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COMPETITIVE RESALE PRICE MAINTENANCE

IN THE ABSENCE OF FREE-RIDING

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I. Introduction

The debate over whether resale price maintenance should be governed by a rule of reason standard, as held in *Leegin*,[1] or returned to the *Dr. Miles per se* rule,[2] as proposed in recently introduced legislation,[3] hinges to a large extent on whether resale price maintenance arrangements are generally motivated by procompetitive efficiencies. As illustrated in the Federal Trade Commission's recent modification of the *Nine West* consent decree, avoiding antitrust liability under a rule of reason standard does not require demonstration of procompetitive efficiencies.[4] However, because a credible procompetitive explanation frequently does not exist for resale price maintenance, some

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[1] Leegin Creative Leather Products, Inc. v. PSKS, Inc., dba Kays Kloset, 127 S.Ct. 2705 (2007).

[2] Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

[3] S. 148: A bill to restore the rule that agreements between manufacturers and retailers, distributors, or wholesalers to set the minimum price below which the manufacturer's product or service cannot be sold violates the Sherman Act. Introduced Jan. 6, 2009, 111th Congress.

[4] Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000, Nine West Group Inc., FTC Docket No. C-3937 (May 6, 2008), *available at* http://www.ftc.gov/os/caselist/9810386/080506order.pdf. Although the FTC did not accept the procompetitive justifications for resale price maintenance offered by Nine West, the FTC modified the consent decree because, consistent with *Leegin*, the FTC found it unlikely that Nine West's resale price maintenance would have an anticompetitive effect.

antitrust commentators believe such arrangements should be subject to a stricter legal standard and prohibited even if an anticompetitive effect cannot be demonstrated.[5]

The primary accepted procompetitive efficiency rationale for resale price maintenance is the prevention of retailer free-riding. Since *Sylvania* it is widely recognized that "discounting retailers can free-ride on retailers who furnish services and then capture some of the increased demand those services generate".[6] The classic form of such free-riding involves consumers who first visit a full-service retailer to obtain valuable services, such as product information and demonstration, before purchasing the product at a lower price from a discount retailer that does not supply such costly pre-sale services. An obvious way to prevent such free-riding is to eliminate retailer price discounting, thereby removing the incentive of consumers to patronize free-riding retailers. This is the economic basis for the primary procompetitive efficiency justification for resale price maintenance.[7]

[5] Even if a per se rule is not adopted, some commentators believe that the antitrust standard should involve a truncated or "quick look" rule of reason that requires establishment of some procompetitive rationale. Robert L. Hubbard, *Protecting Consumers Post-Leegin*, 22 ANTITRUST 41 (Fall 2007).

[6] Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 55 (1977).

[7] *See* Lester Telser, *Why Should Manufacturers Want Fair Trade*?, 3 J. L. & ECON. 86 (1960). Similar economic reasoning can be found much earlier in T.H. Silcock, *Some Problems of Price Maintenance*. 48 ECON J. 42 (1938) and F.W. Taussig, *Price Maintenance*, 6 AMER. ECON. REV. PAPERS AND PROCEEDINGS 170 (1916).

Justice Breyer in his *Leegin* dissent emphasizes that many cases of resale price maintenance do not fit the established free-riding paradigm. Justice Breyer accepts that resale price maintenance may serve the procompetitive purpose of preventing discount dealers from free-riding on investments made by full-service dealers.[8] And he recognizes that such free-riding may be particularly problematical when a new entrant wishes to assure its dealers that they will be able to recoup their investments in building up a new product's brand name.[9] However, while Justice Breyer notes that these considerations are in principle valid, he questions "how often the 'free-riding' problem is serious enough to significantly deter dealer investment."[10]

A number of prominent antitrust commentators who advocated retention of the *per se* standard similarly argue that free-riding is not a widespread phenomenon that can justify most cases of resale price maintenance. For example, Robert Pitofsky has asked us to "think for a moment about the product areas in which resale price maintenance has appeared - boxed candy, pet foods, jeans, vitamins, hair shampoo, knit shirts, men's underwear. What are the services we are talking about in these cases?"[11]

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[8] *Leegin* dissent at 2728.

[9] *Id*.

[10] *Leegin* dissent at 2729.

[11] Robert Pitofsky, *Why 'Dr. Miles' Was Right*, 8 REGULATION 27, 29 (1984). A similar list of products was repeated in Robert Pitofsky, *Are Retailers Who Offer Discounts Really "Knaves"?: The Coming Challenge to the Dr. Miles Rule*, ANTITRUST 61, 63 (Spring 2007).

More recent examples of resale price maintained products where there is a similar apparent lack of retailer investments that create a significant free-riding problem include women's shoes,[12] athletic shoes[13], and the leather products that were the subject of *Leegin*.

The attempt by defendants to place all cases of resale price maintenance within the prevention of free-riding framework has led to absurd, clearly pretextual explanations. For example, the economists retained by Levis Strauss[14] to justify their use of resale price maintenance argued that full-service retailers provided dressing rooms that consumers could use to determine their preferred style and size of jeans, and consumers would then use this information to buy jeans at discount stores that did not provide dressing rooms. However, were there any discount stores that sold jeans without dressing rooms? In fact, many cases of resale price maintenance involve manufacturer attempts to prevent retailer price discounting even when discount retailers provide similar point-of-sale retailing services as non-discount retailers. Discount retailers are terminated in these cases not for failing to supply sufficient services, but solely because they are selling below suggested prices. This appears to

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[12] *Supra* note 4.

[13] In the matter of Keds Corp., 117 FTC 389 (April 1, 1994); In the matter of Reebok International Ltd., 120 FTC 20 (July 18, 1995); In the matter of New Balance Athletic Shoe, Inc., 122 FTC 137 (September 10, 1996).

[14] FTC v. Levi Strauss & Co., D-9081 (July 12, 1978) and subsequent state actions.

describe the facts of *Leegin*, where Leegin suspended product shipments to Kay's Kloset solely because Kay's was selling Leegin's Brighton brand of leather products below required minimum prices.

A number of variants of the standard free-riding theory of resale price maintenance have been developed by economists in response to these facts. Most importantly, the Court in *Leegin* refers to the Marvel and McCafferty theory of resale price maintenance where the free-rideable services provided by a full-service retailer involves product "quality certification."[15] According to this theory the type of free-riding that is prevented by resale price maintenance involves consumers who "decide to buy the product because they see it in a retail establishment that has a reputation for selling high-quality merchandise."[16] For example, a reputable department store that stocks and displays a product is claimed to be certifying quality and thereby increasing overall demand for the product in the marketplace, which discount retailers then free-ride upon.[17] However, most cases of resale price maintenance involve products that

[15] Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346 (1984), cited in *Leegin* at 2715-16.

[16] *Leegin* at 2715-16.

[17] An analytically related "quality image" argument is sometimes presented as a justification for resale price maintenance, where it is claimed that the overall demand for a manufacturer's product is decreased when the product is seen by consumers in discount stores associated with the sale of lower quality products. Rather than high quality reputation stores producing a positive externality on the demand for the product in lower quality reputation stores, this argument maintains that lower quality reputation stores produce a negative externality on the demand for the product in high quality reputation stores.

already have well-established brand names, so that "quality certification" by a full-service retailer is not particularly relevant. Therefore, free-riding, even in this expanded formulation, does not explain most examples of resale price maintenance.[18]

Justice Breyer argues in his *Leegin* dissent that, although some cases of resale price maintenance may be explained by the prevention of free-riding analysis, the number of such cases is limited and there has been no recent advance in the economic analysis of resale price maintenance that would justify overturning the long-established *Dr. Miles* precedent. He dismisses the Court's reference to numerous economic studies that describe the potential consumer benefits of resale price maintenance by stating that "*nothing* in this respect *is new*."[19] However, Justice Breyer notes that "the one arguable exception consists of the majority's claim that 'even absent free-riding', resale price maintenance 'may be the most efficient way to expand the manufacturer's market share

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See, for example, Jacob Jacoby & David Mazursky, *Linking Brand and Retailer Images: Do the Potential Risks Outweigh the Potential Benefits?* 60 J. RETAILING 105 (1984). However, if such a negative demand externality exists, it generally can be prevented by manufacturer control of distribution and of inter-retailer transshipping; it is not necessary for the manufacturer to control retail price. When an authorized retailer such as Kays Kloset that is not transshipping product is terminated, it is unlikely its termination is for this reason.

