COMPETITIVE RESALE PRICE MAINTENANCE IN THE ABSENCE OF FREE RIDING

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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] hinges to a large extent on whether or not one views most instances of resale price maintenance as normal competition on the merits. The reasoning underlying *Leegin* is that because resale price maintenance often is the result of procompetitive market forces, plaintiffs should be required to demonstrate a likely horizontal anticompetitive effect; while defendants, on the other hand, need not prove the existence of procompetitive efficiencies to avoid antitrust liability.[3] In contrast, some antitrust commentators conclude that because a credible procompetitive explanation frequently does not exist, resale price maintenance should be subject to a stricter legal standard and prohibited even if a horizontal anticompetitive effect is not demonstrated.[4]

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1 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

2 Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911). A return to the per se rule was proposed in recently introduced legislation: S.148, introduced Jan. 6, 2009, 111th Congress.

3 This interpretation of *Leegin* is consistent with the Federal Trade Commission's recent modification of the *Nine West* consent decree. Although the FTC did not accept the procompetitive justifications for resale price maintenance offered by Nine West, the FTC modified the consent decree because it found Nine West's use of resale price maintenance unlikely to have had an anticompetitive effect. 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) [hereinafter *Nine West* Modified Order], *available at* http://www.ftc.gov/os/caselist/9810386/080506order.pdf.

4 Some commentators believe that the antitrust standard should involve, at the very least, a truncated or "quick look" rule of reason that requires establishment of a procompetitive rationale. *See, e.g.,* Robert L. Hubbard, *Protecting Consumers Post*-Leegin, Antitrust, Fall 2007, at 41.

Participants on both sides of this debate believe that the prevention of retailer free riding is the primary procompetitive efficiency rationale for resale price maintenance. It is widely recognized and accepted in the law since *Sylvania* that "discounting retailers can free-ride on retailers who furnish services and then capture some of the increased demand those services generate."[5] 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, but then purchase the product at a lower price from a discount retailer that does not supply costly pre-sale services. The usual economic analysis is that the elimination of retailer price discounting prevents such free riding because it removes the incentive of consumers to patronize free-riding retailers and forces retailers to compete on non-price dimensions.[6]

Justice Breyer in his *Leegin* dissent emphasizes that many cases of resale price maintenance do not fit this classic free-riding paradigm. Justice Breyer accepts that resale price maintenance may serve the procompetitive purpose of preventing discount dealers from free riding on full-service dealers.[7] And he recognizes that such free riding may be particularly problematical when an entrant wishes to assure prospective dealers that they will be able to recoup their investments in building up a new product's brand name.[8] However, while Justice Breyer notes that these considerations are in principle valid, he questions "how often the 'free riding' problem is serious enough significantly to deter dealer investment."[9]

A number of prominent antitrust commentators 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?"[10] If one insists on services that fit the

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

[6] The economics of this efficiency justification for resale price maintenance is presented in 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 AM. ECON. REV., SUPPL., PAPERS AND PROCEEDINGS 170 (1916).

[7] Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 915 (2007) (Breyer, J., dissenting); *see id.* at 913–14.

[8] *See generally id.*

[9] *Id.* at 915 (Breyer, J., dissenting).

[10] 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*

classic definition of free riding, then we will find that resale price maintenance is common in products where there is no significant danger of free riding. Recent examples include women's shoes,[11] athletic shoes,[12] and the leather products that were the subject of *Leegin*.

The attempt by some defendants to place all justifications for resale price maintenance within the standard free-riding framework has led to clearly pretextual explanations. One example arose from the FTC's consent judgment for resale price maintenance against Levi Strauss.[13] There, the economists for Levis attempted to justify the use of resale price maintenance by arguing that full-service retailers provided dressing rooms that consumers could use to determine their preferred style and size of jeans, and that consumers could then use this information to buy Levis jeans at discount stores that did not provide dressing rooms. However, the discount retailers that Levi Strauss was concerned about provided dressing rooms. In this instance, and in many other cases, resale price maintenance involves manufacturers preventing discounting even when both discount and non-discount retailers provide similar point-of-sale services. 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 describe the facts of *Leegin*, where product shipments were suspended to the plaintiff retailer, Kay's Kloset, solely because it was selling Leegin's Brighton brand of leather products below required minimum prices.

A number of variants of the standard free-riding theory have been developed by economists in response to such examples of resale price maintenance in the absence of classic free riding. 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 involve product "quality certification."[14] 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."[15] For example, a reputable department store that

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"Knaves"?: The Coming Challenge to the Dr. Miles *Rule*, ANTITRUST, Spring 2007, at 61, 63 [hereinafter *Coming Challenge*].

[11] *Nine West* Modified Order*, supra* note 3.

[12] Keds Corp., 117 F.T.C. 389 (Apr. 1, 1994); Reebok Int'l Ltd., 120 F.T.C. 20 (July 18, 1995); New Balance Athletic Shoe, Inc., 122 F.T.C. 137 (Sept. 10, 1996).

[13] FTC v. Levi Strauss & Co., 92 F.T.C. 171 (1978).

[14] Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346 (1984) (*cited in Leegin*, 551 U.S. at 891).

[15] *Leegin*, 551 U.S. at 891.

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.[16] This quality certification formulation of free riding, however, does not explain most examples of resale price maintenance. Many, if not most, cases of resale price maintenance involve products that already have well-established brand names, so that "quality certification" by a reputable retailer is unlikely to be an especially important determinant of demand at discount retailers.[17] Moreover, firms that insist on resale price maintenance will terminate discounting retailers even when they are reputable sellers of high-quality merchandise.

In addition to emphasizing in his *Leegin* dissent that there are only a limited number of cases of resale price maintenance which can be explained by the prevention of free riding, Justice Breyer notes that 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*."[18]

According to Justice Breyer "the one arguable exception" to the absence of any new economic analysis of resale price maintenance "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 by inducing the retailer's performance and al-

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[16] An analytically similar, but negative, demand externality underlies the protection of "quality image" argument that is also often presented as a justification for resale price maintenance, where the overall demand for a manufacturer's product is claimed to decrease when the product is seen by consumers in discount stores associated with the sale of lower quality products. *See, e.g.*, Jacob Jacoby & David Mazursky, *Linking Brand and Retailer Images: Do the Potential Risks Outweigh the Potential Benefits?* 60 J. RETAILING 105 (1984). However, if the sale of a product in low-reputation stores reduces the demand for the product in high-reputation stores, it generally can be prevented by manufacturer control of distribution, namely by refusing to sell to low-reputation stores and preventing inter-retailer transshipping; it is not necessary for the manufacturer to control retail price. Only if there is a negative image problem associated with price discounting itself is it necessary for the manufacturer to control price.

[17] Sharon Oster claims that free riding on certification services was the economic motivation for Levis' use of resale price maintenance in spite of the fact that Levis had established an independent reputation for its products at the time of the litigation. Rather than attempting to reconcile this apparent inconsistency, Oster concludes that the FTC did Levi Strauss a favor by stopping its economically unnecessary use of resale price maintenance. Sharon Oster, *The* FTC v. Levi Strauss*: An Analysis of the Economic Issues, in* IMPACT EVALUATIONS OF FEDERAL TRADE COMMISSION VERTICAL RESTRAINT CASES 47 (R.N. Lafferty, R.H. Lande & J.B. Kirkwood eds., FTC Bureau of Competition and Bureau of Economics, 1984).

[18] *Leegin*, 551 U.S. at 921 (Breyer, J. dissenting).

lowing it to use its own initiative and experience in providing valuable services.'"[19] However, Justice Breyer finds this claimed advance in the economic analysis of resale price maintenance in the absence of free riding 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.[20]

Justice Breyer correctly recognizes a logical gap in the Court's argument. The Court's conclusion that compensating retailers through the higher margins that arise with resale price maintenance may be an efficient way for a manufacturer to induce retail 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 the different services the retailer must perform."[21] However, this does not explain why retailers need to be compensated by manufacturers for supplying retail services in the first place. Given retailer competition and the absence of 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 manufacturers cannot rely entirely on retailer competition and the absence of free riding to assure retailer supply of point-of-sale promotional services, such as prominent display or salesperson attention devoted to the sale of the manufacturer's products. Although these

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19 *Id.* (Breyer, J. dissenting and quoting *Leegin*, 551 U.S. at 892). 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 and 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. *See* discussion *infra* note 45.

20 *Leegin*, 551 U.S. at 921 (Breyer, J. dissenting).

21 *Id.* at 892.

brand-specific point-of-sale promotional services often do not involve a free-riding problem, in the sense that consumers do not obtain the services from one retailer before purchasing the product from another retailer, retailers often gain substantially less than the manufacturer from the provision of such services. Manufacturers, therefore, have an incentive to design distribution arrangements that compensate retailers for providing increased point-of-sale promotion of their products.

Retailer compensation for increased point-of-sale promotion of a manufacturer's products must entail a sufficient manufacturer payment to cover the retailer's opportunity cost of using its retailing assets (primarily its shelf space and sales staff) to promote the manufacturer's products, i.e., a payment that equals or exceeds the return the retailer alternatively could earn by promoting another manufacturer's products. The expected payment received by the retailer generally will consist of a combination of expected retailer sales of the manufacturer's products and an expected retailer profit margin on those sales. Manufacturers, therefore, frequently will use some form of restricted distribution to increase either or both retailer sales or retailer margin so that retailers earn a sufficient expected return to induce desired promotional efforts.

In these circumstances, a discount retailer that reduces its retail margin on the sale of a manufacturer's products may disturb the manufacturer's desired retail distribution even if the discount retailer is not free riding on the brand-specific point-of-sale promotional services supplied by other retailers. This is because the price-discounting retailer reduces the sales and, therefore, the compensation received by other retailers for promoting the manufacturer's products. Since retailers require a minimum expected return to display, promote, or even stock a product, the reduction in compensation will lead the other retailers to reduce the promotional efforts they devote to sale of the manufacturer's products, and in some cases will result in other retailers dropping distribution of the manufacturer's products entirely.

These inter-retailer effects caused by one retailer's price discounting may sound superficially like the expected effects of normal price competition among retailers, which manufacturers should be in favor of. Manufacturers wish to have their products sold most efficiently at the lowest retail margin; but manufacturers also wish to have their products adequately promoted and otherwise effectively distributed by retailers. If discounting by a retailer competes away the compensation the manufacturer has given to other retailers for increased point-of-sale promotion of the manufacturer's products, and this leads the other retailers to reduce their promotional efforts and possibly drop distribution of the manufacturer's products, the manufacturer's sales and profit may decline in spite of a lower retailer margin. This injures the manufacturer, as well as the consumers who now no longer purchase the manufacturer's products. A manufacturer's fear of reduced sales from the loss of effective retail distribution as a consequence of inadequate retailer promotion or a reduced number of retail outlets, therefore, is a reasonable and common competitive business motivation for the use of resale price maintenance.

The economic analysis of resale price maintenance in this article addresses two distinct questions. First, in response to Justice Breyer's criticism, I explain why non-free-riding, competitive retailers may not have a sufficient independent incentive to adequately promote a manufacturer's products. In doing so I establish an economic justification for manufacturers to adopt arrangements in which retailers are compensated for supplying greater point-of-sale promotion of a manufacturer's products than they would otherwise decide to supply. Second, I examine why a manufacturer may use resale price maintenance as an efficient element in the compensation package provided to retailers in return for supplying increased point-of-sale promotion. The economic answers to these two questions together provide a broadly applicable, procompetitive rationale for resale price maintenance in the absence of free riding.

Given this broadly applicable, procompetitive rationale for resale price maintenance, it is reasonable for antitrust policy to require demonstration of a likely anticompetitive effect before condemning the practice. After analyzing the potential anticompetitive effects of resale price maintenance described by the Court in *Leegin*, I propose a framework for this rule of reason antitrust analysis. An important insight of the framework is that retailer-initiated resale price maintenance has substantially less anticompetitive significance than previously believed. Since retailers will not carry or adequately promote products on which price discounting prevents them from earning a competitive return on their retailing assets, retailers need not be exercising market power when demanding manufacturer use of resale price maintenance. This economic analysis has important implications for antitrust analysis of resale price maintenance even if the law returns to a per se standard.

I. RESALE PRICE MAINTENANCE ENCOURAGES DEDICATED RETAILER PROMOTION

A. Resale Price Maintenance Prevents Retailer Free Riding

The use of resale price maintenance to prevent retailer free riding relies on the relationship of consumer demand for some products 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 the manufacturer's 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 retailer-supplied product explanations and demonstrations 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 product explanation and demonstration 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 the non-service retailer at a lower price. In this way, discount retailers are free riding on the investments made by 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 it has lower costs from not supplying pre-sale product explanation and demonstration 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 unless they are compensated by 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, will ultimately lead to both consumers and the manufacturer being worse off—consumers are worse off because they do not receive desired pre-sale retailer services and the manufacturer is worse off because the demand for its products is reduced.

