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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Leegin's 10-Year Checkup: An Economist's Perspective

By **Thomas Overstreet**

Law360, New York (June 30, 2017, 11:44 AM EDT) -- For nearly a century, resale price maintenance was a per se antitrust violation. Then, on June 28, 2007, the U.S. Supreme Court held that the legality of RPM should be determined on a case-by-case basis under the rule of reason.

Now that a decade has passed since the landmark ruling in Leegin Creative Leather Products Inc. v. PSKS Inc., this weeklong Expert Analysis series examines its impact.

In 2007, the economic literature supported making resale price maintenance subject to the rule of reason.

Thomas Overstreet

In its decision in the Leegin case, the U.S. Supreme Court noted that "[i]n the theoretical literature, it is essentially undisputed that minimum [resale price maintenance] can have procompetitive effects and under a variety of market conditions it is unlikely to have anticompetitive effects." [1]

The court's decision and the economists' amici brief also discussed the empirical evidence regarding resale price maintenance that was available at the time, which both viewed as suggesting that the empirical evidence did not support the per se illegal treatment of RPM either.

In 2007, it was unclear how courts would implement a rule of reason in RPM matters. While the 23 economists who signed the amicus brief agreed that the per se illegality of RPM was not justified on theoretical or empirical grounds, there was disagreement on how to implement a rule-of-reason approach. Views ranged from establishing some narrow "safe harbors," for new entrants or firms with very small market shares, and otherwise treating the practice as illegal, to implementing a full-blown rule-of-reason analysis with the burden of proof fully on the plaintiffs.[2],[3]

From an economic perspective, it was hoped that making RPM subject to the rule-of-reason would help manufacturers more efficiently resolve their vertical control problems, and still allow the antitrust authorities to pursue cases where harm to competition and consumers could be demonstrated — applying a rule of reason of some sort.

Views Regarding RPM 10 Years After Leegin

Many economists were expecting the change in the legal status of RPM to result in more information becoming available for analysis because (1) more firms would probably use RPM agreements (contractual or otherwise), and (2) there would probably be legal challenges that would be examined using the rule-of-reason approach. This information would have facilitated further empirical analysis of RPM by giving practitioners access to more detailed information and data about the use of RPM agreements in practice.[4] This type of detailed evidence could also help economists develop testable hypotheses from the many theories about RPM; that is, hypotheses that clearly distinguish pro-competitive uses of the restraint from anti-competitive ones.[5] And, doing so in a legal setting would contribute to the development of legal precedents regarding the implementation of a rule-of-reason analysis of RPM matters.

A Dearth of Detailed New Evidence on the Use of RPM Agreements

For the most part, these expectations have not been realized in the 10 years since the Leegin decision. First, it appears that because of the different legal status of RPM across states (as well as international jurisdictions), many firms have been reluctant to implement RPM agreements, and have instead increased the use of other types of vertical controls, such as unilateral resale price policies, and/or restraints on minimum advertised prices (MAP), which involve less legal risk than RPM agreements.[6] Moreover, most of the legal action in the U.S. since Leegin appears to have been at the state level, in states where RPM was still considered illegal per se by applicable state laws. The main issues in these cases seem to be whether there was a vertical agreement (instead of a manufacturers' unilateral distributional decision), that is, whether the Colgate exception applied; or, if there was a vertical agreement, whether it restrained minimum resale transaction prices as opposed to advertised prices.

There appears to have been little to no effort in these cases to evaluate the reasonableness of RPM, i.e., whether there was an efficiency explanation for the practice and what the impact was on prices and output levels. As a result, the cases do not provide an adequate basis for practitioners (inside or) outside of the legal setting to evaluate the actual impact of these instances of RPM on competition and consumers.

Following the Leegin decision, the U.S. Department of Justice investigated RPM-related issues and brought suit in federal court against Apple and various e-book publishers challenging their agreements concerning the sale of e-books.[7] However, the decisions of both the lower court and the court of appeals, which were adverse to Apple, were based on the view that the contracts were per se illegal horizontal agreements. As a result, the court decisions in the Apple case don't provide practitioners with any guidance about how to implement a rule-of-reason approach to vertical agreements.

Further (Theoretical) Developments in the Literature

Despite the relative dearth of new empirical evidence from litigated cases, there have been new developments in the economics literature since Leegin. Although major new theories about RPM have not emerged, a number of articles have advanced and refined ideas that were present in the literature at the time of the Leegin decision. To follow are some notable examples.