[18] Sharon Oster, *The FTC v. Levi Strauss: An Analysis of the Economic Issues,* IMPACT EVALUATIONS OF FEDERAL TRADE COMMISSION VERTICAL RESTRAINT CASES 47, R.N. Lafferty, R.H. Lande, O.J. Kirkwood, eds., FTC Bureau of Competition and Bureau of Economics, (1984) uses the free-riding on certification services rationale to explain Levis' use of resale price maintenance. Rather than attempting to reconcile the obvious inconsistent fact that Levis had already established an independent reputation for its products at the time of the litigation, Oster accepts the free-riding on certification services theory as the correct economic motivation for the practice and concludes that the FTC did Levi Strauss a favor by stopping its unnecessary use of resale price maintenance.

[19] *Leegin* dissent at 2732, emphasis in original.

by inducing the retailer's performance and allowing it to use its own initiative and experience in providing valuable services.'"[20]

Justice Breyer finds this claimed advance in the economic analysis of resale price maintenance incomprehensible.

> "I do not understand how, in the absence of free-riding (and assuming competitiveness), an established producer would need resale price maintenance. Why, on these assumptions, would a dealer not 'expand' its 'market share' as best that dealer sees fit, obtaining appropriate payment from consumers in the process? There may be an answer to this question. But I have not seen it. And I do not think that we should place significant weight upon justifications that the parties do not explain with sufficient clarity for a generalist judge to understand."[21]

Justice Breyer correctly recognizes a logical gap in the Court's argument. The Court's conclusion that compensation of retailers with resale price maintenance may be an efficient way for a manufacturer to incentivize retailers to supply services that increase the demand for its products is based on the fact that "it may be difficult and inefficient for a manufacturer to make and enforce a contract with a retailer specifying

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[20] J. Breyer dissent at 2733, quoting *Leegin* decision at 2716. The Court cites three articles for the view that resale price maintenance may be used to expand a manufacturer's sales in the absence of retailer free-riding: Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J. L. & ECON. 265, 295 (1988); Frank Mathewson & Ralph Winter, *The Law and Economics of Resale Price Maintenance*, 13 REV. INDUS. ORG. 57, 74-75 (1998); and Raymond Deneckere, Howard P. Marvel & James Peck, *Demand Uncertainty, Inventories, and Resale Price Maintenance*, 111 Q.J. ECON. 885, (1996). The Mathewson and Winter citation merely refers to the Klein & Murphy article. The Deneckere, et al.. article presents a model where retailers that stock lower inventories produce a negative externality on retailers that stock higher inventories, discussed *infra* at note 43.

[21] *Leegin* dissent at 2733.

the different services the retailer must perform."[22] However, this begs the question of why retailers need to be compensated by manufacturers for supplying retail services in the first place. Given retailer competition and the absence of retailer free-riding, Justice Breyer pointedly asks why retailers would not have the independent incentive to provide services that are valued by consumers and thereby increase a manufacturer's sales without the need for separate manufacturer compensation.

Contrary to Justice Breyer's reasoning, it is demonstrated in this article that retailer competition and the absence of free-riding often are not sufficient to assure adequate retailer distribution of a manufacturer's products. This is because retailers often have substantially less to gain than the manufacturer from retailer point-of-sale promotional activities devoted to the sale of the manufacturer's products, such as the provision of preferential display or increased salesperson attention. Competitive manufacturers therefore have an incentive to design distribution arrangements where retailers are compensated for providing more intensive promotion of the manufacturer's products. Such distribution arrangements frequently involve manufacturer protection of a retail margin sufficient to cover the retailers' additional costs of supplying greater promotional efforts, including the costs associated with

[22] *Leegin* at 2716.

wider retail distribution of the manufacturer's products, than would be supplied under unrestricted retailer price competition.

The economic analysis of resale price maintenance in this article is broken up into two distinct questions. First, in response to Justice Breyer's criticism, we ask why non-free-riding competitive retailers may not have a sufficient independent incentive to adequately promote a manufacturer's products. Once this question is answered, so that we establish an economic justification for manufacturers to adopt arrangements where retailers are compensated for supplying greater point-of-sale promotional services than they would otherwise independently decide to supply, we turn to the second question of why a manufacturer may use resale price maintenance as the efficient way to compensate retailers for supplying such increased promotional services. The economic answers to these two questions together provide a procompetitive efficiency rationale for resale price maintenance in the absence of free-riding.

The competitive implications of this analysis are contrasted with Warren Grimes' recent proposal for reform of the antitrust law of resale price maintenance.[23] Grimes accepts the economic role of resale price maintenance described in this article, agreeing that resale price maintenance often is employed by manufacturers to compensate

[23] Warren S. Grimes, *The Path Forward After Leegin: Seeking Consensus Reform of the Antitrust Laws of Vertical Restraints*, 75 ANTITRUST L.J. 467 (2008).

retailers for more intensively promoting their products. However, in spite of the fact that resale price maintenance is widely used in this way by both large and small firms, Grimes claims that this role of resale price maintenance is anticompetitive and should be presumptively illegal. Grimes bases this conclusion on his belief that resale price maintenance incentivizes retailers to provide biased and misleading information to consumers. This unsupported view fails to recognize that manufacturer arrangements designed to encourage increased retailer promotion solve a legitimate economic problem and are an essential element of the normal competitive process.

II. Resale Price Maintenance Encourages Increased Retailer Promotion

A. Resale price maintenance prevents retailer free-riding.

The use of resale price maintenance to prevent retailer free-riding relies on the fact that consumer demand for some products is related to the quantity of services supplied by retailers at the point-of-sale. For example, consider the commonly discussed case of high-end audio and video equipment. The demand facing manufacturers of such products is said to depend upon retailer supply at the point-of-sale of product information and demonstrations. When retailers supply such services, the demand for the manufacturer's products increases, which explains manufacturer desire for retailers to supply such point-of-sale services. It is further assumed that

manufacturer supplied promotion, such as national advertising, is not an efficient complete substitute for these point-of-sale retailer promotional efforts.

Since some retailer-supplied point-of-sale services are valuable to many consumers, retailers that supply such services will experience a significant increase in their demand. Therefore, retailers could be expected to compete with one another by providing these services to consumers; and consumers in principle will choose a high-price, full-service retailer or a low-price, low-service retailer depending on whether they demand such services. However, a valid economic concern of manufacturers is that retailers will have an incentive to free-ride on the services supplied by other retailers. Specifically, non-service supplying discount retailers may encourage consumers to first visit a full-service retailer to determine what particular product and features they desire before purchasing that product from them at a lower price. In this way discount retailers are free-riding on full-service retailers by capturing some of the increased demand generated by the services provided by full-service retailers.

The discount, non-service providing retailer can sell the product at a lower price because of the cost savings of not supplying point-of-sale services. However, economic analysis of free-riding emphasizes that this is not the likely final market equilibrium. Since retailers do not have an economic incentive to supply services they are not

compensated for in increased sales, full-service retailers will reduce their provision of services in response to free-riding by discount retailers. The standard analysis concludes that the reduction in retailer-supplied services in response to free-riding, therefore, ultimately leads to both consumers and the manufacturer being worse off -- consumers are worse off because they do not receive retailer services that they desire and the manufacturer is worse off because the demand for its products is reduced.

Exactly how resale price maintenance is used to prevent retailers from free-riding and, instead, to incentivize retailers to supply desired point-of-sale services is not adequately described in the usual formulation of the free-riding theory. Most statements of the theory assume that the supply of desired retailer services is the only non-price way retailers can compete once they cannot reduce price. However, in most circumstances free-riding retailers will be able to compete in other non-price ways rather than supplying desired services and continue to free-ride on full-service retailers. For example, free-riding audio equipment retailers will have an incentive to provide non-price services that cannot be free-ridden upon, such as supplying free installation or free CDs, when consumers purchase audio equipment at the resale maintained price. In this way retailers could still free-ride on full-service retailers who provide

demonstrations and other point-of-sale services that create increased consumer demand for the manufacturer's product.[24]

Therefore, even within the standard free-riding theory the manufacturer must do more than merely fix minimum retail prices and expect unmonitored inter-retailer competition to result in the provision of desired retail services. In addition to enforcing resale price maintenance, manufacturers also must enforce retailer performance with regard to the provision of desired retail services. Manufacturers generally accomplish this by monitoring retailer performance and terminating their relationships with retailers who do not perform as desired, including retailers that reduce price or who do not supply desired services. In this way the manufacturer" self-enforces" its distribution arrangements with retailers.[25]

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[24] Klein & Murphy, *supra* note 20. Furthermore, as described *infra* II.B, even without the possibility of free-riding, unmonitored retailers will engage in non-price competition that has the greatest inter-retailer demand effects which is unlikely to be the manufacturer-specific point of sale promotional services desired by the manufacturer. Grimes, *supra* note 23 at 477 misleadingly summarizes the Klein & Murphy extension of the standard analysis as claiming that "Even economists who are sympathetic to imposition of vertical minimum price fixing agree that this restraint does not prevent free riding." As described in what follows, the Klein & Murphy position is that resale price maintenance *alone* does not fully prevent retailer free-riding.

