of premium disproportionately. Consumers were beneficiaries of the Court's decision to allow State Oil to limit the markups of its downstream retailers since this limitation kept premium gasoline prices in check.

Almost every Supreme Court opinion in the antitrust arena provokes critical commentary. But any negative response to the Court's rejection of *Albrecht* has been, at most, a whisper. There has been no serious argument that *Khan* has harmed consumers. At the state level, legislative bodies have not enacted *Khan* "repealers." Just as the rejection of *Schwinn* in *GTE Sylvania* was an advance in antitrust policy, so too was the rejection of *Albrecht* by *Khan*.

6. Conclusion

The generally recognized purpose of antitrust economics is to distinguish procompetitive business conduct, which promotes consumer welfare, from

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40. 522 U.S. 3 (1997).

41. *Id.* at 15. Two scholars whose earlier criticism of *Albrecht* was cited by the Court have criticized *Khan* for not simply making maximum RPM per se legal. *See* Roger Blair & John Lopatka, *The Albrecht Rule after Khan: Death Becomes Her*, 74 NOTRE DAME L. REV. 123 (1998).

anticompetitive behavior, which reduces consumer welfare.[42] Procompetitive conduct by sellers benefits consumers by lowering market prices and/or raising product quality. Anticompetitive conduct harms consumers by raising prices or reducing product quality. Except for instances where it becomes a tool for cartelization or foreclosure, the practice of RPM often is procompetitive. Imposing minimum retail prices generally elicits efficient retail service and sharpens interbrand competition. It is hard to see how imposing maximum retail prices could be anything other than beneficial to consumers. When there is no remotely plausible (or even alleged) horizontal conspiracy, and the manufacturer is not a monopoly, keeping minimum price RPM under the per se rule mainly condemns a procompetitive practice.

Bringing RPM agreements that impose maximum retail prices under the rule of reason is a welcome development. One hopes for a similar future development with respect to minimum price RPM agreements. Continuing to treat RPM agreements that impose minimum retail prices as a per se offense puts manufacturers in a peculiar position. Since using enforceable contracts with retailers to influence retail prices is off limits, manufacturers must use indirect and less efficient arrangements to exert that influence. Either the per se rule about RPM should be reformulated or RPM should be treated under a rule of reason test. The reformulation or test should require independent proof of a manufacturer or retailer cartel, or indications that RPM has a significant exclusionary effect. But for these indications, it should be presumed that RPM is procompetitive.

7. Postscript

On June 28, 2007, the Supreme Court decided *Leegin Creative Leather Products v. PSKS, Inc.*[43] Justice Anthony Kennedy's majority opinion held that a manufacturer no longer automatically violates the antitrust laws if it has an agreement with its retailers as to the minimum resale prices to be charged for the manufacturer's products. *Leegin* overruled the Court's 1911 decision in *Dr. Miles*.

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42. Some would argue that advancing consumer welfare is the only goal of antitrust. *See* ROBERT BORK, THE ANTITRUST PARADOX 89 (1978); Kenneth G. Elzinga, *The Goals of Antitrust: Other Than Competition and Efficiency, What Else Counts?*, 125 U. PA. L. REV. 1191 (1977). Phillip E. Areeda and Herbert Hovenkamp wrote: "Today it seems clear that the general goal of the antitrust laws is to promote 'competition' as the economist understands that term. Thus we say that the principal objective of antitrust policy is to maximize consumer welfare by encouraging firms to behave competitively, while yet permitting them to take advantage of every available economy that comes from internal or jointly created production efficiencies, or from innovation producing new processes or new or improved products." 1 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 4 (2000). A former chairman of the Federal Trade Commission, testifying before the House Judiciary Committee, put the matter this way: "It is virtually undisputed today that the purpose of antitrust is to protect consumers, that economic analysis should guide decisions, and that horizontal cases involving mergers and agreements among competitors are the mainstays of antitrust." Timothy J. Muris, Chairman, Federal Trade Comm'n, Prepared Statement of Federal Trade Commission Before the Committee on Judiciary Antitrust Task Force, United States House of Representatives, Concerning An Overview of Federal Trade Commission Antitrust Activities (July 4, 2003).
43. 127 S. Ct. 763 (2006).

The Court's opinion in *Leegin* does not make RPM automatically legal. What has changed is that an antitrust defendant who has engaged in this marketing strategy now can have its day in court—to show that its conduct was not in fact anticompetitive.

The key to *Leegin* is that it will focus antitrust litigation on the right questions. Rather than arguing about whether a manufacturer did enough to move from a per se legal "policy" to terminate discounters to a per se illegal "agreement" to maintain retail prices, the parties now can focus on the relevant question of whether the practice in question was anticompetitive or not. *Leegin* is in the grain of the Court's decision 30 years ago in *Continental TV v. GTE Sylvania Inc.*, which eliminated the per se rule against vertical nonprice agreements, such as exclusive territories. This makes antitrust policy consistent for both vertical nonprice and price agreements.