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A *decision-theoretic rule of reason for
minimum resale price maintenance*

BY THOMAS A. LAMBERT*

In holding that minimum resale price maintenance (RPM) is not per se illegal but should instead be evaluated under the rule of reason, the *Leegin* Court directed lower courts to craft a structured liability analysis that will separate pro- from anticompetitive instances of the practice. Thus far, courts, regulators, and commentators have proposed four types of approaches for evaluating instances of RPM: (1) approaches focused on the effects on consumer prices; (2) approaches focused on the identity of the party initiating the RPM (i.e., manufacturer or dealer(s)); (3) approaches focused on whether the product at issue is sold along with dealer services that are susceptible to free-riding; and (4) an approach, favored by the Federal Trade Commission, that mechanically applies factors the *Leegin* Court deemed to be relevant to the liability question. Reasoning from a decision-theoretic perspective that seeks to minimize the sum of the error costs and decision costs expected to result from the governing liability rule, this article critiques these four sets of proposed approaches. Finding each deficient, the article sets forth an alternative evaluative approach that would minimize the sum of decision and error costs, thereby maximizing the net social benefits of RPM regulation.

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I. INTRODUCTION

Antitrust commentators have long recognized that minimum resale price maintenance (RPM) is, from a competitive standpoint, a mixed bag.¹ On the one hand, RPM may cause anticompetitive harm by facilitating dealer or manufacturer collusion or by enabling dominant dealers or manufacturers to protect their market power.² On the other hand, RPM may provide a number of procompetitive benefits. Most famously, it may encourage dealers to provide demand-enhancing services or certifications that are susceptible to free-riding by competing dealers and might therefore be underproduced absent RPM.³ It may also provide an efficient means by which manufacturers can induce demand-enhancing dealer activities that are not susceptible to free-riding.⁴ And its use may facilitate a new brand's entry into a market or make it easier for a manufacturer to market products with unpredictable demand.⁵ Empirical evidence suggests

¹ For commentary emphasizing RPM's anticompetitive potential, see Warren S. Grimes, *The Seven Myths of Vertical Price-Fixing: The Politics and Economics of a Century-Long Debate*, 21 SW. U. L. REV. 1285 (1992); F.M. SCHERER & DAVID ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 541–48 (3d ed. 1990); William S. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983 (1985); Robert Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price-Fixing*, 71 GEO. L. J. 1487 (1983); F.M. Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983). For commentary emphasizing RPM's potential procompetitive benefits, see Raymond Deneckere, Howard P. Marvel & James Peck, *Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition*, 87 AM. ECON. REV. 619 (1997); David A. Butz, *Vertical Price Controls with Uncertain Demand*, 40 J.L. & ECON. 433 (1997); Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988); Howard P. Marvel & Stephen McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J.L. & ECON. 363 (1985); Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346 (1984); Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960); Ward S. Bowman, *The Prerequisites and Effects of Resale Price Maintenance*, 22 U. CHI. L. REV. 825 (1955).

² See *infra* notes 29–35 and accompanying text.

³ See *infra* notes 36–37 and accompanying text.

⁴ See *infra* notes 40–45 and accompanying text.

⁵ See *infra* notes 46–47 and accompanying text.

that these procompetitive benefits are not a mere theoretical possibility but instead commonly accompany RPM.⁶

Given the procompetitive benefits that may, and frequently do, stem from a manufacturer's imposition of RPM, the U.S. Supreme Court was correct to hold in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*⁷ that RPM should not be classified as per se illegal, a designation reserved for practices "that would always or almost always tend to restrict competition and decrease output."⁸ Instead, the Court correctly ruled, RPM should be subject to antitrust's more probing rule of reason.⁹ In so holding, the Court left antitrust tribunals and commentators with a considerable challenge: craft a rule of reason that will, in an administratively feasible fashion, separate pro- from anticompetitive instances of RPM.

While the *Leegin* Court left unanswered many questions about the appropriate liability analysis, it did clarify a couple of matters. First, it rejected the position, once advocated by Judge Posner, that RPM arrangements should be per se legal.¹⁰ The Court was clear that RPM arrangements "are to be judged according to the rule of reason,"¹¹ under which "courts [must] be diligent in eliminating [RPM's] anticompetitive uses from the market."¹² At the same time, the Court also rejected the classic version of the rule of reason, under which courts are directed to conduct a broad and free-wheeling inquiry into the purpose and effect of a business practice and to decide whether, on balance, society is better off with the practice than without it.¹³

⁶ See *infra* notes 66–81 and accompanying text.

⁷ 127 S. Ct. 2705 (2007).

⁸ *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 723 (1988).

⁹ *Leegin*, 127 S. Ct. at 2710.

¹⁰ Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981).

¹¹ *Leegin*, 127 S. Ct. at 2725.

¹² *Id.* at 2719.