Exactly how resale price maintenance is used by manufacturers to prevent retailers from free riding and, instead, to incentivize retailers to supply pre-sale product explanation and demonstration services is not adequately described in the usual formulation of the free-riding theory.

Most statements of the theory assume that the only way retailers can compete, once they cannot reduce price, is by supplying these retailer services desired by the manufacturer.[22] However, free-riding retailers often will be able to compete more effectively in other ways. For example, audio equipment retailers that sell the product at the resale-maintained price could provide other non-price services that have larger inter-retailer demand effects, such as free installation or liberal return privileges or possibly even more general services, such as convenient free parking, luxurious store furnishings, fast checkout, or other services that lower the effective price or make the shopping and purchase experience more pleasant. Competing retailers cannot free ride on these services since their customers cannot consume the services at another retailer and then use the services when purchasing the product at their store. Luxurious store furnishings at one store, for example, do not make the second store's furnishings and purchase experience more luxurious.[23] Therefore, audio equipment retailers will have an incentive to compete through the supply of these services while free riding on retailers that provide product demonstrations and other free-rideable services.[24]

Therefore, even within the standard free-riding theory, manufacturers must do more than merely fix minimum retail prices to assure provision of the retail services desired by the manufacturer. In addition, manufacturers must monitor and enforce retailer performance with regard to the provision of desired retail services. A manufacturer accomplishes this by providing retailers with expectations regarding desired performance, compensating retailers for this desired performance, and terminating those retailers that do not perform as expected. In this way the manufacturer "self-enforces" its distribution arrangement with retailers.[25]

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[22] *See, e.g.*, Telser, *supra* note 6. All models that include only two variables, price and desired retailer services, implicitly make this assumption.

[23] While a luxurious environment is not free rideable, the information that the product is being sold in a reputable store is a free-rideable service. *See* Marvel & McCafferty, *supra* note 14. Although the Marvel and McCafferty free-rideable "product quality certification" services may be provided by stores that also provide non-free-rideable luxury services, the two types of services are economically distinct.

[24] Klein & Murphy, *supra* note 19.

[25] Manufacturer self-enforcement of retail distribution arrangements as described in this article 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 (Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752 (1984); Business Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717 (1988)). The fact that transactors often unilaterally self-enforce, rather than legally court-enforce, their business relationships is the fundamental empirical insight of Stewart Ma-

The primary economic role served by resale price maintenance in this self-enforcement framework is that it efficiently compensates retailers for supplying the increased point-of-sale services desired by the manufacturer. Resale price maintenance accomplishes this by providing retailers with a profit margin that is somewhat more than sufficient to cover the retailer's increased costs of supplying desired services. In this way the arrangement is self-enforcing because retailers then have something valuable to lose (an expected future profit stream) if they are terminated for non-performance.[26]

The *Leegin* Court recognized this 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] This incentive was relied upon in Justice Scalia's opinion in *Sharp*, which stated that vertical restraints work 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]

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caulay. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

[26] Klein & Murphy, *supra* note 19. For a distribution arrangement to be self-enforcing the present discounted value of retailer profit when performing as desired by the manufacturer must be greater than the additional short-run profit the retailer can earn by not performing as desired. The fundamental economic reason a profit stream above retailer costs is required for self-enforcement is because manufacturer detection and termination of non-performing retailers is not perfect or immediate. Therefore, without any profit premium the retailer will always be better off not performing as desired and instead collect the increased manufacturer compensation in the short run before termination occurs. *See* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981). However, in most circumstances the extra profit premium will be relatively small. For example, if a non-performing retailer can increase its profit on existing sales by 10 percent for one year by not supplying the desired promotional services the manufacturer has paid for and the interest rate is 5 percent, then the extra profit premium above the costs of supplying desired retail services that would be required to prevent non-performance need be only one-half of 1 percent of sales. If a non-performing retailer also can significantly expand sales by discounting price, its one-year gain, and hence the required profit premium to assure retailer performance, may be substantially larger. This will lead the manufacturer to more closely monitor and control retailer price discounting.

[27] *Leegin*, 551 U.S. at 892.

[28] *Business Electronics*, 485 U.S. at 728 (1988).

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

These three judicial statements focus on an economic motivation for resale price maintenance that is 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 is recognized to be an efficient way for manufacturers to pay retailers for supplying increased services, "free-rideable" or not. However, Judge Easterbrook, Justice Scalia, and the *Leegin* Court do not explain why retailers in the absence of free riding may not have a sufficient independent incentive to provide the type or quantity of services that are desired by the manufacturer and, hence, why the manufacturer must compensate its retailers for supplying increased, desired services.

B. Retailers Have an Insufficient Incentive to Promote a Manufacturer's Products

To understand why non-free-riding retailers have an insufficient incentive to supply the point-of-sale services desired by the manufacturer and the role of resale price maintenance in compensating retailers for such services, we begin with the same assumption that is made in the standard free-riding theory—that consumer demand for some products is related to the pre-sale promotional services supplied by retailers. However, the type of pre-sale promotional services a manufacturer often wishes its retailers to supply may be economically distinct from the retailer services described in the standard free-riding analysis. For example, consider Russell Stover's use of resale price maintenance in the sale of boxed candy, which was challenged by the Federal Trade Commission.[30] This is a particularly difficult case to place in the standard free-riding framework. Russell Stover distributed its boxed candies primarily through drug, card, gift and department stores, and these retailers did not provide any significant pre-sale product explanations or demonstrations that other retailers could free ride upon.

The point-of-sale services Russell Stover wanted its retailers to provide are the promotional services of stocking and displaying its products. Prominent display can be expected to significantly increase a candy manufacturer's sales since a large number of consumers purchase candy only after they notice it when they are shopping for something else. This has been labeled in the marketing literature as "impulse purchases," where consumers who have no prior intent to purchase a product do so

[30] Russell Stover Candies, Inc., 100 F.T.C. 1 (1982).

after observing the product on display.[31] Even when consumers have a prior intent to purchase a particular type of product, such as candy, they may not be committed to purchase a particular brand of the product, so that they may be influenced to purchase the particular brand on display. It is unlikely that such promotional display services that induce incremental manufacturer sales are likely to involve a significant free-riding problem. Consumers will not, for example, observe Russell Stover boxed candy on display, decide at that moment that they want to purchase the product, but then visit another retailer where the candy is not displayed to make their purchase.

Another type of retailer promotional service that may be desired by a manufacturer because it induces incremental sales is brand-specific point-of-sale salesperson promotional efforts. Retailer promotional efforts devoted to a manufacturer's products are the type of retailer service described in the standard free-riding analysis. However, such brand-specific promotional efforts often do not involve a significant free-riding problem. For example, many consumers who are convinced by a salesperson in a department store to purchase a particular article of clothing are unlikely to then go to another store that does not provide point-of-sale assistance in the hope of buying that product at a lower price. Contrary to the audio and video equipment case, the retailer promotional investments involved in making such sales and, hence, the potential savings consumers could receive by purchasing from free-riding discounters, are often relatively small in comparison to the increased costs most consumers would bear by shopping in this way. Therefore, a retailer that provides greater salesperson efforts devoted to the sales of a particular manufacturer's products usually will not create a significant free-riding opportunity for other retailers.[32]

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[31] Charles Areni, Dale Duhan & Pamela Kiecker, *Point-of-Purchase Displays, Product Organization, and Brand Purchase Likelihoods*, 27 J. ACAD. MKTG. SCI. 428 (1999). It has been estimated that 60 percent of all consumer purchases are unplanned. PACO UNDERHILL, WHY WE BUY: THE SCIENCE OF SHOPPING 57 (2009).

[32] A significant retailer free-riding problem may exist with regard to the supply of these types of promotional services, however, 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 an economic 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 many consumers now find it feasible to first obtain point-of-sale promotional services provided by brick-and-mortar retailers before making their purchase at a lower price on-line. Such consumers are not merely taking advantage of savings of retailer point-of-sale promo-

There are three important economic characteristics associated with the non-free-rideable point-of-sale promotional services that are the focus of this article. First, as with free-rideable promotional services, the promotional services are brand-specific; the promotional services involve retailer efforts to increase the sale of a particular manufacturer's products. In contrast to non-brand-specific retailer services, such as free convenient parking, a knowledgeable and accessible sales staff, fast checkout, and other retailer-supplied amenities, the retailer services of concern are devoted solely to the sale of a particular manufacturer's products. A manufacturer desires its retailers to provide, for example, preferable display space or extra salesperson attention for its products.

Second, manufacturer-specific promotional services supplied by retailers are aimed primarily at "marginal consumers" who, absent the promotion, would not purchase the manufacturer's product at current prices, but may do so when the manufacturer-specific promotional services are supplied. These manufacturer-specific point-of-sale promotional services, therefore, can be considered economically equivalent to an effective price discount on the manufacturer's product that is targeted to marginal consumers who value, and are particularly sensitive to, the retailer's promotional efforts. In contrast, consumers that are inframarginal, in that they already know they wish to buy the manufacturer's products, are insensitive to the retailer's supply of manufacturer-specific point-of-sale promotional services. Preferable display space or extra time devoted by sales staff to the manufacturer's products will be of little value to such consumers because they are unlikely to be influenced by a retailer's prominent display and will not want to spend additional time with a salesperson who is describing the favorable features of a product they have already decided to purchase.[33]

The third distinguishing economic characteristic of these targeted point-of-sale, manufacturer-specific promotional services is that retailer supply of such services is unlikely to have significant inter-retailer demand effects. Although the point-of-sale, manufacturer-specific promotional services I am focusing on influence the buying decisions of some marginal consumers and therefore have inter-brand demand effects at

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tional costs, but are also taking advantage of savings achieved by Internet retailers in other selling costs.

[33] The sharp distinction between marginal and inframarginal consumers of the manufacturer's products 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.

the retailer, these services are unlikely to significantly influence the decisions of consumers regarding where to shop. While a retailer's failure to stock a well-known, highly demanded product will influence some consumers' decisions regarding where to shop, retailers will have considerable discretion regarding which of many other products they decide to stock. Moreover, retailer decisions regarding which products they will prominently display or otherwise promote at the point of sale, including whether they will promote well-known, highly demanded products, are decisions that are likely to have little or no inter-retailer demand effects.

For example, if a leather products retailer, such as Kay's Kloset (the plaintiff in *Leegin*), decides to prominently display a particular manufacturer's handbag, rather than another brand of handbag it stocks, Kay's Kloset's sales of the displayed handbag will increase. 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. In contrast, when a retailer provides non-manufacturer-specific retail services, such as free convenient parking or a pleasant selling environment, these services are valued by consumers more generally (and not solely consumers who are marginal with respect to demanding the particular manufacturer's products). And retailer supply of these types of services can be expected to influence consumer decisions regarding where to shop, that is, to have significant inter-retailer demand effects.

The fundamental economic reason manufacturers find it necessary to encourage retailers to supply more manufacturer-specific point-of-sale promotional services is the absence of inter-retailer demand effects. The absence of inter-retailer demand effects implies that the profits earned by a manufacturer from point-of-sale promotional services often will be substantially greater than the profits earned by the retailer. This profit differential creates an incentive incompatibility between the manufacturer and its retailers with regard to retailer supply of manufacturer-specific point-of-sale promotional efforts.[34]

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[34] This incentive incompatibility was originally described in Klein & Murphy, *supra* note 19, where the manufacturer-specific point-of-sale promotion was considered equivalent to a targeted price discount to marginal consumers, and where the greater manufacturer than retailer profit margin on incremental sales by marginal consumers in response to the promotion made it unprofitable for retailers to provide the quantity of promotion desired by the manufacturer. This analysis implicitly assumed an absence of significant inter-retailer demand effects from retailer supply of manufacturer-specific point-of-sale promotional services, an assumption that is made explicit in Benjamin Klein & Joshua D. Wright, *The Economics of Slotting Contracts*, 50 J.L. & ECON. 421 (2007). This economic analysis is related to Ralph Winter, *Vertical Control and Price Versus Nonprice Competition*, 108 Q.J. ECON 61 (1993), where a manufacturer-retailer incentive incompatibility is similarly based on

The retailer-manufacturer incentive incompatibility problem can be formalized by defining the retailer's profit per unit time, Π_R, from supplying additional manufacturer-specific promotional services, S, in terms of the retailer's profit margin on incremental sales, M_R, multiplied by the retailer's sales increase from supplying the promotion, dQ_R/dS,

(1) $\Pi_R = M_R\ (dQ_R/dS)$;

and similarly defining the manufacturer's profit per unit time from retailer supplied promotional services, Π_M, in terms of the manufacturer's profit margin on incremental sales, M_M, multiplied by the manufacturer's demand increase from the retailer's supply of promotion, dQ_M/dS,[35]

(2) $\Pi_M = M_M\ (dQ_M/dS)$.