Expanding on the idea that RPM can have exclusionary effects, John Asker and Heski Bar-Isaac (2014, 2010) show that RPM (as well as slotting fees, loyalty rebates and related vertical practices) can allow an incumbent manufacturer to share profits with retailers. This can cause the retailers to not accommodate

entry by rival manufacturers, because such entry could reduce the incumbent manufacturer's profits, in which the retailers share. This is a variant of the "special services" argument for RPM, but in this analysis the "service" the retailers provide the manufacturer is to deny distribution to (i.e., exclude) rival manufacturers, thereby erecting a barrier to entry at the manufacturer level.[8] Robert Steiner (1982) raised similar concerns about RPM, but without developing a formal model.[9]

In contrast, Ben Klein's 2009 paper "Competitive Resale Price Maintenance In the Absence of Free-Riding" extends the idea that sharing profits with retailers can actually have pro-competitive effects.[10] His analysis focuses on situations in which a manufacturer might use RPM because its incentives are not properly aligned with those of its downstream retailers, not because of concerns about free-riding by retailers. Klein's analysis is a refinement and extension of similar ideas that were in the literature at the time of the Leegin decision.[11]

RPM can increase sales and manufacturer profits by generating retailer services that attract marginal consumers, who benefit from the service, while harming infra-marginal consumers, who would have bought a product without the service, but now must get the service and pay a higher price. While this is not a new idea, Tarcisio B. da Graca and Robert T. Masson (2012) extend the analysis of the differential impact on marginal and infra-marginal consumers of RPM-induced retailer services.[12] Their model and analysis indicate that the effects of RPM on consumer surplus may be far more negative than conceived of in the earlier literature, and they conclude that demand-inducing information provision is a flimsy defense for RPM if consumer surplus is the standard, and not always convincing if total surplus is the standard.

Several papers have evaluated RPM in different contexts than in the literature available before 2007. For example, Patrick Rey and Thibaud Vergé (2010) analyze RPM in the context of interlocking relationships between manufacturers and retailers.[13] Their model highlights how RPM can eliminate both intrabrand and interbrand competition when manufacturers sell their products through the same competing retailers.[14]

Oystein Foros, Hans Jarle Kind and Greg Shaffer (2013) evaluate RPM in the context of an agency model in which an upstream firm chooses and sets the retail price of the product and pays the retailer a fixed percentage of the retail price for its service.[15] Their paper discusses the agency model used by Apple in dealing with application developers and e-book publishers.

More recently, Amelia Fletcher and Morten Hvid (2016) analyze "broad retail price most-favored-nation clauses" and ask whether they are "RPM at its worst."[16] The authors find a close similarity between broad retail price MFNs and RPM, and that broad retail price MFNs can facilitate upstream and downstream collusion, act as a commitment device to protect upstream monopoly rents, and restrict upstream entry or expansion.

Thus, while some new theories of potential harm have arisen, there also are expanded theories of pro-competitive benefits of RPM. Therefore, economic theory still strongly supports a rule-of-reason approach to RPM.

Further (Empirical) Developments in the Literature

Two papers published since the Leegin decision have attempted to evaluate the impact of changes in the legal standard for RPM in the U.S. empirically.[17] Alexander MacKay and David Aron Smith (2014) view the change in the law as an event or natural experiment that allows one to evaluate what

happened to prices and output of various products in states where the Leegin decision changed both state and Federal approaches to RPM from per se illegality to rule-of-reason (treatment states), relative to where the state laws continued to view RPM as illegal per se (control states).[18][19] They identify 15 treatment states and nine control states. Using a difference-in-differences methodology, the authors analyze the prices of goods in various categories compiled in a Nielsen Consumer Panel Data for 12 months prior to Leegin and for two years starting six months after the Leegin decision.[20] Individual products were grouped into over 1,000 product modules, and the authors evaluated changes in the average prices and quantities sold of each product module.

Their results were mixed. Some product modules showed increased prices and reduced output (in treatment versus control states, holding various other things constant), suggesting increased market power, and other product modules showed increased prices but increased output as well, suggesting a pro-competitive result. The authors estimate that the overall price impact was to increase prices by 0.33 percent and to decrease quantity by 3.8 percent.[21] The authors claim that their results give weight to the anti-competitive theories of RPM.

However, Thomas Lambert and Michael Sykuta (2013) question MacKay and Smith's conclusions, noting that the authors did not actually know and could not observe if any firm started using RPM agreements subsequent to Leegin.[22] Instead, firms might have increased the use of unilateral "Colgate" policies, or used MAP programs more intensively after Leegin, which could generate similar results. Second, by using average module prices and quantities, they can't actually evaluate the impact of the Leegin decision on the prices and quantities of individual products. By focusing on products distributed mostly through the grocery channel while excluding more expensive products and products sold in other channels (accounting for about 70 percent of household consumption), Lambert and Sykuta claim that the MacKay and Smith sample might be biased against products where the free-riding and other pro-competitive explanations for RPM could be more applicable.