¹³ Under that version of the rule of reason, first set forth by Justice Brandeis in *Chicago Board of Trade v. United States*, 246 U.S. 231 (1918), and

Instead, the Court pointed to some specific factors lower courts should consider in evaluating RPM,¹⁴ and it directed them to “establish the litigation structure to ensure the rule [of reason] operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses” by, for example, “devis[ing] rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones.”¹⁵

Since *Leegin* was decided, commentators, regulators, and lower courts have proposed several means of structuring the rule of reason applicable to RPM.¹⁶ The proposals create presumptions and allocate

frequently quoted in both judicial opinions and jury instructions (see, for example, Thomas A. Lambert, *Dr. Miles Is Dead. Now What?*, 50 WM. & MARY L. REV. 1937, 1961 nn.82, 83):

The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts.

Chi. Board of Trade, 246 U.S. at 238. Applied to RPM, such an inquiry is likely to be entirely indeterminate. See Posner, *supra* note 10, at 14 (observing that the classic statement of the rule of reason “invites an unlimited, free-wheeling inquiry”); HERBERT HOVENKAMP, *THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION* 105 (2005) (observing that because the classic statement of the rule of reason “never defines what it is that courts are supposed to look for,” it has led courts to “engage[] in unfocused, wide-ranging expeditions into practically everything about the business of large firms in order to determine whether a challenged practice was unlawful”).

¹⁴ *Leegin*, 127 S. Ct. at 2719–20.

¹⁵ *Id.* at 2720.

¹⁶ See, e.g., Amended States’ Comments Urging the Denial of Nine West’s Petition, *In re Nine West Group, Inc.*, No. C-3937 (F.T.C. Apr. 11, 2000), available at http://www.oag.state.ny.us/business/new_antitrust/amici%20pdf%20docs/Amended_State_comments_011708-9west.pdf [hereinafter Amended States’ Comments]; Brief for the American Antitrust Institute as

proof burdens on the basis of various factual prerequisites. Some approaches allocate proof burdens based on the price effects occasioned by the RPM at issue.¹⁷ Others do so according to the identity of the party or parties instigating the RPM arrangement.¹⁸ Still others set proof burdens on the basis of the characteristics of the product whose resale price is being controlled.¹⁹ Finally, one approach allocates proof burdens by mechanically applying certain factors the *Leegin* Court mentioned as relevant.²⁰

This article evaluates these approaches from the perspective of decision theory and, finding each lacking, proposes an alternative approach to structuring the rule of reason governing RPM. Part II sets forth the decision-theoretic perspective, which seeks to maximize the net benefits of liability rules by minimizing the sum of decision and error costs. Part III then evaluates, from the standpoint of decision theory, the proposed approaches to evaluating instances of RPM. Part IV proposes an alternative evaluative approach that is more consistent with decision theory's insights.

Amicus Curiae in Support of Appellant and Reversal, *PSKS, Inc. v. Leegin Creative Leather Prods., Inc.* (5th Cir. 2009) (No. 09-40506) [hereinafter AAI Brief]; Brief for William S. Comanor and Frederic M. Scherer as Amici Curiae Supporting Neither Party, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007) (No. 06-480) [hereinafter Comanor/Scherer Brief]; *McDonough v. Toys "R" Us, Inc.*, No. 06-0242, 2009 WL 2055168, at *21-*22 (E.D. Pa. July 15, 2009); Marina Lao, *Free-Riding: An Overstated, and Unconvincing, Explanation for Resale Price Maintenance*, in *HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST* 215-16 (Robert Pitofsky ed., 2008) ; Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000, *In re Nine West Group, Inc.*, No. C-3937 (F.T.C. May 6, 2008), at 11-14 [hereinafter *Nine West Order*]; and Lambert, *supra* note 13.

¹⁷ See Amended States Comments, *supra* note 16; AAI Brief, *supra* note 16.

¹⁸ See *McDonough*, 2009 WL 2055168, at *21-*22; Comanor/Scherer Brief, *supra* note 16.

¹⁹ Lao, *supra* note 16, at 215-16; See also 8 PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* ¶ 1633e3, at 338 (2d ed. 2004).

²⁰ *Nine West Order*, *supra* note 16, at 11-14.

II. THE DECISION-THEORETIC PERSPECTIVE

Antitrust adjudication—especially when used to evaluate a mixed-bag business practice like RPM—is an imperfect means of discovering truth. The process is costly to conduct, and the factual conclusions it reaches are often wrong. RPM adjudication is therefore a prime candidate for application of decision theory, which “sets out a process for making factual determinations and decisions when information is costly and therefore imperfect.”²¹ When used to structure a liability rule, decision theory aims to maximize social welfare by minimizing the sum of “error costs,” defined as the welfare losses associated with incorrect judgments the rule is expected to generate, and “decision costs,” defined as the costs of reaching a liability decision under the rule.