[25] Retail distribution arrangements in this article refer to purely economic generally unwritten understandings, not legally enforceable contractual agreements. In particular, manufacturer self-enforcement of retail distribution arrangements does not imply the existence of an agreement in the sense required for antitrust analysis of resale price maintenance under the *Colgate* doctrine, United States v. Colgate & Co., 250 U.S. 300 (1919), as it has legally evolved in Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752 (1984) and Business Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717 (1988). The fact that transactors often self-enforce, rather than court-enforce their relationships is the fundamental empirical insight of Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

Resale price maintenance in these circumstances also serves the economic role of providing the retailer with a profit margin that is sufficient to cover its increased costs of supplying the desired retail services. In fact, the profit margin may be somewhat more than sufficient to cover the costs of desired services, so that retailers have something valuable to lose (an expected future extra profit stream) if they are terminated for non-performance.[26] This profit premium self-enforcement theory of resale price maintenance is described by the Court in *Leegin* as an economic motivation for resale price maintenance: "Offering the retailer a guaranteed margin and threatening termination if it does not live up to expectations may be the most efficient way to expand the manufacturer's market share by inducing the retailer's performance and allowing it to use its own initiative and experience in providing valuable service."[27]

The use of resale price maintenance to create a profit premium to cover the retailer costs of supplying the increased retailing services desired by the manufacturer is related to Justice Scalia's opinion in *Sharp*, where vertical restraints are said to work

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[26] The fundamental economic reason a profit stream above costs is required for self-enforcement to be an effective mechanism to assure retailer performance is because manufacturer detection and termination of non-performing retailers is not perfect or immediate. *See* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981). The application of this theory to resale price maintenance contracts is provided in Klein & Murphy, *supra* note 20, where it is shown to be efficient for the manufacturer to generate this extra profit premium by combining resale price maintenance with a reduction in the wholesale price.

[27] *Leegin* at 2716.

by ensuring a dealer profit margin that "permits provision of the desired services." [28] Similarly, Judge Frank Easterbrook has written that "the manufacturer can't get the dealer to do more without increasing the dealer's margin."[29] These statements, as well as the description of this rationale in *Leegin*, focus on an economic motivation for resale price maintenance that is, in principle, distinct from the prevention of free-riding. Resale price maintenance does not merely eliminate the option for consumers to purchase a product at lower-priced retailers after receiving pre-sale services from full-service retailers; resale price maintenance also serves as an efficient way for manufacturers to pay retailers for supplying desired services. However, Judge Easterbrook, Justice Scalia and the *Leegin* Court do not explain why in the absence of retailer free-riding retailers may not have the correct independent incentive to provide services desired by the manufacturer, and hence why the manufacturer must compensate its retailers for supplying desired services.

B. Non-free-riding retailers have an insufficient incentive to adequately promote a manufacturer's products.

The theory of resale price maintenance in the absence of retailer free-riding begins with the same assumption that consumer demand for some products is related to the services supplied by retailers at the point-of-sale. However, the theory recognizes

[28] Business Electronics Corp. v. Sharp, 485 U.S. 717, 728 (1988).

[29] Frank Easterbrook, *Vertical Agreements and the Rule of Reason*, 53 ANTITRUST L.J. 135, 156 (1984).

that some point-of-sale promotional services a manufacturer wishes its retailers to supply are economically different from other retailer services in a number of respects. First of all, the retailer promotional services we are concerned with involve retailer efforts to increase the sale of a specific manufacturer's products, such as the provision of extra salesperson attention or preferable display space devoted to a manufacturer's products. These manufacturer-specific retailer services are distinct from non-manufacturer-specific retail services, such as free convenient parking, a knowledgeable and accessible sales staff, fast payment and check-out, or other non-manufacturer-specific retailer supplied amenities.

Secondly, manufacturer-specific promotional services supplied by retailers are aimed primarily at "marginal consumers" -- consumers who absent the promotion would not purchase the manufacturer's product at current prices, but may do so when the promotional services are supplied. The manufacturer-specific point-of-sale promotional services we are focusing on therefore can be considered economically equivalent to a targeted effective price discount to marginal consumers who value, and are particularly sensitive to, the retailer's promotional efforts. In contrast, inframarginal consumers who already know they wish to buy the manufacturer's products will find point-of-sale promotional services such as preferable display space or extra time devoted by sales staff to a manufacturer's products to be of little value. Inframarginal

consumers are unlikely to be influenced by a retailer's prominent display and will not want to spend additional time with a salesperson that is describing the favorable features of a product they have already decided to purchase. [30]

The third economic characteristic of the targeted point-of-sale manufacturer-specific promotional services we are concerned with is that retailer supply of these promotional services are unlikely to have significant inter-retailer demand effects. For example, consider a retailer's decision to provide the non-manufacturer-specific retail service of free convenient parking. Such a service is likely to be valued by many consumers, not merely marginal consumers, and to influence ex ante consumer decisions regarding where to shop. In contrast, the point-of-sale manufacturer-specific retailer promotional services valued by marginal consumers we are focusing on influence some marginal consumers' buying decisions, but are unlikely to significantly shift marginal consumer decisions regarding where to shop.

To illustrate, consider the most obvious case of what has been labeled in the marketing literature as "impulse sales", where consumers have no prior intent to

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[30] The sharp distinction between marginal and inframarginal consumers is simplifying terminology made for expositional purposes. If manufacturer-specific retailer promotional efforts lead inframarginal consumers to increase their purchases of the promoted manufacturer's products, such consumers would be considered partially inframarginal consumers and also partially marginal consumers with regard to their incremental promotion-induced purchases.

purchase the product, but do so after receiving point-of-sale promotional services such as observing the product in a prominent display. Even when consumers have a prior intent to purchase a type of product, they may not know what brand of the product they wish to purchase.[31]

Some marginal consumers value such point-of-sale promotional services, in the sense that they are on the margin regarding their purchases of the particular product before receiving the services, and after receiving the services their demand increases and they purchase the product. But manufacturer-specific promotional services that induce such impulse sales are unlikely to have any significant inter-retailer demand effects. For example, a leather products retailer that decides to prominently display a particular manufacturer's handbag, rather than another brand of handbag also stocked by the store and available for purchase by consumers who ask for it, will increase its sales of the displayed handbag. However, while some consumers who observe the displayed handbag will choose to purchase it, few, if any, consumers are likely to shift the store at which they shop based on which particular handbag the retailer decides to display.

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[31] Charles Areni, Dale Duhan & Pamela Kiecker, *Point-of-Purchase Displays, Product Organization, and Brand Purchase Likelihoods*, 27 J. OF THE ACADEMY OF MARKETING SCIENCE 428 (1999). It has been estimated that 60 percent of all consumer purchases are unplanned. Paco Underhill, WHY WE BUY: THE SCIENCE OF SHOPPING (Simon & Schuster, 2009) at 47.

The final economic characteristic of these manufacturer-specific retailer promotional services we are concerned with is that they are not generally the type of services other retailers are likely to free-ride upon. For example, most consumers that spend some time with a salesperson that convinces them to purchase a particular article of clothing are unlikely to then, analogous to the audio and video equipment case, go to another store that does not provide sales assistance in the hope of buying that product at a lower price. The magnitude of the retailer promotional investments involved I making the sale are so small that the costs to most consumers of shopping in this way are usually too high relative to the potential free-riding savings they could receive. Therefore, a retailer that provides a manufacturer with preferable display space or greater salesperson efforts devoted to the sales of the manufacturer's products will generally not create a significant free-riding opportunity for other retailers.[32]

[32] A significant retailer free-riding problem may exist, however, with regard to the supply of these types of manufacturer-specific promotional services if the product has a significant likelihood of repeat purchase. A full-service retailer may supply point-of-sale promotional services (such as preferential display space and salesperson attention) that lead to the initial sale, but the consumer's later purchases of the product may be made by free-riding retailers that do not supply these services. The retailer supplying the initial promotional services therefore only receives a return on the first sale, not on future repeat sales. Hence, even when a free-riding opportunity does not exist on the initial sale, the standard prevention of free-riding explanation of resale price maintenance may be applicable. In addition, the growth of the Internet has increased the range of products where consumers now find it feasible to first obtain retailer provided point-of-sale promotional services before making their purchase at a lower price on-line. However, such consumers are taking advantage of savings in total retailing costs, not merely savings of manufacturer-specific point-of-sale promotional costs.