These are fair criticisms, but the MacKay and Smith results do nonetheless suggest that the change in the legal environment led to small but significant changes in the use of vertical restraints (of some sort) on various products with mixed results. Some seem consistent with pro-competitive explanations and some don't, with the average effect for the products studied slightly negative.

However, these results do not support the view that the move to a rule-of-reason approach was a mistake. That would require more evidence of negative effects across a much broader group of products, measured at the level of individual products. It would also seem to require concluding that economists and the courts are not capable of implementing a rule-of-reason analysis and distinguishing the "good" uses of RPM from the "bad," which would be premature without any real experience trying to do so. Moreover, both courts and economists have been able to distinguish good and bad results using the rule of reason approach in other areas like exclusionary conduct and non-price vertical restraints. So, it is not clear why RPM should be different.

Conclusion

So where does this leave us in 2017? In terms of the economics literature, developments over the last 10 years have expanded our understanding of the settings (i.e., models) in which RPM as well as other vertical restraints can have deleterious effects on competition and consumers. However, they also have expanded our understanding of the settings in which RPM can have beneficial effects. For the most part, though, these refined and extended models haven't been tested or verified empirically. The empirical work of MacKay and Smith is interesting, but inconclusive for the reasons mentioned above.

In terms of evidence from litigated matters, we are about where we were in 2014 when Robert L. Hubbard, an assistant attorney general in the Antitrust Bureau of the New York Attorney General's Office, discussed how a rule-of reason challenge to RPM agreements could be done legally.[23] He suggested that the analysis can be made manageable by focusing on what is "relevant, useful, and provable."[24] Hubbard noted that much of the fight over what is relevant, useful and provable will turn on expert testimony. So far, however, there has been a dearth of such opportunities in the U.S., which suggests that learning how to apply the rule of reason to RPM matters will have to occur in future litigation. This situation could persist if a number of large population states continue to view and prosecute RPM agreements as illegal per se, and if the resulting legal risk (and/or the practical difficulties of using RPM agreements in some states but not in others) continues to deter most manufacturers from implementing RPM agreements, as seems to be the case now.[25]

Thomas Overstreet, Ph.D., is a vice president in the Washington, D.C., office of Charles River Associates.

DISCLOSURE: Overstreet was invited to contribute to an amicus brief filed with the Supreme Court in the Leegin case.

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[1] Leegin Creative Leather Products, Inc. v. PSKS, Inc.; 551 U.S. 877 (2007), p. 9, citing Brief for Economists as Amici Curiae, and other published work from the legal and economics literature dealing with resale price maintenance (RPM). The Court also noted that "[e]ven those [economists that are] more skeptical of resale price maintenance acknowledge it can have procompetitive effects."

[2] Some economists advocating a full-blown rule of reason probably also would have required some showing of horizontal elements as well.

[3] Some legal scholars (e.g., Posner) advocated for per se legality for RPM agreements not involving cartels or horizontal agreements, which could be challenged under Section 1 as contracts or conspiracies in restraint of trade. However, this approach would ignore instances where RPM-facilitated tacit collusion, which isn't itself generally illegal.

[4] For a useful discussion of future research about RPM, see Alexander MacKay and David A. Smith (2017), "Challenges for Empirical Research on RPM," Review of Industrial Organization 50, no. 2, pp. 209–220.

[5] The various theories do not always distinguish clearly between pro and anticompetitive outcomes and thus do not always generate testable hypotheses.

[6]See Michael Lindsay's series of articles in the Antitrust Source: "State resale price maintenance laws after Leegin," October 2009; "An update on state RPM laws since Leegin," December 2010; "A tale of two coasts: Recent RPM enforcement in New York and California," April 2011; "From the Prairie to the Ocean: More developments in State RPM law," August 2012; "Repatching the quilt: An update on state RPM laws," February 2014; and "Contact lenses and contact sports: An update on state RPM laws," April 2017.

[7] U.S. v. Apple, Inc., et al; Nos. 12-cv-2826 (DLC). The Maryland Attorney General filed a complaint against Johnson & Johnson Vision Care, Inc., in February 2016 alleging a minimum RPM agreement for contact lens sales. See, State of Maryland v. Johnson & Johnson Vision Care, Inc., File No. 03C16002271. The parties settled on March 29, 2017 and Johnson & Johnson Vision Care discontinued the practice. See, Lindsay (2017). In Jacobs v. Tempur-Pedic International, the 11th Circuit dismissed a resale price-fixing claim and rejected plaintiffs' proposed relevant product definition. See, Robert L. Hubbard, "Applying the Rule of Reason to Resale Price Restraints: A Fresh Perspective," Antitrust (Fall 2014), pp. 95–99.