In the context of a rule of reason for RPM, error costs consist of the allocative inefficiencies that result from wrongly permitting instances of market power-enhancing RPM (the costs of false acquittals) and the efficiency losses that result from improperly deterring output-enhancing instances of RPM (the costs of false convictions).²² Error costs are therefore a function of the probability that a proffered rule will reach an incorrect judgment and the magnitude of loss that will result from that error.²³ Decision costs are a function of the liability rule’s informational requirements and the ease with which it can be applied.²⁴ A decision-theoretic approach to RPM regulation must therefore account for (1) the likelihood that the liability rule at issue will produce an incorrect judgment, (2) the magnitude of losses from the various errors the rule might generate, and (3) the difficulty of administering the rule.

²¹ C. Frederick Beckner III & Steven C. Salop, *Decision Theory and Antitrust Rules*, 67 ANTITRUST L.J. 41, 41 (1999) (emphasis omitted).

²² See Lambert, *supra* note 13, at 1986.

²³ See *id.* If P = probability of an error and M = the expected magnitude of loss from that sort of error, then error costs = $[(P_{\text{false positive}} \times M_{\text{false positive}}) + (P_{\text{false negative}} \times M_{\text{false negative}})]$.

²⁴ See *id.*

A. Likelihood of errors

In order to determine the likelihood that a proposed liability rule will reach incorrect judgments, one must first assess whether instances of RPM are more likely to be pro- or anticompetitive. If one would expect anticompetitive uses of RPM to dominate, then, all else being equal, the liability rule should presume the illegality of the practice and should require defendants to rebut that presumption. By contrast, if instances of RPM are more likely to be pro- than anticompetitive, then, all else being equal, the practice should be presumed legal, and the challenger (a private plaintiff or the government) should bear the burden of proving likely anticompetitive effect.

The starting point for evaluating proposed rules of reason, then, should be consideration of the theories of anticompetitive harm and procompetitive benefit stemming from RPM and the empirical evidence supporting those competing theories. As the following analysis demonstrates, the prerequisites to theories of anticompetitive harm stemming from RPM are less likely to be satisfied than the prerequisites to theories of procompetitive benefit.²⁵ In addition, empirical evidence, including evidence concerning retailing trends, suggests that instances of RPM are more likely to be pro- than anticompetitive.²⁶ All else being equal, then, the governing rule of reason should approve more instances of RPM than it condemns.

1. THEORIES OF RPM'S COMPETITIVE EFFECTS, THE PRECONDITIONS TO THOSE THEORIES, AND IMPLICATIONS FOR THE RULE OF REASON

(a) *Potential competitive effects* Because it imposes a floor on retail prices, minimum RPM tends to increase consumer prices from levels that would exist absent the restraint. Standing alone, though, that fact says nothing about RPM's competitive effects.²⁷ If the higher consumer prices generate retailer activity that so enhances the quality

²⁵ See *infra* notes 50–66 and accompanying text.

²⁶ See *infra* notes 66–85 and accompanying text.

²⁷ See THOMAS R. OVERSTREET, JR., *RETAIL PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE* 116–17, 160 (1983) (observing that higher prices resulting from RPM are consistent with both pro- and anticompetitive effects).

of the product at issue that it leads to greater purchases despite the higher prices, then the RPM is output-enhancing and thus procompetitive.²⁸ Economists have identified several situations in which an instance of RPM could be genuinely output-reducing—as opposed to merely price-enhancing—and thus anticompetitive.

First, RPM may facilitate collusion at the retailer level.²⁹ Somewhat fortuitously, competitor agreements to fix prices are difficult to establish and maintain.³⁰ Parties to the agreement must negotiate and communicate the agreement's terms without being detected (lest they face serious civil and criminal penalties under section 1 of the Sherman Act).³¹ Moreover, even if a price-fixing agreement is established, the arrangement will remain fragile, for each competitor faces a constant temptation to lower its price from the agreed-upon level and thereby steal business from its co-conspirators. Price-fixing agreements therefore require constant policing. RPM can assist with both of these difficulties: The manufacturer may effectively *establish* the cartel by requiring each of its retailers to price above a certain level, and it may *police* the agreement by monitoring retail prices and punishing retailers who deviate.³²

RPM may also facilitate collusion at the manufacturer level.³³ Absent RPM, each manufacturer participating in a cartel has an

²⁸ Note that I am defining competition in terms of output, where a defendant's action is procompetitive if it leads to greater market output and anticompetitive if it leads to a reduction in market output. This output-focused understanding of competition may be somewhat controversial but is frequently employed. *See, e.g., HOVENKAMP, supra* note 13, at 3–4. *See also infra* note 154 (defending market output-focused criterion against argument that it fails to account for welfare effects on inframarginal consumers).

²⁹ *See Lambert, supra* note 13, at 1944–45 (explaining how RPM may facilitate dealer collusion).

³⁰ *See Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 727 (1988) (“Cartels are neither easy to form nor easy to maintain.”).