Retailers generally have less profit incentive than the manufacturer to promote the manufacturer's products both because the manufacturer's profit margin on its incremental sales, M_M, is often greater than the retailer's profit margin on those incremental sales, M_R, and because the manufacturer's incremental sales produced by the retailer's promotional efforts, dQ_M/dS, is often greater than the retailer's incremental sales, dQ_R/dS. Consequently,

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the assumption of a lack of significant inter-retailer demand effects from retailer supply of non-price services. But rather than focusing on manufacturer-specific promotional services that are unlikely to have significant inter-retailer demand effects as I do, Winter considers retailer supply of all non-price services and amenities and then makes the assumption that consumers who value these services are more likely to be infra-marginal and, hence, unresponsive with respect to their inter-retailer demand. However, consumers may be indifferent between brands and, therefore, highly sensitive to point-of-sale retailer promotion, and also highly price-sensitive with regard to the retailer at which they shop. More importantly, the two frameworks have a fundamentally different view of the role of resale price maintenance in alleviating the manufacturer-retailer incentive incompatibility, described *infra* note 54.

[35] The 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. This amounts to assuming that retail prices will increase with retailer marginal cost increases as a result of increased retailer promotion. More generally, the effect of increased promotion on market price is ambiguous because increased demand by brand-marginal consumers that are sensitive to promotion may also make the inter-brand demand more price elastic on the margin if these consumers that value promotion are also the most price-sensitive. In these circumstances the demand curve for the manufacturer's products will rotate counterclockwise in addition to shifting out. As a result, the manufacturer's profit-maximizing wholesale price may decrease and the retailer's price may not necessarily increase; the wholesale price could 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).

(3) M_R $(dQ_R/dS) < M_M$ (dQ_M/dS).[36]

The greater profit margin earned by manufacturers compared to retailers on incremental sales of the manufacturer's products, $M_M > M_R$, 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 because of unique locations and somewhat unique services they may supply, they frequently sell the same products and often face highly elastic demands. On the other hand, manufacturers, especially manufacturers of highly advertised, well-known products with established brand names, generally sell more highly differentiated products and consequently face substantially less elastic demands than retailers. Therefore, manufacturers often price their products above marginal cost and earn a greater incremental profit margin than retailers.

An example provided by Klein and Murphy is the sale of perfume, where the marginal cost of producing an additional unit is low relative to the wholesale price.[37] This example illustrates that some products, especially differentiated branded products with high intellectual property content, such as perfume (or CDs or computer software), have a higher ratio of fixed to marginal cost than is typical for retailing services. Consequently, it is not unusual for manufacturers of such products to earn significantly larger profit margins on incremental sales than retailers.[38]

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[36] This definition of the incentive incompatibility abstracts from the double-marginalization distortion that is present even when M_R (dQ_R/dS) equals M_M (dQ_M/dS). It is assumed throughout this discussion that retailing is highly competitive so that the manufacturer incremental profit margin is close to the total joint (manufacturer plus retailer) incremental profit margin and, hence, the double-marginalization effect is small and can be ignored. However, when manufacturers use resale price maintenance, the retailer incremental profit margin is increased and a double-marginalization problem is created. Therefore, manufacturers contracting for a desired level of dedicated retailer promotional services will want to take account of the double-marginalization effect and contract for a larger quantity of promotional services than is given by this formulation in order to maximize the total joint profit of the manufacturer and retailer.

[37] Klein & Murphy, *supra* note 19, at 283–84.

[38] The fact that manufacturers of differentiated 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 SUP. 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.

However, this first factor alone does not necessarily mean that retailers always have less incentive than manufacturers to provide services that induce incremental sales. If consumers shift their purchases from other retailers in response to a retailer's services, an individual retailer's incremental sales will be greater than the net increase experienced by the manufacturer, that is, (dQ_R/dS) is greater than (dQ_M/dS). And in these circumstances, where a retailer supplies services that have significant inter-retailer demand effects, the retailer's larger incremental sales increase could fully offset its smaller profit margin on incremental sales, so that M_R (dQ_R/dS) equals M_M (dQ_M/dS) and retailers will not have less incentive than the manufacturer to supply such services.[39]

To understand the economic forces involved, consider the case where retailer supply of services with large inter-retailer demand effects is equivalent to a retailer reduction in price. Even though retailers earn a lower profit margin on incremental sales than does the manufacturer, retailers generally do not have an insufficient incentive from the manufacturer's point of view to engage in retail price competition because the profit-maximizing profit margins of both the retailer and manufacturer are determined in equilibrium by their respective elasticities of demand. Therefore, a lower retailer profit margin implies an approximately fully offsetting greater retailer quantity response.[40] For example, assume the manufacturer's incremental profit margin is twenty times the retailer margin. Although retailers do not take account of the much larger manufacturer profit margin on incremental sales when they lower the retail price, the retailer's demand response to its lower price will consist primarily of inter-retailer demand effects and in equilibrium will be approximately twenty times the manufacturer's demand response, which consists solely of inter-brand demand effects.

Analogously, when retailers are deciding to supply non-price services with large inter-retailer demand effects, they will not have an insufficient incentive to supply such services. Although retailers will not take account of the manufacturer's higher profit margin on incremental sales, there will not be an incentive incompatibility if the inter-retailer demand effects from the supply of the non-price services are similar to the inter-retailer demand effects from a price discount. An incentive incompatibility *will* exist, however, with regard to the retailer supply of the manufacturer-specific, point-of-sale promotional services that are the focus of this article because these services do not induce significant inter-

[39] For a formal demonstration, see Klein & Wright, *supra* note 34, at 430.

[40] It is only approximately fully offsetting because we are abstracting from the small double-marginalization effect. *Supra* note 36.

retailer demand effects. Therefore, since inter-retailer demand effects do not offset the lower retailer profit margin, retailers will have less incentive than the manufacturer to promote the manufacturer's products.

The absence of inter-retailer demand effects may mean that the retailer's incremental sales of the manufacturer's products in response to point-of-sale promotional services, rather than being greater than the manufacturer's incremental sales, merely equal the manufacturer's incremental sales, so that (dQ_R/dS) equals (dQ_M/dS). However, more generally, when a multi-brand retailer provides increased point-of-sale promotion of a particular manufacturer's products, such as more prominent display or greater salesperson efforts, it can be expected to decrease, at least to some extent, the retailer's sales of other brands. Therefore, the retailer's net overall sales increase from the supply of manufacturer-specific promotional services is likely to be less than the promoted manufacturer's sales increase, so that (dQ_R/dS) as considered by the retailer is less than (dQ_M/dS). In fact, if these inter-brand "cannibalization" effects are large, so that the retailer promotion has primarily inter-brand demand effects with little or no inter-retailer demand effects, (dQ_R/dS) may be close to zero.

For example, consider the decision of leather goods retailer Kay's Kloset to prominently display or otherwise more intensively promote Leegin's products. This can be expected to increase Kay's Kloset's sales of Leegin's products but also to decrease Kay's Kloset's sales of other brands of leather products that could have been prominently displayed or otherwise actively promoted. Consequently, Kay's Kloset's overall incremental sales increase from its Leegin-specific promotional efforts will be smaller than Leegin's incremental sales increase. In fact, Kay's Kloset's net sales increase may be close to zero if the promotion-induced sales of Leegin's products occur largely at the expense of Kay's Kloset'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, that is, that M_R (dQ_R/dS) is less than M_M (dQ_M/dS). And this difference in the profit incentive of the retailer as compared to the manufacturer exists even if the retailer profit margin on incremental sales of the manufacturer's products is the same as the manufacturer's profit margin.

In sum, given these economic factors commonly present in the marketplace—a significantly greater manufacturer profit margin than retailer profit margin on incremental sales, the absence of significant inter-retailer demand effects from retailer-supplied manufacturer-specific promotional efforts, and the "cannibalization" effects across brands sold by a multi-brand retailer in response to such 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 whereby retailers are compensated for supplying increased manufacturer-specific promotional efforts.

C. Manufacturer Use of Resale Price Maintenance to Induce Dedicated Retailer Promotional Efforts

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

(1) what dedicated promotional services the manufacturer desires its retailers to supply;

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

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

1. *Dedicated Promotional Services Desired by the Manufacturer*

The manufacturer-specific, 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 presentation by sales staff. However, because of the difficulties of specifying detailed retailer performance, it is more common for manufacturers to enter more general understandings with their retailers regarding the promotional efforts they expect retailers to devote to the sale of their products and to 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 services" that most effectively encourage increased sales of the manufacturer's products.[41]

In many cases, manufacturers may want to achieve the desired point-of-sale promotion by establishing a distribution arrangement with an increased number of retail outlets. This is particularly important for products where significant sales are made to consumers when they observe a

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[41] Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 892 (2007).

product display while shopping, such as the Russell Stover boxed-candy example described above. Wide retail distribution provides increased product display and, hence, the potential for increased impulse sales; it also provides increased opportunities for manufacturers to reach a greater number of consumers with other types of point-of-sale retailer promotional efforts that induce incremental sales. Consumers shopping for products do not search every retailer, and sometimes do not even search more than one retailer. Therefore, a manufacturer has access to a larger number of customers when a greater number of retail outlets stock and display the manufacturer's products. These considerations are particularly important when demand for the manufacturer's product is highly sensitive to point-of-sale promotional efforts.

Resale price maintenance is one way in which a manufacturer may produce these favorable economic effects. By creating and protecting an increased retailer margin the manufacturer supports a larger number of retail outlets, which, through the resulting greater quantity of point-of-sale product display and other retailer promotional efforts, increases the demand for the manufacturer's products. This promotional analysis provides an economic basis for the "outlets hypothesis" explanation for resale price maintenance originally presented by Gould and Preston.[42]

Gould and Preston, however, merely assume that the demand for a manufacturer's products is positively related to the number of retail outlets that sell its products without explaining why competitive retailers operating in an unrestricted retail environment will supply less than the desired number of outlets from the manufacturer's point of view. This is not obvious because, if there are consumer benefits associated with an increased number of outlets, such as increased shopping convenience, retailers would appear to have the incentive to supply the desired number of outlets. What the promotional analysis described in this article demonstrates is that manufacturer reliance on these market forces will not always be sufficient. Manufacturers often desire a greater number of retail outlets than would be generated by retailer competition because an additional outlet that sells the manufacturer's products increases point-of-sale promotional services (such as increased product displays) that induce incremental manufacturer sales without producing significant inter-retailer demand effects.

A manufacturer's use of resale price maintenance to obtain a larger number of outlets than would otherwise exist explains many resale price

[42] J.R. Gould & L.E. Preston, *Resale Price Maintenance and Retail Outlets*, 32 ECONOMICA 302 (1965).

maintenance arrangements. For example, Leegin's use of resale price maintenance is likely to have been motivated by this economic consideration. Rather than investing in national advertising or focusing on sales through major department stores, Leegin used resale price maintenance to increase the retail margin in order to support the sale of its leather products through a wide distribution network of more than 5,000 relatively small U.S. specialty retail outlets.[43] As we shall see, resale price maintenance also created an increased economic incentive for these retailers to promote Leegin products at the point-of-sale. Allowing retailers to discount prices would have reduced the retail margin and led to a reduction in the number of retail outlets that carried Leegin's products below the number that Leegin believed maximized its profitability.[44]

Deneckere, Marvel, and Peck use the fact that manufacturers often justify resale price maintenance as a way to support an increased number of retail outlets as evidence for their theory that resale price maintenance is commonly motivated by a desire to induce retailers to hold greater inventories.[45] However, it is inappropriate to assume that a manufacturer's desire for wider retail distribution of its products is identical to a desire for its retailers to hold increased inventories. In most cases where manufacturers claim resale price maintenance is used to support increased retail distribution, it is equally, and arguably more, reasonable to assume that they are using resale price maintenance to increase the number of retailers that sell the manufacturer's products, not to incentivize a given number of retailers to stock increased inventories of the manufacturer's products.

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[43] "[Leegin] sold across the United States in over 5,000 retail establishments, for the most part independent, small boutiques and specialty stores." *Leegin*, 551 U.S. at 882.

[44] Pitofsky mistakenly claims that the economic importance of resale price maintenance as a way to support an increased number of retail outlets is only relevant for new entrants that have to establish a distribution network. Pitofsky, *Coming Challenge*, *supra* note 10, at 63. Because Leegin already had a large distribution network, Pitofsky concludes that this economic rationale cannot justify Leegin's use of resale price maintenance. However, established manufacturers also receive significant economic benefits from a distribution network that includes many retailers, including increased point-of-sale display and other retail promotional services that induce incremental sales.

[45] Deneckere et al., *supra* note 19. In the Deneckere et al. model, discount retailers that reduce their inventories lower their costs and impose an externality on retailers that hold greater inventories and charge higher prices. This is because customers are assumed to 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 and unsold inventories. This externality increases retailer inventory costs, leading to lower inventories, higher prices, and reduced manufacturer sales compared to the equilibrium achieved in their model under resale price maintenance.