Given these economic characteristics of manufacturer-specific point-of-sale promotional services, manufacturers often find it necessary to encourage retailers to supply more of these services in connection with the sale of their products than the retailers would otherwise independently decide to supply. The fundamental economic reason for this is that the profits earned by the manufacturer from retailer supply of manufacturer-specific point-of-sale promotional services are often substantially greater than the profits earned by the retailer. Therefore, an incentive incompatibility exists between the manufacturer and its retailers with regard to retailer supply of manufacturer-specific point-of-sale promotional efforts.[33]

The incentive incompatibility between the manufacturer and its retailers with regard to retailer supply of manufacturer-specific point-of-sale promotional efforts is caused by two economic factors. First, the manufacturer's profit margin on its incremental sales produced by manufacturer-specific retailer promotional efforts is often greater than the retailer's profit margin on those incremental sales; and second, the manufacturer's incremental sales produced by the retailer's manufacturer-specific

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[33] This incentive incompatibility was originally described in Klein & Murphy, *supra* note 20, where the distinction is made between promotion-sensitive marginal consumers and promotion-insensitive inframarginal consumers and manufacturers use vertical restraints to create a profit premium stream to compensate retailers for supplying promotional services aimed at marginal consumers that retailers would not otherwise supply. A more complete economic analysis of the incentive incompatibility based on the lack of inter-retailer demand effects is presented in Ralph Winter, *Vertical Control and Price Versus Nonprice Competition*, 108 Q. J. ECON 61 (1993), discussed *infra* at note 50, and in Benjamin Klein & Joshua D. Wright, *The Economics of Slotting Contracts*, 50 J. LAW & ECON. 421 (2007).

promotional efforts is often greater than the retailer's overall incremental sales. These two economic factors are discussed in turn.[34]

The greater profit earned by manufacturers compared to retailers on incremental sales of the manufacturer's products, factor one, is a consequence of the fact that manufacturers often produce goods that are more highly differentiated than retailing services. Although individual retailers and retailing chains generally face somewhat negatively sloped demands, manufacturers, especially manufacturers of highly advertised well-known products with established brand names, often face substantially less elastic demands than retailers. Therefore, manufacturers often price their products above marginal cost by a greater amount than retailers. In addition, the costs of producing the manufacturer's products, especially products with high intellectual property content such as CDs or computer software, often have a higher ratio of fixed costs to marginal costs than the costs of supplying retailing services. Consequently, manufacturers of differentiated branded products often earn significantly larger profit

[34] The following analysis assumes for simplicity that the retailer's profit margin and the manufacturer's profit margin remain unchanged as a result of the retailer's provision of increased manufacturer-specific promotion. Therefore, the retailer profit and manufacturer profit from increased retailer promotion is due entirely to the incremental sales produced by the retailer's promotion. This amounts to assuming an increase in retail prices resulting from increased retailer promotion corresponding to the increase in retailer marginal costs. More generally, the effect of increased promotion on market price is ambiguous because increased demand by marginal consumers means that the demand curve for the manufacturer's products is likely to rotate counterclockwise in addition to shifting out. As a result, the retailer's profit-maximizing price may either increase, decrease or remain the same. *See* Gary Becker & Kevin M. Murphy, *A Simple Theory of Advertising as a Good or Bad*, 108 Q.J. ECON. 941 (1993).

margins on incremental sales produced by retailer promotion than the retailers themselves earn on those incremental sales.[35]

However, this first factor does not imply that retailers always have less of an incentive than the manufacturer to provide point-of-sale services that induce incremental manufacturer sales. When a retailer supplies services that have significant inter-retailer demand effects, as consumers shift their purchases from other retailers in response to the retailer's supply of services, the individual retailer's perceived incremental sales increase will be significantly greater than the net demand-increase experienced by the manufacturer. Therefore, although retailers do not take account of the manufacturer's higher profit margin on incremental sales when deciding to supply these services, there need not be a distortion with regard to an insufficient retailer incentive to supply the services. The greater manufacturer profit margin may be offset by inter-retailer demand effects. The incentive for retailers to supply services with larger inter-retailer demand effects is equivalent to the retailer incentive to reduce price. In spite of the fact that retailers receive a lower profit margin on incremental sales

[35] The fact that manufacturers of branded products often face significantly negatively sloped demands and price their products substantially above marginal cost does not mean that such manufacturers possess any market power. Almost every competitive firm operating in the economy sells a somewhat differentiated product for which perfect substitutes do not exist. Moreover, the degree by which demand is negatively sloped and the associated gap between a firm's price and marginal cost should not be used as a measure of the extent of a firm's antitrust market power. *See* Benjamin Klein, *Market Power in Antitrust: Economic Analysis After* Kodak, 3 S. CT. ECON. REV. 43 (1993), where antitrust market power is defined not in terms of a firm's own elasticity of demand, but in terms of a firm's ability to affect market prices.

caused by a reduction in retail price than the manufacturer profit margin, retailers generally do not have an insufficient incentive from the manufacturer's point of view to engage in retail price competition.[36]

However, as described above, retailer supply of manufacturer-specific point-of-sale promotional services does not induce any significant inter-retailer demand effects. This means that the retailer's incremental sales of the manufacturer's products equals the manufacturer's incremental sales. Consequently, an incentive incompatibility will exist between a manufacturer and its retailers with regard to retailer supply of these services because there is not a greater retailer sales increase to offset the lower retailer profit margin.

In fact, rather than a greater retailer sales increase from the supply of promotional services offsetting the lower retailer profit margin on incremental sales, a multi-brand retailer's overall incremental sales increase from promoting a particular manufacturer's products often will be less than the manufacturer's incremental sales increase. This is because the manufacturer-specific retailer point-of-sale promotional

[36] Because the retailer and manufacturer profit-maximizing profit margins are determined in equilibrium by their respective elasticities of demand, an individual retailer's higher demand elasticity and hence higher perceived incremental sales increase from the supply of services because of inter-retailer demand effects will approximately fully offset the retailer's lower profit margin on incremental sales. *See* Klein & Wright, *supra* note 33 at 430.

services we are concerned with, such as more prominent display or greater salesperson efforts devoted to a particular manufacturer's products, are likely to have primarily inter-manufacturer demand effects with little or no inter-retailer demand effects. Hence, promotion-induced sales of a particular branded product at a multi-brand retailer can be expected to "cannibalize" to some extent the retailer's sales of other brands.

For example, consider a leather goods retailer that decides to prominently display or otherwise more intensively promote Leegin's products. This can be expected to increase the retailer's sales of Leegin's products, but also to decrease the retailer's sales of other brands of leather products that could have been prominently displayed or otherwise actively promoted. Consequently, a retailer's overall incremental sales from its Leegin -specific promotional efforts will be much smaller than Leegin's incremental sales. In fact, the retailer's net sales increase may be close to zero if the promotion-induced sales of Leegin's products occurs largely at the expense of the retailer's sales of other branded products. This means that a retailer's independent profit incentive to promote a particular manufacturer's products will be significantly less than the profit incentive of the manufacturer. And this distortion in retailer compared to manufacturer profit incentives exists even if the retailer and manufacturer profit margin on incremental sales of the manufacturer's products is the same.

In sum, given these economic factors commonly present in the marketplace -- a significantly greater manufacturer profit margin than retailer profit margin on the manufacturer's incremental sales induced by point-of-sale retailer promotional efforts, the absence of significant inter-retailer demand effects from such manufacturer-specific retailer promotional efforts, and the "cannibalization" effects across brands sold by a multi-brand retailer when such a retailer makes manufacturer-specific promotional efforts -- retailers often will not have the independent economic incentive to provide the level of manufacturer-specific promotional efforts that maximizes manufacturer profitability. This incentive incompatibility between the manufacturer and its retailers creates a profitable opportunity for manufacturers to design distribution arrangements where retailers are compensated for supplying increased manufacturer-specific promotional efforts.

C. Manufacturer distribution arrangements to induce increased retailer promotional efforts.

The distribution arrangement between a manufacturer and its retailers designed to induce increased manufacturer-specific retailer point-of-sale promotional efforts involves three distinct elements:

(1) what increased promotional services the manufacturer desires its retailers to supply,

(2) how the manufacturer compensates its retailers for their increased supply of promotional services,

and (3) how the manufacturer assures retailer performance with regard to the increased promotional services it has purchased.

1. increased promotional services desired by the manufacturer

The increased manufacturer-specific retailer point-of-sale promotional services desired by a manufacturer, element (1) of the distribution arrangement, may involve specific promotional services, such as a particular preferred location for a product display or a particular description of the manufacturer's products provided by a salesperson. More commonly, because of the difficulties of specifying the details of retailer performance, manufacturers will enter implicit understandings with their retailers regarding promotional efforts that expect to be devoted to the sale of their products and leave it up to the retailer to determine the details of how this should be accomplished. As recognized by the Court in *Leegin*, it is often efficient for the manufacturer to let the retailer "use its own initiative and experience in providing

valuable service" that most effectively encourages increased sales of the manufacturer's products.[37]

In some cases manufacturers may want to achieve the desired increased point-of-sale promotional services by establishing a distribution arrangement with a greater number of retail outlets selling their products. This is particularly important for products where significant impulse sales are made by consumers while shopping. Manufacturers of such products will want to compensate retailers in such a way as to support a greater number of retail outlets because that would result in a greater number of locations where their products are displayed, and hence increased incremental sales. An obvious example is the sale of boxed candy.[38] A significant number of consumers may purchase candy only because they notice it displayed by a retailer when they are shopping for something else.[39] Therefore, distribution and display of the product in a greater number of outlets will increase the candy manufacturer's incremental sales. Resale price maintenance serves the economic purpose in this context of creating and

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[37] *Leegin* at 2716.