³¹ *See* 15 U.S.C. § 1 (2008) (prohibiting collusive agreements among competitors).

³² *See Lambert, supra* note 13, at 1944–45.

³³ *See id.* at 1945–49 (explaining how RPM may facilitate manufacturer collusion).

incentive to make a clandestine cut in its price to retailers, hoping the retailers will pass the price cut on to consumers, thereby generating additional sales for the cheating manufacturer at the expense of its co-conspirators. If the colluding manufacturers employ RPM, though, any reduction in the price to retailers should not result in a sales-enhancing retail price cut. And if colluding manufacturers do observe a drop in one brand's retail prices, which are more visible than wholesale prices, they can assume that the manufacturer either has shaved both its price to retailers and its mandated resale price or is failing to enforce its RPM policy. In either case, the manufacturer would be deserving of sanctions from its co-conspirators. Thus, RPM may reduce the sort of behavior (cheating) that would destabilize a manufacturer cartel.

Even when it does not facilitate collusion, RPM may cause anticompetitive harm when imposed by a dominant manufacturer or at the behest of a dominant retailer. A dominant manufacturer may impose RPM as a means of foreclosing its rivals from available marketing outlets.³⁴ The manufacturer might implicitly bargain with its dealers that it will impose RPM to guarantee them an attractive profit margin on its products in exchange for their refusal to distribute competing brands. If dealers choose not to jeopardize their RPM-protected profit margins by handling other brands, competing manufacturers and new entrants may find themselves foreclosed from marketing outlets or, at a minimum, relegated to less desirable channels of distribution. RPM might be therefore be "exclusionary" in that it causes market foreclosure or raises rivals' costs of distribution.

A dominant retailer may seek RPM in order to exercise its market power (i.e., to raise its retail margin above the competitive level) while precluding price competition from more efficient retail rivals.³⁵ While a retailer with market power could unilaterally raise its retail prices to create a greater retail mark-up than that which would persist

³⁴ See *id.* at 1949–50 (explaining how RPM may cause anticompetitive foreclosure).

³⁵ See *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2717 (2007) (explaining how dominant retailer could use RPM to squelch competition from more efficient retail rivals).

in a competitive retail market, such a unilateral increase in retail prices would tend to attract entry by retailers charging lower mark-ups. If the dominant retailer could instead persuade a manufacturer to impose RPM, lower mark-up retailers could not undersell the dominant retailer and thereby usurp its business. Of course, manufacturers generally benefit from retailer competition that reduces retail margins—the “prices” manufacturers effectively pay for retail distribution of their products—and thus normally oppose retailer demands for RPM. If, however, the demanding retailer dominates the relevant retail market, the manufacturer may have no choice but to accede to the demand for RPM. RPM imposed at the behest of a dominant retailer may therefore enable the retailer to maintain its market power by insulating itself from price competition from more efficient retailers.

In addition to these output-reducing harms from RPM, economists have recognized several output-enhancing benefits that may result from the practice. Specifically, RPM may increase interbrand competition by enhancing manufacturers’ distributional efficiency, facilitating entry by new manufacturers, or increasing product offerings for which consumer demand is uncertain.

RPM may enhance the efficiency of the distributional process in at least two ways. Most famously, it may encourage retailers to provide demand-enhancing services (including, as explained below, product certifications) that are susceptible to free-riding by competing retailers and might thus be underprovided absent RPM.³⁶ Retailer services such as providing consumers an opportunity to test a product or educating them about its functionality may enhance consumers’ willingness to pay for a product (i.e., their reservation price) by more than the cost of providing those services. The manufacturer, whose total sales increase, benefits if the services are provided, and consumers are better off if the consumer surplus created by the services exceeds the price increase required to finance them. Retailers would normally provide such services if doing so enabled them to enhance their profits by selling enough additional units or raising their per-unit price by an increment exceeding the cost of the service.

³⁶ See Telser, *supra* note 1, at 91–93; Robert Bork, *The Rule of Reason and the Per Se Concept: Price-Fixing and Market Division (Part II)*, 75 YALE L.J. 373 (1966).

But they may not do so if other retailers are able to free-ride off the provision of those services.³⁷ The absence of such services will injure the manufacturer by reducing demand for its products. In addition, consumers will suffer if, in fact, the point-of-sale services originally provided were valued more than they cost to produce. RPM discourages free-riding by preventing low-service retailers from passing their cost savings on to consumers in the form of lower prices. It may therefore encourage output-enhancing point-of-sale services that are susceptible to free-riding.