For example, a case that Deneckere et al. discuss in detail as an example of manufacturer desire for increased inventories is Microsoft's introduction of Windows 95. However, it is clear that Microsoft's intention was to achieve "the broadest possible distribution," selling Windows 95 in "about 25,000 different retail outlets in the US, up from about 12,000 stores in past launches."[46] According to Microsoft's director of distribution channel policies, many of the additional retailers through which Microsoft desired to distribute Windows 95 would not have found it profitable to do so if it were widely advertised and sold below the suggested retail price of $89.95.[47] Therefore, Microsoft required that retailers not cut their advertised price below $89.95 in order to be eligible for Microsoft rebates.

Deneckere et al. incorrectly claim that because Microsoft engaged in a massive national advertising campaign for Windows 95, Microsoft's minimum advertised price policy to support increased retail distribution could not have been designed to increase point-of-sale retailer promotional efforts. However, because Windows is a product with a very low marginal cost and high incremental profit margin, any additional point-of-sale retailer promotional efforts induced by wide retail distribution (such as increased retailer devotion of valuable shelf space to Windows 95) was very valuable to Microsoft.[48]

Manufacturer use of resale price maintenance to increase the number of retail outlets, not the level of inventories stocked by a given number of retailers, also is consistent with the facts of *Leegin*. There was no claim that Kay's Kloset, the price-discounting retailer terminated by Leegin, held insufficient inventories. It seems obvious that Kay's Kloset was terminated solely because it reduced its retail margin by cutting price, and that this was profitable to Kay's Kloset not because it cut costs by reduc-

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[46] Deneckere et al., *supra* note 19, at 910.

[47] *Id.*

[48] Distinct from the inter-retailer negative externality described by Deneckere et al., a manufacturer may desire that its retailers stock increased inventories of its products because manufacturer profit is greater than retailer profit on the incremental sales produced by greater retailer inventories. Although consumers are more likely to shop at a retailer that holds greater inventories, this inter-retailer demand effect may be insufficient to make the retailer and manufacturer incentives coincide with regard to the level of inventories. One reason is because a retailer that runs out of a manufacturer's products may be able to switch consumers to another brand. However, when the manufacturer's desire for increased retail inventories is economically important, the manufacturer is likely to accomplish this with more direct financial incentives, such as subsidized financing of inventories, liberal return policies, or wholesale price refunds. These more direct forms of retailer compensation for increased inventories generally will be more effective because resale price maintenance is more likely to induce retailers to engage in other forms of non-price competition that have greater inter-retailer demand effects than increased inventories.

ing inventories. Instead, Kay's Kloset took advantage of the increased retail margin established by resale price maintenance to profitably expand its sales of Leegin products. If Leegin had permitted Kay's Kloset to continue to sell large quantities of its products at discounted prices, Leegin could not have maintained its wide distribution in 5000 specialty outlets. The new retail equilibrium would have involved a substantially smaller number of outlets, each with greater sales, with an associated decrease in total retail point-of-sale promotional services, such as product display. Leegin terminated Kay's Kloset to prevent this undesirable result.

2. *Efficient Manufacturer Compensation of Retailers*

The primary economic question for antitrust policy concerns element (2) of the distribution arrangement, the way in which a manufacturer compensates retailers for providing increased promotion of its products. In general, one can consider three alternative forms of retailer compensation:

(a) retailer compensation on a per service supplied basis;

(b) retailer compensation on a per unit time basis; and

(c) retailer compensation on a per unit sold basis.

There is unlikely to be an antitrust problem if a manufacturer compensates its retailers for services on a per service 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 the retailer promotional services that are the focus on this article, it is often not efficient for the manufacturer to compensate retailers on a per service supplied basis. For example, consider 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."[49]

Retailer compensation on a per unit time basis may sometimes be a reasonable form of compensation when the promotional services consist of preferential or increased display. In these circumstances the retailer costs of providing the promotional services are largely per unit time

[49] Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 892 (2007).

costs. The manufacturer is essentially renting an increased quantity of retail shelf space or a preferential location of its retail shelf space that may be relatively easy for the manufacturer to monitor. Compensation for these promotional services with per unit time payments is similar to supermarket shelf space slotting arrangements.[50]

The promotional services provided by retailers of the products subject to resale price maintenance, however, often are substantially more complex than supermarket shelf space. While a supermarket provides very little other than shelf space, a department store selling branded clothing, for example, supplies significant complementary point-of-sale promotional services in addition to shelf space, such as dedicated salesperson efforts. These costs are also primarily per unit time costs (the wages of salespeople). But there is likely to be a significant economic advantage in compensating retailers for supplying these dedicated promotional services on a basis that is related to the number of units of the manufacturer's product the retailer sells rather than solely on a per unit time basis because it creates an increased incentive for retailers to promote the manufacturer's products. This is what is accomplished when a manufacturer lowers its wholesale price and then prevents price discounting with resale price maintenance, thereby generating retailer compensation over time related to sales that is equal to $M_R Q_R$.[51]

The increased retailer profit margin generated by resale price maintenance (the increase in M_R) increases the retailer's profitability on incremental sales, increasing the retailer's incentive to supply additional promotional services. The retailer's independent economic incentive to perform becomes more closely aligned with the retailer performance desired and paid for by the manufacturer. As a result, resale price maintenance lowers the manufacturer's costs of monitoring and enforcing retailer performance, a consideration that is economically more important when retailer promotional efforts are more complex. That is why a department store generally will be compensated for increased promotional services by a clothing manufacturer at least partially with pay-

[50] *See* Klein & Wright, *supra* note 34.

[51] If a manufacturer's per unit time payment is related to a retailer's sales, a per unit time payment also will create an increased incentive for retailers to promote the manufacturer's products. The per unit time payment then may have to be combined with some form of resale price maintenance to prevent excessive individual retailer price discounting in an attempt to increase per unit time manufacturer compensation that decreases the per unit time compensation and corresponding promotional efforts of other retailers.

ments earned in relation to the department store's sales of the clothing manufacturer's products.[52]

Although resale price maintenance increases the retailer's independent profit incentive to promote incremental sales of a particular manufacturer's products, the retailer's profit incentive is still less than the manufacturer's profit incentive. This is because the retailer's profit on incremental sales produced by its promotional efforts remains below the manufacturer's profit on incremental sales (M_R is less than M_M).[53] Therefore, in order for the manufacturer to induce the additional retailer promotional effort it desires, the manufacturer must create a distribution arrangement in which retailers are compensated for promoting more intensively than they would otherwise find in their independent interests. The manufacturer then monitors retailer behavior and terminates retailers that fail to perform as expected. The increased independent retailer incentive to promote that is created by a resale price maintenance form of retailer compensation, however, means that the manufacturer need not devote as much resources in monitoring retailers and that the manufacturer need not supply retailers with as large a profit premium stream in order to assure retailer performance.[54]

[52] Another advantage of compensating retailers on the basis of their sales with the use of resale price maintenance is that it reduces an inherent measurement problem facing manufacturers in determining the appropriate level of compensation to be paid to each retailer. When retailers are of varying size, retailers are likely to differ in the quantity of incremental sales they are able to induce with increased promotional efforts. Resale price maintenance provides a reasonable measure of compensation across retailers when the supply of desired promotional services increases each retailer's sales of the manufacturer's products approximately the same percentage amount.

[53] M_R is less than M_M with resale price maintenance because retailer compensation for promotional efforts with resale price maintenance involves a higher profit margin on all the retailer's sales, not solely the incremental sales induced by the retailer's promotion. *See infra* note 68 (providing an illustrative numerical example).

[54] This view of resale price maintenance as an efficient way to compensate retailers for supplying desired promotional services because it facilitates the self-enforcement of retailer performance is distinct from the role of resale price maintenance in the Winter model. Winter, *supra* note 34. In the Winter model, resale price maintenance is claimed to eliminate the retailer-manufacturer incentive incompatibility by transferring the manufacturer's profit on incremental sales to the retailer and thereby increasing the retailer's independent profit incentive to engage in desired non-price competition without manufacturer monitoring of retailer performance. If the retailer's marginal profit from non-price competition equals the manufacturer's marginal profit, that is, M_R equals M_M, it may appear that the manufacturer need only enforce resale price maintenance to obtain desired retailer performance. However, this solution overcompensates retailers by providing them with an unnecessarily large share of the profit on incremental sales. For example, the model implies that manufacturers of products with low marginal costs and high incremental profits, such as software, should dramatically cut the wholesale price and institute resale price maintenance so that retailers earn a profit margin that is approximately the same as the manufacturer's profit margin. Not only would this involve an unnecessarily large payment to retailers (compared to the alternative described in this article of manu-

Alternatively, a manufacturer may achieve similar contract enforcement advantages by generating the required per unit time retailer compensation necessary to induce increased promotion, $M_R Q_R$, with the use of exclusive territories. This generally increases an individual retailer's sales in equilibrium compared to resale price maintenance and consequently may lower the necessary level of M_R. All that is required to induce desired retailer behavior is that the retailer receives a sufficient per unit time payment from the manufacturer that may consist of any combination of expected retailer sales and an expected retailer profit margin on those sales. In this way, both exclusive territories and resale price maintenance increase independent retailer incentives to promote the manufacturer's products while creating a profit stream that compensates retailers for (and assures the supply of) the extra retailer promotional efforts desired by the manufacturer.

This fundamental economic equivalence of exclusive territories and resale price maintenance as alternative ways to compensate retailers for increased promotional efforts has not been fully recognized in the antitrust economics literature because of the unfortunate focus on the prevention of free riding as the sole rationale for restricted distribution arrangements. Resale price maintenance is mistakenly claimed to eliminate the incentive of retailers to free ride on full-service retailers because free-riding retailers cannot offer consumers a lower price.[55] An exclusive territory, on the other hand, is claimed to eliminate the incentive of retailers to free ride on full-service retailers because it is difficult for consumers to first visit a retailer outside of their territory to receive services before purchasing the product at the designated retailer within their territory. However, unless customers are, in effect, allocated to specific retailers, as when a newspaper publisher gives a home delivery distributor an exclusive area,[56] the free-riding potential is not eliminated with most exclusive territory arrangements.[57] When the product is of sig-

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facturer compensation of retailers solely for their opportunity costs of supplying promotional services and then monitoring retailer behavior to assure performance), but this profit-sharing solution would lead both the manufacturer and retailers to supply less than the jointly profit-maximizing amount of their respective promotional efforts. The manufacturer, for example, will advertise less than would be jointly profitable and retailers will promote at the point of sale less than would be jointly profitable because they each would earn only half of the profit on the resulting incremental sales. Moreover, since the inter-retailer demand responsiveness to retailer supply of non-price services is unlikely to be the same for all types of non-price services, merely fixing the retail price will give retailers a greater incentive to engage in forms of non-price competition with larger inter-retailer demand effects than the point-of-sale promotional services desired by the manufacturer.

[55] *See supra* Part I.A.

[56] *See, e.g.,* Albrecht v. Herald Co., 390 U.S. 145 (1968).

[57] For example, in *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 38 n.2 (1977), Sylvania did not grant an exclusive distribution area for each approved dealer. Sylvania

nificant value, consumers can be expected to shop multiple retailers over a fairly wide area.

In many cases, the primary economic purpose of granting a retailer a limited exclusive territory is not to eliminate free riding by allocating customers to specific retailers, but (as with resale price maintenance) to give the retailer an increased independent incentive to promote the manufacturer's product and provide the retailer with something valuable to lose if terminated by the manufacturer for poor performance. That is, rather than solely preventing free riding, both resale price maintenance and exclusive territories often serve as efficient compensation mechanisms for increased retailer promotional efforts.[58]

An exclusive territory in some circumstances may have an advantage over resale price maintenance as a way of compensating retailers because it more effectively reduces inter-retailer free-riding problems and provides retailers with increased pricing flexibility compared to resale price maintenance. The major economic advantage of resale price maintenance, on the other hand, is that it permits the manufacturer to have a larger number of retailers within an area selling its products. When the number of retailers in an area that sell a manufacturer's products has a significant positive effect on total demand for the manufacturer's products, as described above, an exclusive territory arrangement is a relatively inefficient way to generate retailer compensation for promotional effort; in that case, resale price maintenance is the preferred restricted distribution arrangement.

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merely limited the number of approved dealers in each area, with at least two dealers in each metropolitan area of more than 100,000 people and substantially more dealers in larger areas.

[58] In both *GTE Sylvania* and *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752 (1984), for example, there does not appear to be unambiguous evidence that the terminated distributor engaged in free riding, but there is clear evidence that both Continental TV and Spray-Rite did not adequately promote their respective manufacturer's products. Specifically, no evidence was presented in *GTE Sylvania* that Continental was serving customers in San Francisco (its designated territory) who first visited and received promotional services from other full-service Sylvania retailers. However, the evidence does suggest that Continental was not aggressively promoting Sylvania TVs in San Francisco. Sylvania's share was only 2.5 percent in San Francisco compared to its 5 percent national share and 15 percent share in Sacramento, the territory into which Continental desired to ship Sylvania TVs. *GTE Sylvania*, 433 U.S. at 38–39, nn.4 & 6. Similarly, the evidence indicates that Spray-Rite did not sell Monsanto herbicides to buyers after they received promotional services from other distributors, but that Spray-Rite primarily sold to large knowledgeable customers who did not demand promotional services. Monsanto failed to renew the Spray-Rite distributorship not because of evidence of free riding, but solely "because of Spray-Rite's failure to hire trained salesmen and promote sales to dealers adequately." *Monsanto,* 465 U.S. at 757. *See* Benjamin Klein, *Distribution Restrictions Operate by Creating Dealer Profits: Explaining the Use of Maximum Resale Price Maintenance in* State Oil v. Khan, 7 SUP. CT. ECON. REV. 1, 15–19 (1999).