[8] A working paper version of their analysis ("Exclusionary Minimum Resale Price Maintenance") was out in 2010, and an expanded version of their work was published in the American Economic Review in 2014 – "Raising Retailers' Profits: On Vertical Practices and the Exclusion of Rivals."

[9] Robert Steiner, "Vertical Restraints and Economic Efficiency," FTC Bureau of Economics Working Paper, No. 66, June 1982. In addition, see Bruno Jullien and Patrick Rey, "Resale Price Maintenance and Collusion," RAND Journal of Economics (2007). An earlier version was in circulation in 2000 ("Resale price maintenance and collusion," GREMAQ and IDEI, Université des Sciences Sociales Toulouse, May 9, 2000).

[10] Benjamin Klein, "Competitive Resale Price Maintenance In the Absence of Free-Riding," The Antitrust Law Journal 76(2) (2009).

[11] For example, see Klein and Leffler, "The Role of Market Forces in Assuring Contractual Performance," 89(4) Journal of Political Economy, 615 (1981); and Klein & Murphy, "Vertical Restraints as Contract Enforcement Mechanisms," 31 Journal of Law and Economics 265 (1988).

[12] Tarcisio B. da Graca and Robert T. Masson (2012), "The "Services" Explanation for Resale Price Maintenance: Deleterious results Missed in the Economics Literature and in Legal Decisions," Southern Economic Journal 79(2), 450-463.

[13] See, Patrick Rey and Thibaud Vergé, "Resale Price Maintenance and Interlocking Relationships," Journal of Industrial Economics (2010). Jullien and Rey (2007) "Resale Price Maintenance and Collusion" in the RAND Journal of Economics expand on the idea that RPM can facilitate upstream collusion.

[14] In the analysis, RPM eliminates intra-brand competition, and common agency eliminates competition between manufacturers. They indicate that this effect can't be replicated through the use of other vertical restraints, which thus might justify a relatively negative attitude towards RPM.

[15] O. Foros, H. J. Kind and G. Shafffer, "Turning the Page on business Formats for Digital Platforms: Does Apple's Agency model Soften Competition?" CESifo Working Paper No. 4362, Category 11: Industrial Organization, August 2013.

[16] Amelia Fletcher and Morten Hvid (2016), "Broad Retail Price MFN Clauses: Are they RPM "At Its Worst?" Antitrust Law Journal 81, pp. 65–98. The article contains a summary of the literature on retail price MFNs and RPM.

[17] Ratfai (2007) studied the effect of RPM on meat prices in Hungary. Ratfai, A. (2007), "The frequency and size of price adjustment: Microeconomic evidence," Managerial and Decision Economics, 28(7), pp.

751–762.

[18] Alexander MacKay and David Aron Smith, “The Empirical Effects of Minimum Resale Price Maintenance,” Kilts Center for Marketing at Chicago Booth – Nielsen Dataset Paper Series 2-006, June 16, 2014.

[19] Ibid, at p.3.

[20] Nielsen estimates that 30 percent of household consumption is accounted for by the categories in the data set, most of which are sold through the grocery channel.

[21] The second study in the U.S. was by E. M. Bailey and G. K. Leonard, “Minimum Resale Price Maintenance: Some Empirical Evidence from Maryland,” The B.E. Journal of Economic Analysis & Policy, Volume 10, Issue 1 (2010). They use a difference in differences approach to analyze the impact of a change in the law in Maryland that made RPM agreements illegal per se on the prices of video games in Maryland relative to prices in Virginia, which was used as a control state. They found no effect of the new statute on video game prices. However, these results can be criticized because local politics in Maryland were very hostile to the Leegin decision in the time preceding the enactment of the new statute, which suggests that Maryland might have been a poor “treatment” state, and because the time period analyzed was very limited.

[22] Thomas Lambert & Michael Sykuta, “Why the New Evidence on Minimum Resale Price Maintenance Does Not Justify a Per Se or “Quick Look” Approach,” CPI Antitrust Chronicle, November 2013 (1).

[23] Robert L. Hubbard, “Applying the Rule of Reason to Resale Price Restraints: A Fresh Perspective,” Antitrust (Fall 2014), pp. 95–99.

[24] He suggested addressing whether RPM unreasonably restrains trade by asking: Does it raise prices? Does it increase sales? Do category sales increase, or just sales of the manufacturer using RPM? Do increased sales flow from freely exercised consumer choice, as opposed to deception or coercion? Does the restraint increase non-price services for consumers? And, does it enhance competition on the merits?

[25] For a more upbeat assessment of future research possibilities see MacKay and Smith’s “Challenges for Empirical Research on RPM,” Review of Industrial Organization (January 2017).

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