[38] In the matter of Barton's Candy Corp., 79 FTC 101 (July 21, 1971) and In the matter of Russell Stover Candies, Inc., 100 FTC 1 (July 1, 1982).

[39] Barton's Candy distributed its boxed chocolate candies through its franchised candy stores in addition to department stores, drug stores, and company outlets; Russell Stover Candies distributed its boxed chocolates primarily through drug, card, gift and department stores.

protecting the increased retailer margin necessary to support a larger number of retail outlets selling a manufacturer's product. [40]

Wide retail distribution not only increases retailer displays, and hence provides an increased opportunity for impulse sales, but also creates opportunities for increased retailer point-of-sale promotional efforts. This explains, for example, Leegin's desire for wide distribution of its leather products. Rather than investing in national advertising or focusing on sales through major department stores, Leegin created a distribution arrangement where resale price maintenance was used to support the sale of its products through more than 5,000 relatively small U.S. specialty retail outlets, each of whom had an economic incentive to promote the sale of Leegin products. Since an expanded number of outlets means that each retailer in equilibrium is selling at less than minimum efficient scale, this arrangement must be supported with some restriction on price competition. Allowing price competition in these circumstances

[40] This promotional analysis provides an economic basis for the "outlets hypothesis" explanation for resale price maintenance presented in J.R. Gould & L.E. Preston, *Resale Price Maintenance and Retail Outlets*, 32 ECONOMICA 302 (1965). It is not economically sufficient merely to assert that the demand for a manufacturer's product is positively related to the number of retail outlets that sell the product, as Gould and Preston do. Since the usual consumer benefits associated with an increased number of outlets (such as increased shopping convenience) have inter-retailer demand effects, such demand effects from increased outlets will be taken account of by competitive retailers operating in an unrestricted retail environment. It is because manufacturers desire a greater number of retail outlets as a way to increase manufacturer-specific retailer point-of-sale promotional services, which does not have inter-retailer demand effects, that the unrestricted competitive process does not lead to the appropriate number of outlets. In these circumstances manufacturers compensate retailers by imposing restrictions on retailer competition to obtain a larger number of desired outlets than would otherwise exist.

would lead to a reduction in the number of retail outlets that carry Leegin's products below the number desired by Leegin that maximizes its demand and profitability.[41]

Deneckere, Marvel and Peck[42] use the commonly stated manufacturer justification for resale price maintenance as a way to support increased distribution as evidence for their theory that resale price maintenance is used to induce retailers to hold greater inventories. [43] However, it is inappropriate to identify the manufacturer desire for increased distribution with the desire for increased inventories. In most cases where manufacturers claim they are using resale price maintenance to support wide retail distribution of their products, they are not using resale price maintenance to incentivize a given number of retailers to stock increased inventories but as a way to increase the number of retailers that sell their products.

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[41] *Leegin* at 2710. Pitofsky (2007), *supra* note 11 at 63, mistakenly claims that the economic importance of resale price maintenance to support an increased number of retail outlets is only relevant for new entrants who have to establish a distribution network, and therefore this rationale cannot justify Leegin's use of resale price maintenance because of Leegin's large established distribution network. However, Pitofsky ignores the economic advantage to an established manufacturer of increased point-of-sale retail promotional services provided by a large distribution network of retailers.

[42] *Supra* note 20.

[43] In their model discount retailers that reduce their inventories and therefore have lower costs impose an externality on retailers that hold greater inventories and charge higher prices. This is because customers first visit discount retailers to purchase the manufacturer's products, so that an increased cost of inventories per unit sales is placed on the higher priced retailers who are left with a smaller share of sales. This externality increases retailer inventory costs, leading to lower inventories, higher prices and reduced manufacturer sales in equilibrium compared to the result achieved in their model under resale price maintenance, where the primary form of retailer non-price competition is unrealistically assumed to involve inventory levels.

For example, in *Leegin* there was no claim that Kays Kloset, the price discounting retailer terminated by Leegin, held insufficient inventories. It seems clear that Kays was terminated solely because it reduced its retail margin by cutting price, and that this was profitable to Kays not because it cut costs by reducing inventories, but because it profitably expanded sales. However, if Leegin had permitted Kays to continue to sell large quantities of its products at discounted prices, Leegin could not have maintained the wide distribution of its products in 5,000 specialty outlets. The new retail equilibrium would have involved a substantially smaller number of outlets, each with greater sales, and a decrease in retailer point-of-sale promotional services associated with wide distribution. [44]

2. efficient manufacturer compensation of retailers

The primary economic question for antitrust policy concerns element (2) of the distribution arrangement, the form in which a manufacturer compensates retailers for providing increased promotion of its products. In general, there is not an antitrust problem if a manufacturer compensates its retailers for other services on a per service

[44] [Distinct from a greater number of retailers that display and otherwise promote a manufacturer's products, a manufacturer also may desire each of its retailers to hold greater inventories than they would under unrestricted competition because it increases incremental manufacturer sales. This is not because of the inter-retailer externality described by Deneckere et al., but because a retailer that runs out of a manufacturer's products may promote the sale of an alternative manufacturer's products. When this effect is economically important, the manufacturer is likely to increase retailer inventories either with specific requirements or with more direct retailer compensation, such as subsidized financing of inventories and liberal return policies, rather than with resale price maintenance.]

supplied basis. For example, a manufacturer may compensate retailers directly for their costs of supplying warranty repair services or of providing local cooperative advertising. However, for some retailer promotional services it is not efficient for the manufacturer to compensate retailers on a per service supplied basis.

For example, consider retailer point-of-sale promotional services that take the form of increased salesperson efforts. What is the measureable unit of service the manufacturer is purchasing that could be the basis of a per service retailer compensation formula? This is what the Court in *Leegin* is referring to when it states that "it may be difficult and inefficient for a manufacturer to make and enforce a contract with a retailer specifying the different services the retailer must perform."[45]

In contrast, it may appear reasonably easy to specify retailer promotional services when the services consist primarily of prominent display rather than salesperson efforts. Because manufacturers are essentially renting shelf space, manufacturers may be able to efficiently induce retailers to supply these promotional services with per unit time retailer compensation contracts similar to supermarket shelf space slotting arrangements.[46] However, the promotional services provided by

[45] *Leegin* at 2716.

[46] See Klein & Wright, *supra* note 33.

department stores and other retailers of the products that are often subject to resale price maintenance are substantially more complex than supermarket shelf space. While a supermarket provides very little other than shelf space, the promotional services supplied by a department store selling a brand of clothing also involve substantial point-of-sale selling efforts in addition to shelf space, and these complementary services are difficult to specify. Consequently, although a department store may be partially compensated by a clothing manufacturer such as Levi Strauss with a per unit time payment for an exclusive display and perhaps a specific sales area in the store, it will generally be efficient for department store compensation to consist of more than just a per unit time payment.

An efficient compensation formula in these circumstances would relate compensation of retailers at least partially to the number of units the retailer sells. In this way an incentive is created for retailers to make incremental sales to marginal consumers and thereby perform as desired and paid for by the manufacturer by supplying the more difficult to specify promotional services. This is exactly what resale price maintenance accomplishes. For example, if the manufacturer compensates the department store based on the sales of the manufacturer's products on which the manufacturer is maintaining the retailer's margin with resale price maintenance, the department store will be incentivized to provide desired point-of-sale promotional

efforts. Alternatively, a manufacturer may generate retailer compensation that is related to the retailer's sales with the use of exclusive territories rather than with minimum resale price maintenance. This has the advantage of reducing inter-retailer free-riding problems and of providing retailers with increased pricing flexibility, but is inefficient when the number of outlets significantly affects demand for the manufacturer's products, as described above.[47]

Similarly, although it may appear that the increased promotional services associated with an increased number of outlets could be induced entirely with a per unit time retailer payment, the magnitude of the payment would be expected to vary across retailers. One of the additional economic advantages of resale price maintenance is that it provides a reasonable compensation formula across retailers when desired additional retailer promotional efforts can be expected to increase each retailer's sales of the chosen manufacturer's products a particular percentage amount.