3. *Manufacturer Enforcement of Retailer Performance*

As I have described, the enforcement mechanism manufacturers commonly use to assure that retailers supply the increased promotional services they have been compensated for, element (3) of the distribution arrangement, generally involves self-enforcement rather than court enforcement. That is, in most cases the distribution arrangement between a manufacturer and its retailers 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 desire for increased promotion and they expect to be terminated if they do not supply the promotional services they have been compensated to provide. Manufacturers operating under this type of arrangement do not take non-performing retailers to court to demand performance. Instead, manufacturers monitor retailer efforts and terminate those retailers that the manufacturer determines are not performing adequately. Such manufacturer monitoring may involve sending an undisclosed representative to examine the retailer's promotional efforts (such as the location and appearance of the retailer's displays and the extent of salesperson efforts) or may involve comparing a retailer's sales to other retailers. When retailer performance is judged to be inadequate, the manufacturer may pull the product from the non-performing retailer and shift distribution to other retailers that are promoting more intensively, or the manufacturer may adjust the non-performing retailer's compensation.[59]

Retailer non-performance may occur in two primary ways. First, and most obviously, the retailer may not supply the desired promotional services. Although the increased retail profit margin created by resale price maintenance provides the retailer with an increased independent incentive to supply promotional services, on the margin the retailer does not have the independent incentive to supply all of the promotional services the manufacturer has purchased and expects to receive. When the retailer is deciding whether to supply additional promotional services, such as providing a salesperson near the display of a clothing manufacturer's products or keeping the clothing manufacturer's products neatly displayed, M_R (dQ_R/dS) is still less than M_M (dQ_M/dS). A retailer that supplies less than the desired level of promotion will make fewer incre-

[59] Adjustment of retailer compensation in response to inadequate retailer performance may involve a reduction in compensation, so that compensation more closely relates to actual performance, or possibly an increase in compensation if the manufacturer recognizes that retailer performance is inadequate because compensation is insufficient relative to what competing manufacturers are paying for dedicated retailer promotional efforts.

mental sales than if it supplied the desired level of promotion and, therefore, the retailer's compensation will be reduced because it loses the profit on those additional incremental sales. However, it will still be more profitable for the retailer to reduce its promotional efforts below the level desired and paid for by the manufacturer.

The fundamental economic reason for this is that resale price maintenance provides compensation to retailers for increased promotional efforts in the form of a payment based on all of a retailer's sales, not solely a retailer's incremental sales. Therefore, when a retailer reduces its promotional effort and its sales decrease, it still receives additional compensation on its remaining sales. Because of this key economic difference between the form of retailer compensation for promotional effort that is based on total retailer sales and the effect of retailer promotional effort that solely influences incremental retailer sales, the cost to the retailer on the margin of supplying additional promotional effort will be greater than its profit on promotion-induced incremental sales. Therefore, the retailer has an economic incentive not to supply all the promotional services paid for by the manufacturer.[60]

It is important to emphasize that this incentive of a retailer not to supply all the promotional services it has been paid to supply 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 retailers who are not supplying all the manufacturer-specific promotional efforts they have been compensated to provide.

A second, often empirically more important way a retailer may not perform and violate its understanding with the manufacturer occurs when a retailer provides the desired increased level of manufacturer-specific promotional services but lowers its price below the resale price maintained level. This has the effect of increasing the retailer's sales to price-sensitive inframarginal consumers who decide to switch their purchases to the price-discounting retailer. Since these inframarginal consumers are assumed to already know that they want to purchase the product, they are not free riding in the sense of first obtaining promotional services from other retailers before purchasing the product from the discount retailer. However, because resale price maintenance in-

[60] The attempt by a manufacturer to base compensation solely on retailer incremental sales, for example, by paying a bonus solely on sales increases over some benchmark level, has obvious measurement difficulties and increases the incentive of retailers to expand sales by violating resale price maintenance.

volves retailer compensation on the basis of all of a retailer's sales, the shift in sales means that the compensation received by the discount retailer from the manufacturer increases. Meanwhile, the non-discounting retailers that lose sales receive less compensation from the manufacturer. Since retailer costs associated with the supply of promotional services are primarily per unit time costs unrelated to the increased sales made to infra-marginal consumers, the shift in sales means that the price-discounting retailer is over-compensated and the other retailers are under-compensated for the supply of desired promotional services.

Price discounting, therefore, will lead non-discounting retailers to reduce their manufacturer-specific promotional efforts below the level desired and paid for by the manufacturer. It will no longer be profitable for the non-discounting retailers to devote as much of their valuable shelf space or their salesperson promotional efforts to the manufacturer's products. In fact, non-price discounting retailers may even stop distributing the manufacturer's products altogether. And if some non-discounting retailers respond to the price discounter by also reducing price, retail margins will be further reduced, leading to a further reduction in the promotional efforts undertaken by non-price discounting retailers and, hence, a further deterioration in the manufacturer's effective retail network. The reduction in the overall demand for the manufacturer's products as a consequence of these deleterious effects on the manufacturer's retail distribution network explains why price discounting retailers are a concern to manufacturers even when such retailers supply the desired level of manufacturer-specific promotional services.

This explains why manufacturers will terminate retailers that discount price even when such retailers seem to be providing the promotional services desired by the manufacturer. For example, when Kay's Kloset discounted the price of Leegin's products, it made increased sales to inframarginal customers and left other Leegin retail outlets with reduced sales and profit. Therefore, if permitted to continue, such price discounting would have resulted in some of these other outlets reducing their promotion of Leegin products or dropping distribution of Leegin products entirely. Other retail outlets would have insufficient sales to cover the costs associated with the shelf space and promotional efforts desired by Leegin. In this and other cases the price discounting retailer is not free riding on the promotional services supplied by other retailers. However, similar to the free-riding analysis, the price discounting will lead other retailers to no longer supply the manufacturer's desired promotional services. Leegin has to prevent retailer price discounting in order to insure that a sufficient number of retailers will continue to distribute and adequately promote its products.[61]

This also explains why manufacturers will be more concerned if retailers are permitted to publicly advertise their discount prices. Widely disseminated price advertising, especially Internet price advertising, will result in a greater shift of inframarginal consumer purchases to the discounting retailer, exacerbating these deleterious effects on the manufacturer's retail network. On the other hand, in-store promotion of price reductions may have primarily within-store inter-brand effects without producing significant inter-retailer intra-brand effects. Therefore, a manufacturer may sometimes permit within-store retailer price discounting but prevent significant adverse effects on its retail network by adopting a minimum advertised price policy.[62]

II. ANTITRUST POLICY IMPLICATIONS OF RESALE PRICE MAINTENANCE

A. Resale Price Maintenance in the Absence of Free Riding 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.[63] A manufacturer does not appear to have an economic interest in increasing retail margins unless it serves the competitive purpose of increasing the demand for its products. Manufacturers are in effect purchasing retailing services at an implicit price equal to the retail margin defined by the gap between the wholesale price manufacturers receive and the retail price paid by consumers. Therefore, it would not appear to make economic sense for a manufacturer to institute resale price maintenance if the increased re-

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

[62] For Internet retailers this distinction between in-store price promotion and more general price advertising is not as clear. Internet retailers subject to minimum advertised price policies may provide the consumer with price discount information only after the item is in the consumer's shopping cart. But consumers learn to expect such discounts and can easily check and shop for such discounted prices across Internet sites pre-purchase. Consequently, such "in-store" non-advertised price promotions on Internet sites are likely to have significant inter-retailer demand effects that manufacturers may attempt to control.

[63] Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 895–97 (2007).

tailer margin and the associated increased implicit price the manufacturer was paying for retailing services produced by resale price maintenance did not compensate retailers for supplying services that increased the demand for the manufacturer's products.[64] The economic analysis presented in this article substantially expands the number of cases where manufacturers are purchasing demand-increasing retailer services with resale price maintenance by demonstrating that purchased retailer services need not involve a free-riding problem.

Although a manufacturer may have an economic motivation to institute resale price maintenance to increase retailer compensation as a way of increasing demand for its products, William Comanor and Frederic Scherer emphasize in their *Leegin* amicus brief that an increase in sales does not necessarily imply an increase in total consumer welfare.[65] Comanor and Scherer argue that because the dedicated point-of-sale promotional services manufacturers purchase from retailers with increased retail margins are not demanded by all consumers, some consumers are better off but other consumers worse off as a result of the manufacturer's actions. Specifically, while marginal consumers who increase their purchases of the manufacturer's products value and, hence, benefit from the increased promotional services paid for with resale price maintenance, inframarginal consumers who would have purchased the manufacturer's products in any event are worse off since they are paying higher prices without receiving any benefit from the retailer's increased promotional services. Comanor and Scherer therefore conclude that the net welfare effect of the increased manufacturer-specific retailer promotion induced by resale price maintenance depends on the relative number of inframarginal and marginal consumers that purchase the manufacturer's products.[66]

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[64] This proposition was emphasized in a seminal article by Robert H. Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 75 YALE L.J. 373, 402–03, 424 (1966). *See also* Robert H. Bork, *Resale Price Maintenance and Consumer Welfare*, 77 YALE L.J. 950 (1968).

[65] Brief for William S. Comanor and Frederic M. Scherer as Amicus Curiae Supporting Neither Party, Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S. Ct. 2705 (2007), 2007 WL 173679 [hereinafter Comanor & Scherer *Leegin* Amicus Brief]. This is a long-standing position of both Comanor and Scherer. *See, e.g.*, William B. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983 (1985); F.M. Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983).

[66] Although under the Comanor and Scherer assumptions inframarginal consumers may be paying higher prices than they would in the absence of resale price maintenance, this may not necessarily be the case if manufacturers substitute less efficient ways to purchase the dedicated retailer point-of-sale promotional efforts they desire. Such alternatives may include increased manufacturer advertising with higher wholesale prices, or possibly vertical integration into retail distribution with the direct supply by manufacturers of desired point-of-sale promotion. These and other alternative arrangements may

While there are likely to be distribution effects across consumers when a manufacturer uses resale price maintenance to compensate retailers for dedicated promotional efforts, this is a normal consequence of competition. Some consumers are likely to gain and other consumers likely to lose from most marketing practices adopted by competitive firms. For example, many competitive retailers provide free services, such as free delivery, that are not consumed by all customers. The provision of free sales assistance is another obvious example. One customer may try on twenty different pairs of shoes over an hour-long period before making a purchase while another customer purchases the same pair of shoes in five minutes without trying on any shoes. The fact that retailer provision of free sales assistance may increase retail prices without any offsetting benefit to inframarginal consumers who do not demand the assistance does not mean that we should prohibit retailers from supplying such services or prohibit manufacturers from compensating retailers for supplying such services. Although inframarginal consumers may be better off as a result of such a prohibition, this does not make such a prohibition procompetitive. The provision of free services that are valuable to only a subset of consumers is a pervasive part of the normal competitive process undertaken by firms without any market power.

Antitrust policy leaves it up to firms competing in the marketplace to determine which free services will be supplied by retailers, often with financial assistance provided by manufacturers to retailers for the supply of services devoted to the sale of the manufacturer's products. The role of antitrust is not to microregulate this competitive process by calculating whether a particular marketing practice in a particular circumstance produces a net consumer welfare gain or not. It is highly unlikely that a court could empirically estimate these differential effects between marginal and inframarginal consumers and accurately determine when total consumer welfare was or was not reduced. Moreover, independent of these difficult empirical considerations, when a competitive firm decides to adopt a particular retailing arrangement as a way to increase promotion and therefore demand for its products, this should be considered an element of the normal competitive process independent of any potential distribution effects across consumers that may occur.

This article describes a fundamental incentive incompatibility between a manufacturer and its retailers with regard to the supply of dedi-

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result in higher retail prices than under resale price maintenance. Moreover, if retailer promotional efforts induced by resale price maintenance are aimed at the most price-sensitive consumers, it is possible that the manufacturer's profit-maximizing wholesale price could decrease. *See* Becker & Murphy, *supra* note 35.

cated point-of-sale promotional efforts that primarily have inter-brand demand effects with little or no inter-retailer demand effects. The existence of this incentive incompatibility implies that both small and large manufacturers will often find it in their individual economic interests to compensate retailers for promoting the sale of their products. The key economic requirements for the likely presence of this competitive motivation for manufacturer compensation of retailers for increased promotion are: (1) a significant manufacturer profit margin on incremental sales, and (2) a significant effect of retailer point-of-sale promotion in inducing incremental manufacturer sales. Both of these conditions commonly exist in competitive markets and will often lead manufacturers to contract with retailers for promotional efforts. And because dedicated retailer promotional efforts often cannot easily be contractually specified and enforced, resale price maintenance often will be an efficient way for manufacturers to compensate retailers for supplying dedicated promotional efforts in such contractual arrangements.