Among the demand-enhancing services a retailer may provide are quality certifications and indications of prestige.³⁸ A retailer that routinely carries only high-quality brands may develop a reputation as an arbiter of quality, and the mere fact that the retailer stocks a manufacturer's brand may enhance consumer demand for that brand.³⁹ Similarly, if a retail outlet offers customers a luxurious shopping experience and high levels of service, consumers may view it as the sort of store where discriminating, sophisticated, and fashionable shoppers purchase their wares, and the retailer's stocking of a brand may amount to a demand-enhancing "prestige stamp" by a perceived arbiter of fine taste. Because it is costly to provide quality certifications (which require research into the quality of competing brands) and prestige stamps (which require expenditures to attract a fashionable clientele), retailers who provide these demand-enhancing

³⁷ For example, suppose that one dealer of a high-end stereo system provides customers with a knowledgeable sales staff and comfortable listening rooms where the equipment can be tested, and that a nearby dealer provides no such services. A customer could easily go to the first dealer to take advantage of the point-of-sale services but then purchase the product from the second dealer, which is able to charge lower prices since it need not pay for those expensive services. If such free-riding is extensive, the high-service dealer will find that it cannot profitably continue to offer costly point-of-sale services and will cease to do so.

³⁸ See generally Marvel & McCafferty, *Welfare Effects*, *supra* note 1.

³⁹ For example, a bicycle shop staffed by knowledgeable bicycle enthusiasts with informed opinions about the quality of various brands may implicitly certify the quality of the brands it elects to carry, and the mere fact that the shop carries a particular brand may raise consumers' reservation price for that brand.

services will tend to have higher costs and thus higher prices. But consumers can easily reap the benefits of these services without paying for them. A bicycle buyer could, for example, visit a highly regarded bicycle shop to see what brands the store stocks, and then order one of those certified brands from a low-cost Internet retailer that sells all brands. A manufacturer could prevent widespread free-riding of this sort, which would discourage the provision of quality certifications and prestige stamps, by imposing RPM.

In addition to preventing free-riding on retailer-provided services and certifications, RPM may provide manufacturers with a means of inducing demand-enhancing conduct that is *not* susceptible to free-riding.⁴⁰ Because some of the benefit stemming from a retailer's product-promotion efforts inures to the manufacturer, retailers are not perfectly motivated to provide an optimal level of retail service (i.e., service to the point at which the incremental cost of the service, borne entirely by the retailer, equals the service's incremental benefit, some of which is captured by the manufacturer).⁴¹ Manufacturers therefore need some way to encourage the optimal provision of services that enhance demand for their products. In theory, they could simply draft

⁴⁰ See Klein & Murphy, *supra* note 1. While the "avoidance of free-riding" rationale for RPM is probably the most commonly articulated procompetitive justification for the practice, it has some important limitations. As an initial matter, RPM is frequently observed in situations in which widespread free-riding on point-of-sale services seems implausible. *Id.* at 265. In addition, it is unlikely that RPM actually eliminates the incentive to free-ride on other retailers' provision of services the manufacturer desires. For example, even if a manufacturer sets a minimum resale price at a level that would provide a margin sufficient to cover desired point-of-sale services, individual retailers could still send customers to other retailers to attain those services and then use the mark-up provided by RPM to provide customers with some other desired amenity, such as a discount on a complementary product. *Id.* at 266. If retailers took that tack, they could win business from their high-service rivals who bore the cost of the point-of-sale services, and those high-service retailers would eventually curtail their efforts. Finally, the free-rider explanation seems particularly implausible when consumers, prior to purchase, cannot detect retailer services that affect product quality, such as the regular rotation of items possessing a limited shelf-life. *Id.*

⁴¹ See *infra* notes 146–53 and accompanying text. See also Benjamin Klein, *Competitive Resale Maintenance in the Absence of Free-Riding*, 76 ANTITRUST L.J. 431 (2009).

contracts that exhaustively specify the precise services a retailer must provide. That approach, however, would create significant difficulties in terms of *ex ante* specification and enforcement: It would be prohibitively costly to specify all the elements of dealer performance in a way that would permit determination of breach and measurement of damages⁴² and monitoring and enforcing a dealer's performance obligations along multiple service dimensions would require substantial effort. Employing express contracts to align the incentives of the manufacturer and its retailers is therefore difficult.⁴³

RPM offers an attractive alternative. If a manufacturer monitors its retailers' general performance (sales levels, etc.), retains the right to terminate underperformers, and provides an attractive retail margin as an incentive to avoid termination, then the manufacturer can motivate its retailers to provide demand-enhancing point of sale services without specifying them exhaustively.⁴⁴ RPM's role in

⁴² Indeed, one of the reasons manufacturers outsource distribution to dealers rather than provide it themselves is that they do not possess expertise on exactly how their products can best be promoted to end-users.

⁴³ As Benjamin Klein & Kevin Murphy observe:

[I]t is generally recognized that it is uneconomic to create a complete contingent contract to govern the employment relationship. A complete contingent contract entails high transaction costs, rigidities, and hold-up potentials associated with initial contractual negotiation and renegotiation in the face of changing market conditions. In addition, many elements of performance, such as the energy and enthusiasm the worker devotes to a particular task, are essentially unmeasurable (although not unobservable) and must remain unspecified and unenforceable in court.