3. manufacturer enforcement of retailer performance

As described above, the mechanism manufacturers use to assure that retailers supply the increased promotional services they have been compensated for, element (3)

[47] Benjamin Klein, *Distribution Restrictions Operate by Creating Dealer Profits: Explaining the use of Maximum Resale Price Maintenance in* State Oil v. Kahn, 7 *Supreme Court Econ Rev.* 1 (1999).

of the distribution arrangement, generally involves self-enforcement rather than court-enforcement.[48] That is, in most cases the arrangements are not contracts in the legal sense of a court-enforceable agreement, but are self-enforced understandings in the economic sense that retailers are generally aware of the manufacturer's requirements for desired performance and they expect to be terminated if they do not perform as required. Manufacturers operating under this type of arrangement will not take a non-performing retailer to court to demand performance. Instead, manufacturers monitor retailer efforts, which may include considering a retailer's sales relative to comparable retailers or sending an undisclosed representative to examine the retailer's promotional efforts (such as the appearance of the retailer's displays and the extent of salesperson efforts), and terminate those retailers that the manufacturer determines are not performing adequately.

For the distribution arrangement to be self-enforcing the present discounted value of retailer compensation generated by, say, resale price maintenance must be greater than the additional short-run profit the retailer can earn by not performing as desired. However since the manufacturer must monitor and terminate non-performing retailers whether or not there is resale price maintenance, the advantage of generating the required retailer compensation with resale price maintenance rather than on some

[48] *See supra* note 25.

alternative way within this self-enforcing framework may not seem obvious. The economic advantage is that, as described above, compensating a retailer on the basis of sales creates retailer incentives to perform that are more closely aligned with the manufacturer's desired retailer performance. Therefore, resale price maintenance lowers the manufacturer's costs of monitoring retailer performance. And because the manufacturer need not monitor retailers as intensively (nor supply retailers with as large a profit premium stream[49], resale price maintenance makes it cheaper for the manufacturer to assure retailer performance.[50]

However, while resale price maintenance creates an added economic incentive for retailers to perform, it also creates an added economic incentive for retailers not to perform. Retailer non-performance in these circumstances may occur in two primary

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[49] See *supra* note 26.

[50] Ralph A. Winter, *supra* note 33, bases his theory of resale price maintenance on the incentive incompatibility between the manufacturer and retailer with regard to retailer supply of promotional efforts aimed at marginal consumers. However, he does not recognize the role of resale price maintenance in solving this problem by creating a premium stream that facilitates manufacturer monitoring and self-enforcement of retailer performance. Instead, Winter uses resale price maintenance as a way for the manufacturer to equalize the retailer's profit on incremental sales produced by retailer promotion with the manufacturer's profit on such incremental sales. However, unmonitored retailers would still have an incentive to engage in non-price competition with larger inter-retailer demand effects. Moreover, their solution provides retailers with an unnecessarily large share of profit on incremental sales. For example, for products with large marginal profits, such as CDs or software, Winter's model implies that the manufacturer should institute resale price maintenance and significantly lower the wholesale price so that retailers earned a profit margin that was essentially the same as the manufacturer. Not only is this an unnecessarily large payment to retailers compared to manufacturer compensation and monitoring of retailers for supplying the desired increased level of promotional services, but the Winter solution would lead to the manufacturer and retailers both supplying less than the jointly profit-maximizing level of promotional services since they each would be earning only half of the profit on incremental sales.

ways. An obvious way a retailer may not perform is by not supplying the increased desired promotional efforts that have been paid for by the manufacturer. A retailer that does not supply the increased promotion does not make any incremental sales, and therefore is not compensated with the additional profit on such incremental sales. But a key economic aspect of resale price maintenance is that retailer compensation for increased retailer promotional efforts involves a payment based on all of a retailer's sales, not merely a retailer's incremental sales. Therefore, when a retailer does not supply the additional promotional efforts, it still receives additional compensation on its non-incremental sales. Since the cost to the retailer of the additional promotional effort is greater than its profit on promotion-induced incremental sales (which is the economic motivation for the manufacturer to establish the compensation arrangement for increased retailer promotion in the first place), the retailer has an economic incentive not to supply the promotional services paid for by the manufacturer. [51]

This incentive not to supply paid-for promotional services is present even when the retailer is not free-riding on the promotional services supplied by other retailers. That is why, in addition to monitoring minimum retail prices and preventing free-riding, the manufacturer also must monitor retailer performance and terminate those

[51] A payment based solely on a retailer's incremental sales would appear to solve this problem. But it would require the manufacturer to specify an initial level of sales for each retailer, an extremely difficult task when retailers' sales vary considerably.

retailers who do not supply the increased manufacturer-specific promotional efforts they are being compensated to provide.

A second way a retailer may not perform and violate its understanding with the manufacturer occurs when the retailer provides the desired increased level of manufacturer-specific promotional services, but also lowers its price below the resale price maintained level. Such a retailer will make increased sales to price-sensitive inframarginal consumers who decide, in response to the retailer's lower price, to switch their purchases to the retailer. These inframarginal consumers know they want the product, and therefore are not free-riding in the sense that they do not first obtain promotional services from other retailers before they purchase the product from the discount retailer. However, because resale price maintenance involves retailer compensation on the basis of all the retailer's sales, such a discount retailer is still taking advantage of other retailers because it earns profits that would have been earned by other retailers if it had not lowered price.

Instead of sales to inframarginal consumers distributed among non-discounting retailers on the basis of factors other than price (such as convenience of a retailer's location), sales to price sensitive inframarginal consumers are shifted to the price cutting retailer. This involves more than the normal competitive process because the

price cutting retailer is talking advantage of the fact that the manufacturer has created an extra retailer profit premium to compensate retailers for supplying additional point-of-sale promotional efforts. The discount retailer disturbs this arrangement because, even if it is providing the desired increased level of manufacturer-specific promotional services, the discount retailer is overcompensated for supplying the desired promotional services. [52]

On the other hand, retailers that have not reduced price and have lost sales to price discounting retailers are undercompensated for supplying the desired level of manufacturer-specific promotional services. Consequently, these retailers will either reduce their promotional efforts below the level desired by the manufacturers, or stop distributing the manufacturer's products altogether. It will no longer be profitable for retailers to devote their valuable shelf space or their promotional efforts to the manufacturer's products. This explains why price discounting retailers are a concern to manufacturers even when such retailers supply the desired level of manufacturer-specific promotional services.

[52] The discount retailer's overcompensation will be greater if it can advertise its discount prices, and thereby shift sales of a greater number of inframarginal consumers in its favor. This explains why a manufacturer may adopt a minimum advertised price policy for its retailers or make cooperative advertising payments dependent on a minimum advertised price. The greater is a retailer's short-run potential gain from violating the manufacturer's compensation arrangement, the greater is the manufacturer's costs associated with its required monitoring efforts and the profits it must share with retailers as a premium stream to assure retailer performance.

For example, as described above, a retailer selling Leegin's products that discounted price, such as Kays Kloset, will make an increased number of sales to price-sensitive inframarginal customers who know they want to purchase the product. This switching of purchases to Kays leaves other Leegin outlets with reduced sales and profit that is now insufficient to cover the increased costs associated with the greater number of outlets desired by Leegin. Uncontrolled price competition therefore would lead to the exit of outlets, resulting in lower overall manufacturer sales and profitability.

This explains why manufacturers will terminate retailers that discount price even when such retailers are providing the promotional services desired by the manufacturer. In this case the discounting retailer is not free-riding on the promotional services supplied by other retailers; but the other retailers will no longer supply the manufacturer's desired promotional services if the price discounting is permitted. The manufacturer has to prevent retailer price discounting in order to assure that other retailers continue to distribute and adequately promote its products.[53]

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[53] The preservation of the manufacturer's retail distribution network was the primary rationale offered by Dr. Miles for its use of resale price maintenance, Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373, 375 (1911), where Dr. Miles claimed that as a consequence of retail price competition a majority of retail druggists had dropped the Dr. Miles products as unprofitable.

III. The Competitive Effects of Resale Price Maintenance

A. Resale price maintenance is part of the normal competitive process.

The Court in *Leegin* made it clear that, although resale price maintenance may increase a product's retail price, the appropriate antitrust standard should not focus solely on the short-term, or even long-term, effect of a vertical restraint on a product's price.[54] Manufacturers do not have an economic interest in increasing retail margins unless it serves a competitive purpose. On the contrary, manufacturers generally have an incentive to adopt distribution arrangements where retailing services are supplied at the lowest implicit price, that is, where the gap between the wholesale price and the final price to consumers is minimized. Therefore, if the increased retailer margin produced by resale price maintenance was not compensating retailers for supplying services that positively shifted the demand for the manufacturer's products, it would not make economic sense for the manufacturer to prevent low-cost discount retailers from cutting prices.