Manufacturers compete with one another in the retail distribution marketplace for retailer point-of-sale promotion by offering retailers increased compensation for their dedicated promotional efforts. In some cases, the market equilibrium may involve preferential or de facto exclusive retailer promotion devoted to a single manufacturer's products;[67] in other cases, multiple manufacturers will compensate and receive dedicated retailer promotion of their products. In all cases, the value a manufacturer places on a retailer's promotion is equal to the increased profit earned by the manufacturer—from the added sales the manufacturer receives as a result of preferential retailer promotion or the sales the manufacturer is prevented from losing if other manufacturers pay for retailer promotion and they do not. The competitive process by which manufacturers compete for retailer promotional efforts will result in retailer compensation that is approximately equal to the value the manufacturer places on the retailer's promotional services.[68]

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[67] Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L.J. 433 (2008), describes the economic conditions when exclusivity is likely to be the competitive contractual solution that provides the greatest benefits to retailers and ultimately to consumers.

[68] Retailer compensation will more precisely equal the value placed on the promotion by the next highest valuing manufacturer that does not obtain the retailer's promotional efforts. This is the retailer's opportunity cost of supplying promotional services to a manufacturer, namely what it could sell the services for to another manufacturer. Given manufacturer competition for retailer promotional efforts and the existence of multiple manufacturers that do not differ greatly in the value they place on a retailer's promotional efforts, this will be close to the value of the services received by the manufacturer. If the retailer receives the full value of the services received by the manufacturer, retailer compensation will equal M_M (dQ_M/dS). This does not imply that M_R is increased to equal

Competition between manufacturers for dedicated retailer promotional efforts has the immediate effect of benefiting retailers because resale price maintenance creates a condition where increased profit is earned by retailers on their sales of the manufacturer's products. However, the highly competitive nature of retailing implies that any retailer return from the provision of promotional services that is greater than retailer costs of supplying the promotional services is likely to be largely passed on to consumers as part of the competitive retailing process. This obviously will be the case in the many retail markets where each retailer faces consumer demand that is highly elastic. But it also will be the case when retailers face less elastic consumer demands because they possess distinct reputations for expected quality across various dimensions, including charging reasonable prices while supplying conveniently located, well-stocked stores, or providing attentive and courteous sales people. In these circumstances consumers will have loyalty to particular retailers and may not be highly responsive in the short run to small price changes. However, since manufacturer payments to retailers for promotional services are related to a retailer's sales, retailers will compete with one another along these retailer quality dimensions in order to develop a loyal customer base that increases both their sales and the compensation they will receive from manufacturers for their promotional efforts. Consequently, retailers face long-run competitive pressures to use any manufacturer payments they receive for product promotion in excess of costs to either lower their overall average prices (when the retailer is a multi-product retailer) or to supply consumer services that have large inter-retailer demand effects. Such price and non-price inter-retailer competition therefore results in manufacturer promotional payments ultimately benefiting consumers.[69]

B. POTENTIAL ANTICOMPETITIVE EFFECTS OF RESALE PRICE MAINTENANCE

While resale price maintenance often is competitively motivated by the desire of manufacturers for increased retailer promotion of their

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M_M. Since retailer compensation with resale price maintenance occurs with a profit margin on all the retailer's sales, not only on the incremental units induced by the retailer's promotion, M_RQ_R will equal M_M (dQ_M/dS). For example, if M_M equals $10/unit and the effect of retailer promotion on the manufacturer's sales, (dQ_M/dS), is a 10 percent increase in demand, then the manufacturer bidding for retailer supply of promotional services need only increase M_R $1/unit in equilibrium.

[69] An illustration of these competitive forces is described by Klein and Wright with regard to manufacturer promotional payments to supermarkets in the form of slotting fees. Klein & Wright, *supra* note 34, at 436. Although slotting payments have increased dramatically since 1980, the inter-retailer competitive process has fully dissipated these promotional payments so that supermarket profitability has not increased.

products, the Court in *Leegin* recognized that resale price maintenance also may be anticompetitively motivated. Specifically, the Court described four potential anticompetitive motivations for resale price maintenance—the use of resale price maintenance (1) by a group of manufacturers to facilitate a manufacturer cartel, (2) by a group of retailers to facilitate a retailer cartel, (3) by a dominant manufacturer to maintain its market power, or (4) by a dominant retailer to maintain retail market power.[70] A framework for rule of reason antitrust analysis of resale price maintenance must evaluate the risks associated with these potential anticompetitive motivations for resale price maintenance in each particular case.

One way to organize the analysis of the anticompetitive motivations for resale price maintenance, which I have followed here, is to distinguish between resale price maintenance arrangements that are initiated by manufacturers and arrangements that are initiated by retailers. However, in many cases this distinction is not economically relevant. A manufacturer may ask a retailer to carry (or more intensively promote) its products, and the retailer then may inquire how the manufacturer intends to distribute the products, for example, asking the manufacturer who else will be carrying the products in the area and what will be the manufacturer's other terms of retail distribution. In this context, there is no substantive economic difference between the manufacturer saying it plans to institute resale price maintenance and expects the retailer to intensively promote its products, or the retailer saying it will stock and intensively promote the manufacturer's products and expects the manufacturer to maintain retail margins. In both cases the manufacturer is purchasing retailer services and the retailer is selling retailer services; and the manufacturer and retailer both expect to be better off as a result of the transaction. It certainly is incorrect to infer that only "the initiator" of resale price maintenance is benefiting, while the other party is coerced to accept the arrangement. In particular, resale price maintenance initiated by retailers in many cases may be beneficial to the manufacturer, which would have also independently proposed it. It certainly does not make economic sense to claim that, while a manufacturer may competitively initiate the use of resale price maintenance to increase the demand for its products, there are no circumstances where retailer-initiated resale price maintenance is similarly procompetitive.[71]

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[70] Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 892–94 (2007).

[71] *See, e.g.*, William S. Comanor, *The Two Economics of Vertical Restraints*, 5 REV. INDUS. ORG. 99 (1990). Comanor and Scherer state in their *Leegin* Amicus Brief, that "[t]o the knowledge of the amici, there are no arguments in economic analysis supporting re-

1. *Anticompetitive Manufacturer-Initiated Resale Price Maintenance*

Manufacturers can be thought of as delivering their products to final consumers through the implicit purchase of retailing services, with the price paid by the manufacturer for retailing services equal to the difference between the final price charged by retailers and the wholesale price charged by the manufacturer. The lower this retail margin, or implicit purchase price of retailing services, the lower is the retail price for any given level of wholesale price and, hence, the greater are the manufacturer's sales and profits at any given wholesale price. Consequently, if a manufacturer voluntarily increases the retail margin with resale price maintenance, it appears that the manufacturer would do this only if it shifts out the demand for its products through the creation of increased consumer value.

The *Leegin* Court describes two anticompetitive exceptions to this general proposition that manufacturer-initiated resale price maintenance must be procompetitively motivated. The first manufacturer-initiated anticompetitive motivation involves the use of resale price maintenance by a group of manufacturers to facilitate a manufacturer cartel.[72] It is claimed that resale price maintenance may facilitate a horizontal price-fixing agreement among manufacturers in two ways—by decreasing the incentive of individual manufacturers to cheat on the cartel by reducing their wholesale prices below the collusively set prices and by increasing the ability of cartel members to detect manufacturers that do cheat on the cartel by reducing their wholesale prices.

The economic forces described in this article imply that resale price maintenance does not eliminate the incentive of individual manufacturer cartel members to cheat on the cartel by reducing their wholesale prices. A manufacturer that reduces its wholesale price while continuing to maintain retail prices with resale price maintenance creates an increased incentive for retailers to promote its products at the expense of rival products. However, while in some circumstances this manufacturer incentive to encourage favorable retailer promotional activity may destabilize a cartel, restraining the ability of retailers to reduce price with resale price maintenance can be expected to decrease substantially the incentive of manufacturers to cut wholesale prices and, hence, will generally stabilize a cartel. Resale price maintenance also makes it somewhat easier in this context to detect manufacturers that cheat on a cartel by reducing wholesale price, but this cartel stabilizing effect is likely to

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straints arising from distributor actions or pressures." Comanor & Scherer *Leegin* Amicus Brief, *supra* note 65, at 8.

[72] *Leegin*, 551 U.S. at 892.

be minor. Even if there were not resale price maintenance, observation of a retailer's lower prices would be a strong indication that a cheating manufacturer had violated the conspiracy by lowering its wholesale prices. However, it is important to emphasize that, even if these two factors are present, the role of resale price maintenance under a manufacturer cartel theory is, at most, a cartel-facilitating practice and not anticompetitive in itself. As discussed in Part II.C, applicability of the theory therefore requires other evidence of the existence of a collusive horizontal agreement among manufacturers to fix wholesale prices.

The second manufacturer-initiated anticompetitive theory of resale price maintenance described by the Court in *Leegin* involves the use of resale price maintenance by a dominant manufacturer to maintain its market power, either by driving smaller manufacturing rivals out of the market or by preventing new competitive manufacturing rivals from entering the market.[73] It is not clear exactly how this anticompetitive theory operates. One way may involve the dominant manufacturer combining resale price maintenance with the threat to terminate retailers that carry the competing rival or new entrant's product. This anticompetitive theory amounts to the use of resale price maintenance by a dominant firm as a way to pay retailers for de facto exclusive dealing. Therefore, in evaluating potential anticompetitive effects under this theory we should focus on the question of whether there are likely to be anticompetitive effects from exclusive dealing. This generally involves a determination of whether, given economies of scale in manufacturing or economies of scope in distribution for the manufacturer, the dominant manufacturer is able to place rival manufacturers at a significant competitive disadvantage by foreclosing rivals' access to a sufficiently large share of retailing. However, while an anticompetitive effect is certainly possible under this exclusivity scenario, resale price maintenance has no anticompetitive significance by itself; resale price maintenance is merely the way in which a dominant manufacturer may pay for exclusivity.

The Court in *Leegin* does not describe the potential anticompetitive effects of a dominant firm's use of resale price maintenance in this way, namely as a method of compensating retailers for a de facto exclusive agreement. Instead, the Court describes the potential anticompetitive effects of a dominant firm's use of resale price maintenance as a way for the dominant firm to maintain its market power because it "give[s] retailers an incentive not to sell the products of smaller rivals or new en-

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[73] *Id.* at 894.

trants."[74] In particular, it is claimed that retailers have a reduced incentive to carry a rival brand because retailers operating under resale price maintenance are earning a protected, higher than normal margin on sales of the dominant manufacturer's brand. However, absent the dominant manufacturer's threat to terminate retailers that carry rival products, that is, absent a de facto exclusivity agreement, there is no reason why retailers would not also carry competing products.

All that is necessary for retailers to carry rival products is that they expect to earn a sufficient return on such products. When a retailer's return on the dominant manufacturer's established brand is protected with resale price maintenance, this is likely to increase what competing manufacturers of rival products must offer retailers to obtain distribution. But rival product manufacturers could also assure retailers that they will earn a sufficient return by compensating them with resale price maintenance. Resale price maintenance by itself is not exclusionary; it is just an element of the normal competitive process by which manufacturers compete for retail distribution. Small new manufacturers, as well as large established manufacturers, may use resale price maintenance within this competitive framework as an effective way to compensate retailers for stocking and promoting their products.

2. *Anticompetitive Retailer-Initiated Resale Price Maintenance*

The two retailer-initiated anticompetitive theories described by the Court in *Leegin* implicitly assume that when resale price maintenance is initiated by retailers, the manufacturer is being forced by retailers to act against its economic interests in adopting resale price maintenance. This would suggest that the manufacturer and the manufacturer's consumers are made worse off by the resale price maintenance, and explains why Comanor and Scherer advocate a presumptively per se illegal antitrust standard for resale price maintenance when it is initiated by retailers.[75] However, as we shall see, this is an incorrect analysis.