Klein & Murphy, *supra* note 1, at 294.

⁴⁴ As Klein & Murphy explain:

The potential loss of this future quasi-rent stream [i.e., RPM's margin guarantee] takes the place of a potential court-imposed sanction in assuring dealer performance. If the expected present discounted value of the future quasi-rent stream earned by an honest dealer exceeds the expected value of the gain to a dealer who shirks on the supply of desired services, then the capital loss that can be imposed on a dealer by manufacturer termination will be sufficient to assure dealer performance.

Id. at 268.

enhancing distributional efficiency may therefore extend well beyond the context of “free-rideable” point-of-sale services.⁴⁵

A third procompetitive benefit of RPM, which is really a version of the first (avoidance of free-riding), may exist when the manufacturer is a new entrant. A manufacturer entering a market containing well-established incumbent brands faces marketing disadvantages. The incumbents’ brands are easily recognizable without retailer promotion or extensive advertising, and the brands are virtually guaranteed desirable shelf space, for retailers routinely carry and display them prominently in order to respond to consumer demand. New entrants, by contrast, must rely heavily on retailer promotion and cannot assume that they will attain favorable shelf space. While retailers will want to promote and afford attractive shelf space to high-quality entrants, there are costs to doing so: out-of-pocket costs on promotion efforts and opportunity costs from denying favorable shelf space and marketing efforts to incumbent brands. Retailers might not be willing to incur these brand-promotion costs if they would be susceptible to being undersold, once the brand becomes established, by later-appointed retailers who did not invest in market development efforts and thus have lower costs. By giving retailers a guaranteed profit margin and protection against discounting pressures from later-appointed dealers, RPM creates an incentive for retailers to carry a new brand, display it prominently, and engage in more aggressive promotion efforts.⁴⁶ RPM may therefore enhance interbrand competition by facilitating entry into markets with strong incumbent brands.

Similarly, RPM may facilitate the marketing of products with unpredictable demand.⁴⁷ For many products such as books or musical

⁴⁵ See also Frank Mathewson & Ralph Winter, *The Law and Economics of Vertical Resale Price Maintenance*, 13 REV. INDUS. ORG. 57, 72 (1998).

⁴⁶ See Lambert, *supra* note 13, at 1958–59; Kenneth G. Elzinga & David E. Mills, *The Economics of Resale Price Maintenance*, in 3 ISSUES IN COMPETITION LAW AND POLICY 1841, 1848 (Wayne D. Collins ed., 2008) (“To secure entry, a new entrant may seek to gain retail distribution by offering independent retailers protections against discounting, in the hope that margin protection will induce retailers to market and promote the new product.”).

⁴⁷ See generally Deneckere, Marvel & Peck, *supra* note 1; Butz, *supra* note 1.

recordings, consumer demand is uncertain at the time the retailer must order the product from the manufacturer. If consumer demand for a product turns out to be strong, a retailer who carries it will do well, but if demand is slack, the retailer may find itself with excess inventory and may have to offer deep discounts, which lower the market-clearing price of the product. Given the potential for precipitous price declines, retailers may decline to stock products for which demand is uncertain, choosing instead to wait for products to prove themselves in the marketplace.⁴⁸ If enough retailers take that route, untested products will have access to few retail outlets in which to establish their commercial viability, and high-quality products that could have become commercial successes had they gained access to enough retail outlets may never have the opportunity to prove themselves.

A manufacturer may use RPM to address this problem. By setting a minimum retail price, the manufacturer may prevent precipitous price declines during periods of slack demand. Reduced price volatility may then encourage retailers to take a chance on untested products or to order larger inventories than they otherwise would order. This benefits both the manufacturers of such products and consumers who otherwise might be deprived of high quality, but unproven, products.

(b) Prerequisites to each theoretical effect Each of the competitive effects discussed above is plausible only under certain circumstances. We may therefore estimate a potential effect's likelihood by assessing the probability that its factual prerequisites will be satisfied. Such an analysis of RPM's potential effects suggests that the preconditions for anticompetitive harm are less likely to be satisfied than those for procompetitive benefit, implying that RPM is more likely to be output-enhancing than output-reducing.

First consider the narrow sets of circumstances in which RPM can cause anticompetitive harm. In order for RPM to facilitate a dealer

⁴⁸ Indeed, this is the strategy utilized by many discount retailers. See 8 AREEDA & HOVENKAMP, *supra* note 19, ¶ 1601h, at 15 (observing that "deep discounters offer significantly lower markups on books and CDs, but also a much narrower inventory largely limited to titles whose popularity has already been proven").