The economic role of resale price maintenance outlined in this article is part of the normal competitive process. Given the fundamental incentive incompatibility that frequently exists between the manufacturer and its retailers with regard to point-of-sale

[54] *Leegin* at 2718-19.

retailer promotional efforts, both small and large manufacturers will often find it in their interests to use resale price maintenance to compensate retailers for promoting their products. In the final competitive retail equilibrium, this manufacturer compensation of retailers will just cover the additional retailer costs of supplying the increased manufacturer-specific promotional services. For example, when the retailer promotional services the manufacturer is purchasing consists of increased salesperson efforts, manufacturer compensation in equilibrium covers salesperson salaries; when the promotional services consists of increased preferential display, manufacturer compensation in equilibrium covers the retailer's opportunity cost of its display space. Given the highly competitive nature of the retailing market, any extra profit earned by retailers on the supply of these promotional services can be expected to be fully dissipated to the benefit of consumers, either by lower prices on other products or by retailer supply of services that have large inter-retailer demand effects.[55]

However, in this competitive equilibrium the point-of-sale promotional services manufacturers purchase with increased retailer margins are not demanded by all consumers. Therefore, some consumers are better off and other consumers may be worse off as a result. Specifically, while marginal consumers that increase their

[55] An illustration of these competitive forces in supermarket retailing is provided in Klein & Wright, *supra* note 33 at 436, where it is shown that while manufacturer shelf space slotting payments to supermarkets have increased dramatically since 1980, supermarket profitability has not increased over this period.

purchases of the manufacturer's products benefit from the increased promotional services induced by resale price maintenance, inframarginal consumers could be worse off because they may be paying higher prices than they otherwise would have without resale price maintenance. This has led some economists to argue that increased retailer promotion induced by resale price maintenance results in welfare distribution effects between marginal and inframarginal consumers, and that the net welfare effect depends on the relative quantities of inframarginal and marginal consumers in the market.[56]

It is important to emphasize, first of all, that preventing manufacturers from purchasing retailer point-of-sale promotional efforts with resale price maintenance will not necessarily result in lower retail prices. Manufacturers are likely to substitute a less efficient alternative compensation arrangement in the circumstances, such as an exclusive territory arrangement or manufacturer direct provision of increased promotion with increased advertising or vertical integration into retail distribution. In all these alternative cases, there may be a higher final retail price than under resale price maintenance.

Moreover, the essence of the competitive process is that some consumers gain and others may lose. For example, there are many competitively supplied costly retailer

[56] William B. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARVARD L. REV. 983 (1985).

services that increase price which are not consumed by all customers, such as free delivery or intensive sales assistance. The fact that one customer tries on twenty different pairs of shoes over an hour-long period while another customer purchases the same pair of shoes in five minutes without trying them on does not mean that we should prohibit retailers from supplying free sales assistance, and prohibit manufacturers from compensating retailers for supplying such service. Although there may sometimes be positive net welfare effects from such a prohibition because inframarginal consumers who do not use intensive sales assistance may be better off as a result, it does not make the prohibition procompetitive. The provision of free retailer services, such as salesperson service, is part of the normal competitive process undertaken by firms without any market power. Therefore, rather than attempting to regulate this competitive process to protect inframarginal consumers, antitrust policy should leave it up to the competitive market to determine which of these free services are supplied by retailers, often with the financial assistance of manufacturers.

B. Anticompetitive motivations for resale price maintenance.

While resale price maintenance commonly is motivated by the desire of competitive manufacturers for increased retailer promotion of their products, the Court in *Leegin* recognized three potential anticompetitive motivations for resale price

maintenance. One of three anticompetitive motivations for resale price maintenance involves a retailer cartel that anticompetitively forces a manufacturer to increase the retail margin.[57] Under this theory the manufacturer is acting contrary to its interests, and both consumers and the manufacturer are worse off. Therefore, as recognized by the Federal Trade Commission in *Nine West*, if the manufacturer is the party instituting resale price maintenance, it is unlikely that a retailer cartel exists.[58]

While a manufacturer that institutes resale price maintenance on its own initiative is convincing evidence of the absence of a retailer cartel, one cannot infer the existence of a retailer cartel from the contrary fact that the manufacturer appears to have been "forced" by its retailers to adopt resale price maintenance. A number of retailers may simultaneously inform a manufacturer that unless other retailers stop discounting its products and a sufficient retail margin is maintained, they will refuse to distribute the manufacturer's product in the future.[59] A manufacturer that responds to such complaining retailers by terminating discounting retailers because of the legitimate fear it will lose distribution by other retailers is economically not the same

[57] *Leegin* at 2717.

[58] The other characteristic that made anticompetitive resale price maintenance unlikely for the FTC was Nine West's relatively small market share. "Nine West has demonstrated it lacks market power and that Nine West itself is the source of the resale price maintenance." FTC Order, *supra* note 4, at 17.

[59] However, if retailers do this jointly, there may be an antitrust problem. United States v. General Motors Corp., 384 U.S. 127 (1966)

thing as a manufacturer terminating a discounter against its will in response to a retailer cartel.

A second anticompetitive use of resale price maintenance described in *Leegin* is the enforcement of a manufacturer cartel.[60] This anticompetitive theory involves the use of resale price maintenance to facilitate a horizontal price fixing agreement among manufacturers by reducing the incentive of individual manufacturers to "cheat" on the conspiracy by cutting wholesale prices. Fundamentally, resale price maintenance is claimed to reduce this incentive to reduce wholesale prices because it is easy to observe if the lower wholesale price is passed on by retailers in lower retail prices.[61] However, this theory has fairly limited applicability. Given resale price maintenance, individual manufacturers may still have an incentive to lower wholesale prices because the increased retailer margin will induce increased retailer promotional efforts that will increase the sale of a manufacturer's products at the expense of its rivals. Moreover, this theory requires that all (or most) manufacturers in an industry use resale price maintenance. But when the use of resale price maintenance is widespread in an

[60] *Leegin* at 2716.

[61] Under this theory, resale price maintenance is a "facilitating practice"; it is not anticompetitive by itself without finding the existence of a collusive horizontal agreement. Therefore, there must be separate evidence of a horizontal agreement among manufacturers to infer an anticompetitive effect from resale price maintenance under this theory.

industry, it may merely illustrate that there is an important efficiency reason for firms in the industry to use resale price maintenance.[62]

A third theory described in *Leegin* involves the use of resale price maintenance by a dominant manufacturer or dominant retailer to maintain their market power by placing rival manufacturers or retailers at a disadvantage.[63] For example, it is claimed that resale price maintenance may be used by a dominant manufacturer to prevent competitive manufacturers from entering; and resale price maintenance may be used by a dominant retailer to prevent lower-cost discount retailers from entering.

The dominant manufacturer case involves using resale price maintenance to pay retailers for de facto exclusive dealing and we should evaluate this potential anticompetitive effect under standard exclusive dealing antitrust criteria- - where a manufacturer must be able to exclude a sufficient share of retailing by significantly increasing the costs of manufacturer rivals for a significant period of time.[64] Analysis of the dominant retailer case, on the other hand, must recognize that it is not in the

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[62] This is consistent with the Federal Trade Commission modification of the *Nine West* consent order, where the FTC ignored the anticompetitive significance of the fact that many shoe manufacturers used resale price maintenance. FTC Order*, supra* note 4.

[63] *Leegin* at 2717.

[64] Jonathan M. Jacobson*, Exclusive Dealing," Foreclosure" and Consumer Harm,* 70 ANTITRUST L.J. 311 (2002) notes that courts "routinely sustain the legality of exclusive dealing arrangements with foreclosure percentages of 40 percent or less" (citing cases at n. 85).

interests of a manufacturer to prevent a lower cost retailer from entering. However, as described in this article, manufacturers are often concerned about the possibility of a discount retailer disturbing the distribution arrangement by driving out other retailers that has the consequence of reducing the overall supply of manufacturer-specific promotional services and shifts down the demand for the manufacturer's products. [65]

C. Warren Grimes' antitrust analysis of resale price maintenance.

Warren Grimes believes that, in addition to the three potential anticompetitive effects of resale price maintenance described in *Leegin*, there is another anticompetitive effect of resale price maintenance when resale price maintenance is used to compensate retailers for supplying increased manufacturer-specific promotional efforts as described in this article. In fact, Grimes argues that this economic role of resale price maintenance should be presumptively illegal.[66]

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[65] Warren Grimes, supra note 23 at 474, claims that the dominant retailer case may be illustrated by Business Electronics Corp. v. Sharp Electronics Corp. 48 S.U.S. 717 (1988) because Sharp appears to have been "forced" by a large retailer to terminate a price-cutting smaller retailer, Business Electronics. However, as described above, there is nothing anticompetitive about a retailer threatening to drop distribution of a product where it cannot earn a sufficient return on its retailing assets (shelf space and sales staff) because of inter-retailer price competition. Moreover, Grimes recognizes that the larger retailer threatened to drop distribution of Sharp products unless distribution to Business Electronics was terminated "only after Sharp failed to honor an agreement to make the large retailer an exclusive Sharp dealer in the Houston area." *Id.* at 475. Sharp may have granted the exclusive territory as way to encourage investments in promoting its new product. *See supra* note 47.