One instance of retailer-initiated resale price maintenance that fits the anticompetitive scenario is when a group of colluding retailers force the manufacturer to institute resale price maintenance solely to limit inter-retailer competition and thereby increase retailer margins. However, while resale price maintenance established by a retailer cartel

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[74] *Id.*

[75] Comanor & Scherer *Leegin* Amicus Brief, *supra* note 65, at 9. Comanor and Scherer state that per se liability would be rebuttable, but do not present the conditions under which this would be the case, merely noting that the presumption of liability would be rebuttable "on the presentation of credible contradictory evidence." *Id.*

against the wishes of a manufacturer is anticompetitive, the simultaneous independent demand by multiple retailers that a manufacturer stop retailer price discounting and adopt resale price maintenance should not be interpreted as an antitrust problem analogous to a retailer cartel. The economic theory of resale price maintenance presented in this article indicates that it often will be in each retailer's independent economic interest to complain to the manufacturer about the existence of retailer price discounting and for each retailer to communicate its plans to drop distribution or reduce promotion of the manufacturer's products if the manufacturer does not prevent such price discounting. It is important to recognize that retailers are selling something to the manufacturer—point-of-sale promotional services that may or may not involve free riding as described in this article—and that price discounting may mean that the retailer is not getting paid for the supply of these services. In particular, if retailers are not earning a sufficient return on their retailing assets, such as shelf space and sales staff, they will each have an incentive to stop distributing the manufacturer's products and can be expected to independently warn the manufacturer of their intention to do so.[76]

A manufacturer that responds to retailer complaints in these circumstances by terminating price discounting retailers is not equivalent to a manufacturer that is being coerced to act contrary to its economic interests in response to a demand by a retailer cartel. If the manufacturer knew that retailer price discounting was occurring, and expected that it would lead other retailers to individually decide to drop distribution of the manufacturer's products, it would be in the manufacturer's economic interest to terminate the price discounting retailers even if the manufacturer had not received any retailer warnings. Although the manufacturer may receive some short-term benefits in the form of increased sales as a result of the price discounting, the manufacturer would have unilaterally initiated resale price maintenance on its own because the manufacturer knows it will be unable to obtain or maintain adequate retail distribution for its products without controlling such price discounting.[77]

The second anticompetitive retailer-initiated resale price maintenance scenario described by the Court in *Leegin* involves a dominant

[76] When the demand is jointly made through a retailer trade association or otherwise involves joint retailer action, however, it may be legally considered concerted action. *See, e.g.,* United States v. Gen. Motors Corp., 384 U.S. 127 (1966).

[77] Consistent with this analysis, since *Monsanto*, manufacturer termination of price discounting retailers in response to individual retailer complaints provides no evidence of a vertical price agreement.

retailer that anticompetitively uses resale price maintenance in an attempt to maintain market power by preventing the entry of new, lower-cost retailers. The theory is that if lower-cost retailers entered, the dominant retailer would lose market share. Therefore, the dominant retailer "might request resale price maintenance to forestall innovation in distribution that decreases costs."[78] And the manufacturer may acquiesce to the dominant retailer's demands because "it has little choice but to accommodate the retailer's demands for vertical price restraints if the manufacturer believes it needs access to the retailer's distribution network."[79]

This statement of the dominant retailer-initiated anticompetitive theory of resale price maintenance is similar to the retailer cartel theory in the sense that it would appear not to be in the interests of the manufacturer to prevent the entry of a new, lower-cost retailer. Since the manufacturer wishes to purchase retailing services at the lowest implicit cost, entry of a new innovative retailer that has lower retailing costs would increase the manufacturer's profits. The theory assumes the manufacturer is forced against its economic interests by the dominant retailer to use resale price maintenance to prevent the new, lower-cost retailer from reducing its retail prices. In this way, it is claimed that the established retailer protects its dominant position because consumers will not have the incentive to shift their purchases to the new, lower-cost retailer that is charging the same price, thereby deterring, or at least delaying, the entry of the lower-cost retailer.

However, the demand for resale price maintenance by a dominant retailer may be motivated by similar procompetitive considerations as described above with regard to the independent demand for resale price maintenance by multiple non-dominant retailers. Specifically, there may be procompetitive reasons for dominant retailers to complain about and discourage manufacturer sales to discount retailers and for manufacturers to find it in their independent economic interests to take account of such dominant retailer complaints because of the effect discount retailers have in reducing the normal competitive return non-discount retailers earn from stocking and promoting the manufacturer's products. The manufacturer, therefore, may terminate price discounting retailers not because it is forced by an exercise of dominant retailer

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[78] *Leegin*, 551 U.S. at 893.

[79] *Id.* at 893–94 (citing THOMAS R. OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE 31 (Fed. Trade Comm'n Bureau of Economics staff report Nov. 1983); 8 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION 47 (2d ed. 2004); Toys "R" Us, Inc. v. FTC, 221 F.3d, 928, 937–38 (7th Cir. 2000)).

market power, but because the manufacturer fears that discounting may lead established retailers to conclude that it no longer pays to devote their selling space or other promotional efforts to the manufacturer's products. Manufacturers recognize that if this occurs, there may be a reduction in the overall long-run demand for their products in spite of the lower retail prices charged by the discount retailer, as consumers lose the option of purchasing the manufacturers' products at their preferred outlets. Consequently, manufacturers may decide to prevent retail discounting even in cases where the new, lower-cost discount retailer supplies the same promotional services as established retailers. And manufacturers may prevent such retail discounting even when the complaining established retailer is not exercising any market power.[80]

To illustrate this potential procompetitive reason for dominant retailer initiated resale price maintenance, consider what occurred in *Business Electronics v. Sharp*.[81] The larger of Sharp's two retailers in the Houston area, Hartwell, threatened to drop distribution of Sharp products if Sharp did not terminate the other retailer that was discounting Sharp products, Business Electronics. Sharp acquiesced and decided to no longer supply Business Electronics, leading Business Electronics to claim that this amounted to illegal resale price maintenance.[82]

An anticompetitive effect in this type of case requires that the manufacturer be forced by an exercise of dominant retailer market power to act contrary to what would be its economic interests absent anticompetitive dominant retailer coercion. However, there is nothing anticompetitive about a retailer advising a manufacturer that it will stop distributing the manufacturer's products if it cannot earn a sufficient return on its retailing assets, either because of free riding by other retailers (for which there was conflicting evidence in *Business Electronics*) or more generally because the retailer is losing sales to discounting retailers (for which the evidence was unambiguous in *Business Electronics*). For whatever reason, if it no longer pays a retailer to sell a manufacturer's

[80] An alternative to resale price maintenance as a way for the manufacturer to preserve desirable retail distribution may involve the manufacturer selling the product to higher-cost established retailers at a lower wholesale price than to discount retailers. However, this involves potential Robinson-Patman problems and does not prevent established retailers transshipping product purchased at a low price to discount retailers, a generally much more difficult problem for the manufacturer to monitor and control than retail prices.

[81] Business Elecs. Corp. v. Sharp Elecs. Corp. 485 U.S. 717 (1988).

[82] The Court in *Business Electronics* did not find a vertical price-fixing antitrust violation because there was no actual or implied further agreement between Sharp and Hartwell regarding a minimum price. Hartwell was essentially demanding an exclusive territory, illustrating the economic similarity of resale price maintenance and exclusive territories in terms of the common purpose and effect of guaranteeing retailers a sufficient return to induce desired retailer promotional efforts.

product, the retailer may reasonably inform the manufacturer that it intends to drop distribution unless conditions change. An anticompetitive effect requires an economic determination that the manufacturer has been anticompetitively coerced to terminate what otherwise would be desirable, long-term retailers in order to increase the dominant retailer's return above the competitive return (including a normal return on the dominant retailer's tangible and intangible assets), and that retailer termination was not motivated by the manufacturer's legitimate procompetitive concerns regarding long-run preservation of its desirable retail distribution network.[83]

C. ANTITRUST ANALYSIS OF RESALE PRICE MAINTENANCE

The Court in *Leegin* recognized the need for lower courts to "establish a litigation structure to ensure that the rule [of reason] operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses."[84] Christine Varney, Assistant Attorney General of the Antitrust Division of the Department of Justice, in an important recent speech[85] outlines this structured rule of reason framework by, first, requiring the plaintiff to establish a prima facie showing of a likely anticompetitive effect that shifts the burden "to the defendant to demonstrate either that its RPM policy is actually—not merely theoretically—procompetitive or that the plaintiff's characterizations of the marketplace were erroneous."[86]

The four anticompetitive theories of resale price maintenance described by the *Leegin* Court imply a set of circumstances where the anticompetitive effects required to meet the first condition are present. These circumstances are fairly limited under the theories of manufac-

[83] Robert Steiner claims that, even when there is not an anticompetitive exercise of established retailer market power, the decision by manufacturers to voluntarily terminate price discounting retailers because of the likelihood that their established retailers will drop distribution may result in welfare costs if it slows down the entry of new, more efficient retailers. However, if it does not involve the exercise of retailer market power, this should not be an antitrust concern. Moreover, although Steiner describes the economic factors that individual manufacturers are likely to consider under alternative scenarios in making this decision to reduce intra-brand competition, he does not provide a demonstration of the conditions under which the manufacturer's actions will reduce consumer welfare nor does he establish that this potential welfare-reducing effect is empirically important. Robert L. Steiner, *How Manufacturers Deal with the Price-Cutting Retailer: When Are Vertical Restraints Efficient*, 65 ANTITRUST L.J. 407 (1997)

[84] *Leegin*, 551 U.S. at 898.

[85] Christine Varney, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Antitrust Federalism: Enhancing Federal/State Cooperation, Remarks as Prepared for the National Association of Attorneys General Columbia Law School State Attorneys General Program (Oct. 7, 2009), *available at* http://www.justice.gov/atr/public/speeches/250635.htm.

[86] *Id.* at 5.

turer-initiated anticompetitive resale price maintenance. The claim that resale price maintenance may be used by manufacturers to stabilize a manufacturer cartel requires, first of all, that resale price maintenance is used by a large fraction of firms in a concentrated industry.[87] Furthermore, as noted above, resale price maintenance under the manufacturer cartel theory is only a potentially facilitating practice. Therefore, applicability of the manufacturer cartel anticompetitive theory of resale price maintenance requires more than that a large fraction of manufacturers in a concentrated industry are using resale price maintenance; it also requires other convincing evidence of the existence of a collusive horizontal agreement among the manufacturers to fix wholesale prices. One must demonstrate, for example, that individual manufacturers are acting contrary to their independent economic self-interests absent a conspiracy. Without such evidence, the widespread use of resale price maintenance in an industry, by itself, should not be considered anticompetitive. In these circumstances widespread use of resale price maintenance more likely suggests the existence of an important efficiency reason for resale price maintenance that has led many firms in the industry to use the practice.[88]

Antitrust liability under the dominant manufacturer-initiated anticompetitive theory of resale price maintenance requires the firm employing resale price maintenance to have a large market share—say, for purposes of discussion, at least a 50 percent share of the relevant market. Resale price maintenance initiated by relatively small firms, such as Leegin, therefore should fall into a safe harbor of per se legality.[89] If this safe harbor screen is exceeded, plaintiffs then should be required to demonstrate the likely applicability of the dominant firm anticompetitive theory of resale price maintenance, recognizing that in most cases

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[87] Overstreet shows that most resale price maintenance arrangements are unlikely to be cartel stabilizing devices because the concentration ratio is too low in the industries where it has been widely used to credibly suggest the presence of a manufacturer conspiracy. OVERSTREET, *supra* note 79, at 71–82.

[88] This is consistent with the relevance assigned by the Federal Trade Commission to the widespread use of resale price maintenance in an industry in the FTC's modification of the *Nine West* consent order. Although the FTC rejected Nine West's contention that prohibiting its use of resale price maintenance when many other women's shoe manufacturers were using resale price maintenance placed Nine West at a competitive disadvantage, the FTC also failed to infer any anticompetitive significance from the fact that resale price maintenance was widely used in the industry. FTC *Nine West Order*, *supra* note 3, at 16.

[89] This is consistent with the antitrust liability standard adopted by the Federal Trade Commission when modifying the *Nine West* consent order. There, the FTC concluded that resale price maintenance initiated by a manufacturer that does not possess market power is a sufficient condition to infer the absence of any anticompetitive effects and is legal under *Leegin*. *Id.* at 17.

an anticompetitive use of resale price maintenance effectively to exclude rivals is highly unlikely without some form of actual or de facto exclusivity agreement with retailers. And such exclusivity agreements should be evaluated separately from resale price maintenance for anticompetitive effects.[90]

Anticompetitive effects from retailer-initiated resale price maintenance are also applicable in only a fairly limited set of circumstances. A very small minority of resale price maintenance arrangements are the result of organized retailer group pressure of manufacturers consistent with the existence of a retailer cartel.[91] And the anticompetitive use of resale price maintenance by a dominant retailer requires evidence of a significant anticompetitive effect from the coercion of manufacturers forced to act contrary to their economic interests by the exercise of retailer market power. This is more than the dominant retailer merely informing a manufacturer that it will drop distribution (or stop active promotion) of the manufacturer's products if retailer price discounting is not eliminated.[92]

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[90] Comanor and Scherer similarly conclude that manufacturer-initiated resale price maintenance should potentially be illegal only when instituted by a large firm or by a large fraction of firms in an industry. Comanor & Scherer *Leegin* Amicus Brief, *supra* note 65. However, Comanor and Scherer do not require further evidence of the use of resale price maintenance by a group of firms to facilitate a conspiracy, or its use by a dominant firm to maintain market power, which are the two potentially anticompetitive motivations for manufacturer use of resale price maintenance described in *Leegin*. Instead, Comanor and Scherer claim that resale price maintenance may be anticompetitive when used in these circumstances because consumers may not have the choice to purchase low priced/low retailer service products and because individual firm expansionary demand effects from retailer-induced promotion "will largely cancel each other out in the aggregate leading to . . . relatively little if any expansion in demand." *Id.* at 8–10. However, neither of these potential effects is an anticompetitive effect. If a sufficient number of consumers desire and therefore demand lower cost products, absent a manufacturer conspiracy it will pay at least one manufacturer to discontinue resale price maintenance. And although there may be largely "canceling out" effects on total demand from an individual manufacturer's expansion in demand, there are likely to be such "canceling out" effects for all forms of competitive promotion undertaken by rival firms, such as advertising. Rather than considering total industry effects, as long as there is an increase in the sales of the individual firm that advertises or the individual firm that uses resale price maintenance to encourage retailer promotion, this should be a clear indication that the motivation and effect of the firm's conduct is procompetitive.