cartel,⁴⁹ dealers must seek the policy, and the manufacturer must be willing to impose it.⁵⁰ Dealers will be unlikely to seek the policy for the purpose of raising retail margins if a supracompetitive price for the manufacturer's product will induce a significant number of customers to switch to another brand.⁵¹ Such demand substitution will presumably occur unless switching is difficult because either (1) the manufacturer has market power in the market for the product subject to RPM, or (2) most of the manufacturer's competitors similarly impose RPM. Thus, one of those criteria must be satisfied for dealers to seek RPM in order to enhance retail markups.⁵² A manufacturer will comply with such a request (which will increase the retail margin, the "price" the manufacturer effectively pays its retailers for their distribution services) only if either it expects the margin increase to enhance total sales, in which case the RPM will be procompetitive, or it lacks alternative means of distributing its products. That latter contingency will be satisfied only if (1) there is not a sufficient number of other retailers to distribute the manufacturer's product or the cost of switching to those retailers is high, and (2) forward integration into product distribution is not feasible.⁵³

⁴⁹ The prerequisites discussed in this paragraph would also apply to a dominant dealer's use of RPM for the mere purpose of enhancing its retail margin; such a use of RPM would be unlikely unless the prerequisites discussed in the text are satisfied. Later discussion addresses the prerequisites to a dominant dealer's use of RPM to *maintain or enhance*, rather than merely to exercise, its market power. See *infra* notes 58–59 and accompanying text.

⁵⁰ See generally HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE, § 11.2b at 449–51 (explaining that dealers must seek, and manufacturers must consent to, RPM if it is to be used to facilitate dealer collusion).

⁵¹ See *id.* at 449 ("If the manufacturers in the market have no market power, then the retailers of any single manufacturer could not raise the price of the manufacturer's product to monopoly levels. Customers would switch to different brands.").

⁵² *Id.* (observing that the precondition for dealers' seeking RPM is either "1) the manufacturer imposing the restriction is a monopolist in the retailer's area; or 2) the restriction is used by a very high percentage of the manufacturers in the market").

⁵³ *Id.* at 451 (discussing situations in which manufacturers may have difficulty rejecting retailer demands for RPM).

In order for RPM to facilitate a manufacturer cartel, the market in which the manufacturer participates must be susceptible to cartelization, and the use of RPM must be widespread enough to assist with the collusion. Thus, anticompetitive harm from the facilitation of a manufacturer cartel is unlikely unless (1) the manufacturer market is concentrated,⁵⁴ (2) the product at issue is fairly fungible,⁵⁵ (3) there are entry barriers into the manufacturer market,⁵⁶ and (4) RPM is used by manufacturers comprising a substantial portion of the market.⁵⁷

In order for RPM to succeed as an exclusionary device by which a dominant dealer squelches competition from more efficient rivals, RPM policies must be implemented so widely that those rivals cannot gain an effective foothold in the dealer market. At a minimum, the brands upon which a dominant retailer procures RPM must comprise a significant portion of sales within the relevant retail market. Suppose, for example, that a dominant retailer of baby products successfully demands that a handful of product manufacturers impose RPM policies.⁵⁸ While this would make it impossible for more efficient retailers of baby products (e.g., Internet baby stores) to sell the price-restrained products at a discount, those more efficient retailers could still stay in business, and may grow their share of any putative baby product retail market, if that market includes retail

⁵⁴ See RICHARD A. POSNER, *ANTITRUST LAW* 66 (2d ed. 2001) (“Some degree of concentration thus appears to be a necessary condition of successful collusion in markets subject to the Sherman Act.”).

⁵⁵ See *id.* at 75 (“The less standardized (more customized) a product is, . . . the more difficult it will be for the sellers of the product to collude effectively. The heterogeneity of the product will make it impossible for the sellers to agree upon a single price for all orders.”).

⁵⁶ See *id.* at 72–75 (explaining that lack of entry barriers precludes cartelization).

⁵⁷ See HOVENKAMP, *supra* note 50, § 11.2b2, at 453 (“The manufacturers’ cartel will work, however, only if its members collectively control enough of the market to wield monopoly power.”).

⁵⁸ See, e.g., *McDonough v. Toys “R” Us, Inc.*, No. 06-0242, 2009 WL 2055168 (E.D. Pa. July 15, 2009), discussed *infra* notes 115–34 and accompanying text.

sales of a significant number of brands that are not subject to RPM policies. As those more efficient retailers grow their market shares by selling other brands, the dominant retailer will find it increasingly difficult to procure output-limiting RPM policies from manufacturers, who will want access to the dominant retailer's efficient rivals. Thus, RPM cannot act as a durable means of excluding rivals from a dominant retailer's market unless a significant portion of the product sales within that market are subject to RPM policies.⁵⁹

Finally, in order for RPM to facilitate manufacturer monopolization by creating an entry barrier that effectively forecloses the manufacturer's rivals from the market, the margin guaranteed to dealers must be large enough to induce them to drop, or to refrain from promoting, competing brands. Even then, there can be no *anticompetitive* harm unless the RPM extends so broadly that it generates significant foreclosure of rivals from the market (i.e., the rivals cannot have access to other acceptable channels of distribution).⁶⁰ Given the ubiquity of discount retailers, who compete with each other primarily on price and would be unlikely to forgo carrying a lower-priced product in exchange for a higher margin,⁶¹ these conditions will rarely be satisfied.