[66] The presumption of illegality may be rebutted in Grimes' proposed antitrust framework by showing that a distribution arrangement is "closed" (involves retailer sale of a single manufacturer's products), so that retailers cannot promote one brand in preference to another. Alternatively, illegality may be rebutted by showing that resale price maintenance is undertaken by a firm with a small market share and

Grimes does not recognize the competitive market forces outlined in this article that lead manufacturers to compensate retailers for more intensively promoting their products. Rather than manufacturers taking account of the incentive incompatibility that is likely to exist between manufacturers and their retailers with regard to the supply of manufacturer-specific point-of-sale promotional services, Grimes asserts that "if such services really help a dealer make sales, the dealer has a built-in incentive to offer them,"[67] and therefore will do so "without additional reward from the manufacturer."[68]

However, the failure to understand why competitive retailer and manufacturer promotional incentives do not coincide does not, by itself, lead Grimes to his conclusion that manufacturer use of resale price maintenance to compensate retailers for increased point-of-sale promotional efforts is anticompetitive. Grimes bases his conclusion on criticism of what he claims is the mistaken *Sylvania* maxim that vertical restraints

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that resale price maintenance has the effect of encouraging dealer investments (Grimes, *supra* note 23 at 469). However, a small market share should be a sufficient condition for the absence of anticompetitive effects. Grimes' additional necessary condition to avoid antitrust liability amounts to the requirement of finding a potential free-riding problem. Grimes' proposed antitrust framework also advocates elimination of the *Colgate* doctrine as a defense in resale price maintenance cases (*Id.* at 487-91), a policy change that has nothing to do with his analysis of the claimed anticompetitive effects of resale price maintenance when it used to compensate multi-brand retailers for increased promotion.

[67] Grimes, *supra* note 23 at 476-77.

[68] *Id.* at 481, n. 60.

increase interbrand competition.[69] Grimes acknowledges that in some circumstances resale price maintenance may increase interbrand competition, for example, when it is used to prevent free-riding and thereby encourage retailer investments. But when resale price maintenance is used to increase retailer promotion of a manufacturer's products, this "may not be consistent with interbrand competition in the broader sense" because "[b]rand selling often leads to niche marketing, and this sort of marketing decreases interbrand competition."[70]

It is unclear what Grimes means by "niche marketing" and how such marketing reduces interbrand competition "in a broader sense." Grimes provides some indication of what he means when he states that his view is consistent with the fact that economists refer to the marketing of branded products as "monopolistic competition."[71] However, this incorrectly identifies "monopolistic" as used in the label of a particular economic model with antitrust monopoly power. All that "monopolistic" signifies in

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[69] *Id.* at 472. Grimes believes there are a number of such mistaken maxims of the *Sylvania* legacy that are "blindly invoked regardless of underlying factual support." *See infra*, note 76.

[70] *Id.* at 472. Grimes at one point in his argument does not seem to be opposed to brand selling and manufacturer compensation of retailers for supplying increased promotion of their products, but is just opposed to retailers being compensated for their increased promotional efforts with resale price maintenance. He asserts that "the single most effective way of fostering dealer promotion is likely to be a promotion allowance that, under contract terms, will be paid only if the dealer provides the required pre-sale promotion." Grimes, *supra* note 23 at 477-78. This ignores the contracting problems present with alternative, direct compensation arrangements for retailer promotion described *supra* II.C, and in any event would lead to the same amount of "niche marketing" that Grimes considers anticompetitive.

[71] Grimes at 472.

this context is that, in contrast to the assumption made in the abstract economic model of perfect competition, firms in the "monopolistic competition" model are producing goods that are not homogeneous and perfectly substitutable for one another. This alternative assumption describes almost all real world firms, where what is sold is a somewhat differentiated branded product and the firm's demand curve is somewhat negatively sloped. Such conditions do not indicate a unique form of "niche marketing" but are pervasive throughout the economy, and they do not imply the existence of any antitrust market power whatsoever.[72]

In addition to this definitional argument, the fundamental basis for Grimes' assertion that brand marketing by retailers operating under resale price maintenance is likely to lead to anticompetitive results is his claim that such marketing produces misleading information. He argues that when such marketing arrangements involve dealers that sell multiple brands, resale price maintenance creates "incentives for dealers to push a product regardless of its underlying merits."[73] Therefore, rather than the "multibrand retailer perceived as neutral among brands, consumers can be misled into purchasing non-superior products at inflated prices."[74] This is what Grimes

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[72] *See supra* note 35.

[73] Grimes at 472.

[74] *Id.* Grimes (at 472-73) uses this claimed effect of resale price maintenance in creating an incentive for retailers to supply misleading information to dismiss what he describes as two other maxims of the *Sylvania* legacy- - that the manufacturer will protect consumer interests by adopting efficient distributions

believes is the primary anticompetitive effect of resale price maintenance. Retailers operating in a multi-brand environment will more intensively promote products on which they earn a higher profit margin regardless of the relative merits of the products.[75]

Grimes asserts that his competitive analysis of resale price maintenance is based on a commonly agreed upon consensus among antitrust scholars, however he refers to no economic study to support his claim that resale price maintenance leads retailers to supply misleading information. Moreover, his legal conclusion of presumptive illegality due to this unsupported effect has no basis in established principles of antitrust law because the analysis is not placed within the competitive context. In particular, manufacturer encouragement and compensation of retailers for supplying increased manufacturer-specific promotional efforts is an essential element of the competitive retailing process that is undertaken by both small and large manufacturers.

(which Grimes claims is contradicted by the fact that manufacturers adopt distribution arrangements where retailers provide misleading information) and that the protection of interbrand competition should be the sole goal of antitrust policy with regards to vertical restraints (which Grimes claims is contradicted by the fact that by increasing intrabrand competition the incentive of retailers to promote by providing misleading information is reduced).

[75] This is why Grimes claims exclusive retail distribution is preferable-- because consumers know there is a bias in the information supplied and are less likely to be misled. However, exclusive dealing is in fact likely to increase manufacturer-specific promotional efforts by retailers because under exclusivity retailers that do not convince the consumer to purchase a particular manufacturer's product will not make any sale. *See* Benjamin Klein and Andres V. Lerner, *The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty*, 74 ANTITRUST L.J., 473 (2007).

While retailers may sometimes supply incomplete and misleading information, consumers are not tied to particular retailers. Consumers choose the retailers they shop at because of the overall price and services they expect to receive, including whether the retailer employs a knowledgeable sales staff that provides reliable information, and retailers compete intensively with one another to develop reputations with respect to these characteristics. In this competitive retail marketplace it is unlikely that retailers will survive if they consistently sell inferior products at relatively high prices because they are able to convince consumers on the basis of biased and misleading information.

Grimes is advocating use of the antitrust laws to microregulate this competitive process primarily because it produces results he does not prefer, namely the sale of high brand name products at what he believes are unreasonably high prices.[76] Grimes is not advocating the prohibition of resale price maintenance because it will increase the ability of consumers to purchase such high brand name products at somewhat lower prices because of increased inter-retailer price competition, but because he believes consumers will choose to substitute lower priced, lower brand name products of alternative manufacturers that he considers "just as good or better" once retailers are no longer incentivized to promote high brand name products because of a protected retail

[76] The example Grimes uses to show that resale price maintenance leads to poor consumer decisions is the market for premium golf clubs. Grimes believes consumers purchase Ping and other premium golf clubs at high prices when there are lower-priced golf clubs that are "just as good or better" based on "objective" ratings in Golf Digest. Grimes at 499-503.

margin. However, lower brand name product manufacturers may compete for retailer promotional efforts devoted to the sale of their products in a similar way by creating and protecting the retailer margin. In any event, this attempt to regulate the result of the competitive process is not a task that should be assigned to the antitrust laws.

IV. Conclusion

Whether or not the *per se* treatment of vertical price fixing is restored by statute, courts will continue to be influenced in their decisions if a credible efficiency rationale exists for a manufacturer's termination of a price discounting retailer. The analysis in this article demonstrates that manufacturers need not search, often in vain, for a free-riding problem in order to justify resale price maintenance. Even when a free-riding problem does not exist, retailers often will not provide the point-of-sale manufacturer-specific promotional efforts a manufacturer is willing to pay for. The normal competitive process therefore involves manufacturer compensation of retailers for supplying increased promotional efforts, and resale price maintenance often is the efficient form in which this retailer compensation is made.