[91] OVERSTREET, *supra* note 79, at 13–19, 80, 140–44, 161–63.

[92] Christine Varney clarifies these conditions by requiring that retailer coercion "resulted in RPM covering much of the [product] market," and that "RPM plausibly has a significant exclusionary effect that impacted an actual rival." Analysis of the potential anticompetitive effects of the resale price arrangements, therefore, would involve a determination of whether the dominant retailer is able to use its market power to coerce a significantly large number of manufacturers in a way that significantly forecloses retailing rivals from the market. Varney, *supra* note 85, at 7.

Dominant retailers will be concerned, as retailers without market power and manufacturers are concerned, about discount retailers that prevent other retailers from earning a competitive rate of return on their retailing assets. It is economically counter-intuitive in these circumstances for a retailer to be able to demand that the manufacturer completely drop distribution to such discount retailers, as occurred in *Business Electronics*,[93] while not being able to demand that the manufacturer prevent such retailers from discounting. Moreover, because there are likely to be procompetitive as well as potentially anticompetitive effects in these cases, evaluating the cases under a rule of reason standard will require more than merely determining that price discounters have been terminated by the manufacturer in response to dominant retailer demands. It certainly is a mistake to conclude, as have Comanor and Scherer, that resale price maintenance initiated by retailers should be presumptively per se illegal.[94]

Finally, an antitrust implication of the economic analysis presented in this article is that the plaintiff's initial legal burden of demonstrating a specific potential anticompetitive effect in resale price maintenance cases is likely to become substantially greater. Although the rule of reason antitrust standard as established by *Leegin* theoretically requires such a demonstration, in cases where there is no obvious procompetitive rationale for a resale price maintenance arrangement, this initial requirement may, as a practical matter, be easily met. But once it is recognized that resale price maintenance is often an efficient way for manufacturers to compensate retailers for increased point-of-sale promotion as an element of the normal competitive process, plaintiffs will have to demonstrate the probable existence of one of the four anticompetitive scenarios outlined by the Court in *Leegin* far more convincingly before resale price maintenance is condemned. And in those cases where a firm's use of resale price maintenance raises potential anticompetitive concerns, these concerns should be fully ameliorated by demonstrating that the effect of resale price maintenance in inducing increased retailer promotional efforts results in the long-run increase in demand for the manufacturer's products.

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[93] *Supra* note 82. The Court found that acquiescing to the demand to terminate a price discounting retailer did not imply the existence of a vertical price agreement.

[94] Comanor & Scherer *Leegin* Amicus Brief, *supra* note 65, at 9.

D. Warren Grimes's Antitrust Standard for Resale Price Maintenance

Warren Grimes has recently proposed an antitrust standard for resale price maintenance that recognizes the important role of resale price maintenance described in this article to encourage retailers to supply increased manufacturer-specific promotion.[95] However, rather than considering this role of resale price maintenance to be an essential element of the competitive process, Grimes advocates a highly restrictive antitrust standard for resale price maintenance when it serves this purpose. In particular, Grimes argues that resale price maintenance should be presumptively illegal even when used by a small firm such as Leegin to compensate its retailers for increased promotional efforts.[96]

Grimes does not recognize the incentive incompatibility that is likely to exist between manufacturers and retailers with regard to retailer supply of point-of-sale promotional services, and consequently fails to accept that competitive market forces often lead manufacturers to compensate retailers for more intensive promotion. Instead, Grimes mistakenly asserts that "if such services really help a dealer make sales, the dealer has a built-in incentive to offer them,"[97] and, therefore, dealers will do so without additional manufacturer compensation.[98] But this, by itself, does not explain Grimes's conclusion that the use of resale price maintenance to compensate retailers for increased manufacturer-specific promotional efforts is anticompetitive.

Grimes bases his anticompetitive conclusion on the proposition that resale price maintenance, when used to increase point-of-sale retailer promotion of a manufacturer's products, "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 in-

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

[96] The presumption of illegality in Grimes's proposed antitrust framework may be rebutted by showing that the distribution arrangement is "closed" (involves retailer sale of a single manufacturer's products), so that retailers cannot promote one brand in preference to another. *Id.* at 492. Alternatively, according to Grimes, illegality may be rebutted by showing that resale price maintenance is undertaken by a firm with a small market share and has the effect of encouraging dealer investments, that is, that resale price maintenance solves a potential free-riding problem. *Id.* at 469. Neither of these conditions was present in *Leegin*.

[97] *Id.* at 477.

[98] "[I]f providing more or better pre-sale services helps to sell the product, dealers, without additional reward from the manufacturer, will have a built-in incentive to provide that service to generate more sales." *Id.* at 481 n.60.

terbrand competition."[99] Specifically, Grimes argues that when dealers sell multiple brands, resale price maintenance creates "incentives for dealers to push a product regardless of its underlying merits"[100] because dealers will more intensively promote products on which they earn a higher profit margin. Therefore, rather than the "multibrand retailer perceived as neutral among brands, consumers can be misled into purchasing non-superior products at inflated prices."[101]

Grimes asserts that this anticompetitive analysis of resale price maintenance due to its effects in encouraging "niche" brand marketing that produces misleading consumer information is based on a consensus among antitrust scholars. However, he refers to no economic study to support his claim that, when resale price maintenance is used to compensate retailers for increased promotion, it leads retailers to supply misleading information. And he does not explain why this claimed effect should serve as a basis for presumptive antitrust liability. Rather than placing his analysis and policy conclusion within the accepted anticompetitive effects context of established antitrust law, Grimes merely labels his claimed inefficiency of resale price maintenance as anticompetitive. However, his supposed anticompetitive effect is present even when resale price maintenance is employed by a small manufacturer that is actively competing for retail distribution.[102]

While retailers may sometimes supply incomplete and misleading information to consumers as part of the competitive retailing process, consumers are not tied to particular retailers. Consumers choose the places where they shop because of the overall average prices they expect to pay and the services they expect to receive, including whether the retailer employs a knowledgeable sales staff that provides reliable information. The retailing sector of the economy is highly competitive, with retailers

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[99] *Id.* at 472.

[100] *Id.*

[101] *Id.* This is why Grimes claims that exclusive (or "closed") retail distribution is preferable to resale price maintenance—because consumers are more likely to know there is a bias in the information supplied by an exclusive retailer and, therefore, are less likely to be misled.

[102] Grimes states that his position is consistent with the fact that economists refer to the marketing of branded products as "monopolistic competition." *Id.* at 472. However, this incorrectly identifies the "monopolistic" term used in a particular economic model with antitrust monopoly power. All that "monopolistic" signifies in this context is that, in contrast to the assumption made in the abstract economic model of perfect competition, firms are producing goods that are not homogeneous and, therefore, are not perfectly substitutable for one another. This describes the products sold in almost all real-world markets, where firms face demand curves that are somewhat negatively sloped. Such selling conditions are pervasive throughout the economy and do not imply the presence of any antitrust market power whatsoever. *See supra* note 38.

competing intensively with one another to develop favorable reputations among consumers with regard to these and other dimensions. 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 advocates use of the antitrust laws to microregulate this competitive retailing process primarily because competition produces results he does not prefer, namely consumer purchases of established brand-name products at what he believes are unreasonably high prices. Grimes advocates prohibition of resale price maintenance in these circumstances not because such a prohibition may increase the ability of consumers to purchase established brand-name products at somewhat lower retail prices as a consequence of increased intrabrand price competition among retailers, but because he believes that, without resale price maintenance and a protected profit margin, retailers will no longer be incentivized to promote established brand-name products. As a result, consumers will choose to buy lower-priced, lower brand-name products that "perform as well, or almost as well."[103] What Grimes is fundamentally challenging with his criticism of resale price maintenance is not retailer promotion (or the reduced intra-brand price competition that exists under resale price maintenance), but retailer promotion of established brand-name products. This attempt to regulate the results of the competitive retailing process in order to discourage the consumption of highly advertised brand-name products is not now, and should not become, a recognized goal of the antitrust laws.

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[103] *Grimes*, *supra* note 95, at 500. The example Grimes uses to show that resale price maintenance leads to poor consumer product decisions is the market for golf clubs. Grimes believes consumers purchase Ping and other premium golf clubs at high maintained prices when there are lower-priced golf clubs that perform as well based on ratings in *Golf Digest*. *Id.* at 499–503. At one point in his argument Grimes is not opposed to manufacturer compensation of retailers for supplying increased promotion of their established brand-name products, but is merely 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 presale promotion." *Id.* at 477–78. This ignores the contracting problems often present with per service compensation arrangements for retailer promotion and the fact that such manufacturer payments are similarly likely to lead to higher wholesale and therefore retail prices. *See* discussion *supra* Part I.C. In any event, such alternative compensation arrangements will lead to the retailer brand promotion that Grimes considers potentially misleading and likely anticompetitive.

III. CONCLUSION

Justice Breyer dissented in *Leegin* not only because the decision overturned a long-established precedent, but also because he believed that resale price maintenance only infrequently produces procompetitive benefits. Although he recognized that free riding sometimes occurs, he pointedly asked "But does it happen often?"[104] Since Justice Breyer believed the answer was no, and that "resale price maintenance can cause harms with some regularity,"[105] he concluded that the per se rule should remain the law, reaching this conclusion in spite of the fact that he would likely agree with the majority that resale price maintenance does not "always or almost always tend to restrict competition and decrease output" or "lack . . . any redeeming virtue."[106] Although resale price maintenance sometimes provides the benefits of preventing free riding, to Justice Breyer the fundamental question is "How easily can courts identify instances in which the benefits are likely to outweigh potential harms? My own answer is, *not very easily*."[107]

The economic analysis of the procompetitive benefits of resale price maintenance presented in this article substantially shifts this calculus. It is no longer necessary to search, often in vain, for a free-riding problem in order to provide a procompetitive rationale for a manufacturer's termination of a discounting retailer (or a retailer's termination of a manufacturer that does not prevent retail discounting). Because competitive manufacturers wishing to expand the demand for their products often want retailers to provide substantially greater point-of-sale promotional services than the retailers themselves have an incentive to provide, manufacturers establish distribution arrangements to incentivize and compensate retailers for providing those services. Resale price maintenance often is used in such distribution arrangements to prevent retailers, even retailers who are not free riding, from competing away the manufacturer's payments for increased retailer promotional efforts.

Since this rationale for resale price maintenance is broadly applicable, it eliminates Justice Breyer's concern that the procompetitive benefits of resale price maintenance are too infrequent to warrant striking down the per se rule. I also have shown that, on the other side of the equation,

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[104] Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 916 (2007) (Breyer, J. dissenting).

[105] *Id.* at 915.

[106] *Id.* at 886 (citing, respectively, Business Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717, 723 (1988), and Northwest Stationers, Inc. v. Pacific Stationery & Printing Co., 472 U.S. 284, 289 (1995) as the legal standard defining the type of restraints to which per se rules should be restricted).

[107] *Leegin*, 551 U.S. at 916 (Breyer, J. dissenting).

the potential anticompetitive harms of resale price maintenance are unlikely to apply in the great majority of cases. Certainly, there should be no anticompetitive problem when a small firm like Leegin independently decides to use resale price maintenance. These considerations imply that the Court's movement to a rule of reason standard for resale price maintenance makes economic sense.

However, the economic analysis presented in this article has important implications for antitrust litigation *even if* Congress overturns *Leegin* and the law of resale price maintenance returns to a per se standard. The analysis demonstrates that the prevention of retailer price discounting is a common and efficient way for manufacturers operating in their own independent self-interest to assure desired point-of-sale promotion of their products. Once this widely applicable procompetitive incentive for manufacturer prevention of retailer price discounting is recognized, it becomes more likely that the trier of fact will conclude in ambiguous circumstances—even if vertical price-fixing agreements are per se illegal—that no such price-fixing agreement actually came into existence between the manufacturer and its retailers. In those cases, the manufacturer's unilateral pricing policy would generally be shielded from antitrust liability under the doctrine of *Colgate*.[108]

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[108] United States v. Colgate & Co., 250 U.S. 300 (1919). *See supra* note 25.