In contrast to the uncommon sets of circumstances under which RPM could cause anticompetitive harm, the preconditions for procompetitive uses of RPM are frequently satisfied. RPM may be used to ensure point-of-sale services or certifications that might be the subject

⁵⁹ Even then, it is unlikely that a market-leading dealer could long maintain any significant market power in a retail market, for interbrand competition and low entry barriers make retail markets difficult to monopolize. *Cf. Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 727 n.2 (1988) ("Retail market power is rare because of the usual presence of interbrand competition and other dealers.").

⁶⁰ See Elzinga & Mills, *supra* note 46, at 7 (observing that RPM-augmented foreclosure theory "cannot apply where manufacturing competitors and entrants retain access to the market via competing retailers or alternative channels of distribution. Nor can it apply where the manufacturer using RPM does not control a large share of the relevant market in spite of using this practice.").

⁶¹ See *infra* notes 82–84 and accompanying text.

of free-riding⁶² whenever such dealer-provided services or certifications enhance demand for a manufacturer's product and are susceptible to free-riding (because, for example, dealers are located within close proximity of each other). RPM may provide an optimal means of ensuring dealer performance of unspecified agreements⁶³ whenever dealer activities would enhance the attractiveness of a manufacturer's offerings, and the quality-enhancing activities are difficult to delineate in advance or to monitor. RPM may facilitate entry⁶⁴ whenever a new producer seeks to gain access to or promotion by retail outlets that already stock and provide favorable shelf space to well-established brands. And RPM may be used to stem the potential price volatility that inhibits retailers from carrying untested goods⁶⁵ whenever consumer demand for a new product is unpredictable. Because these various conditions quite often exist, procompetitive rationales for instances of RPM, unlike anticompetitive effects, are frequently plausible.

(c) Implications for the rule of reason The implications of the foregoing analysis for the rule of reason governing RPM should be obvious. If the preconditions for anticompetitive uses of RPM are less likely to be satisfied than those for procompetitive uses, then, all else being equal, one would expect most instances of RPM to be procompetitive. And if most instances of RPM are procompetitive, the liability rule should presume the legality of the practice and should place the burden on the plaintiff to establish that a challenged instance of RPM is more likely to have anti- than procompetitive effect.

Of course, the analysis so far is based entirely on the *theories* of RPM's effects and the apparent likelihood of each theory's preconditions. Actual *evidence* concerning the relative incidence of RPM's various competitive effects may disrupt this theory-based initial conclusion, so we turn to that next.

EMPIRICAL EVIDENCE OF RPM'S EFFECTS The empirical evidence on the actual competitive effects of RPM, while somewhat sparse, seems

⁶² See *supra* notes 36–39 and accompanying text.

⁶³ See *supra* notes 40–45 and accompanying text.

⁶⁴ See *supra* note 46 and accompanying text.

⁶⁵ See *supra* notes 47–48 and accompanying text.

to confirm the theory-based conclusion that most instances of RPM are pro- rather than anticompetitive. In a 1983 Bureau of Economics Staff Report to the FTC, Thomas R. Overstreet examined RPM's competitive effect by analyzing all FTC RPM cases from mid-1965 through 1982⁶⁶ and cataloguing existing empirical studies of RPM.⁶⁷ Overstreet's report suggests that most instances of RPM are not anticompetitive. With respect to the RPM in the FTC cases, which he took to be representative of instances of RPM generally,⁶⁸ Overstreet concluded that most occurred in markets that could support neither manufacturer nor dealer collusion.⁶⁹ While he provided a more equivocal summary of his findings from the survey of empirical studies,⁷⁰ close examination of those findings suggests that they

⁶⁶ OVERSTREET, *supra* note 27, at 63–82.

⁶⁷ *Id.* at 106–63.

⁶⁸ *Id.* at 81 (“[T]he structural snapshot of the 1950s, comparing fair trade markets to all manufacturing markets, combined with our finding that recent FTC RPM cases have involved markets which structurally are distributed in about the same way as all manufacturing markets, suggests that the FTC case sample may provide a fairly reasonable basis for drawing some limited general conclusions.”).

⁶⁹ *Id.* at 71–76 (discussing lack of manufacturer concentration in markets in which RPM was challenged); *id.* at 80 (“[O]f the 47 cases with data on the number of distributors, over 80 percent involved in excess of 200 dealers. Widespread dealer collusion involving more than 100 (or 200) decision makers seems unlikely to be effective or persistent in the absence of restrictions on entry . . . or some mechanism for overt coordination”); *id.* at 81 (concluding that “[i]t is unlikely that there is effective manufacturer coordination featuring RPM in all or even most of these markets” and that “available information also suggests that the use of RPM is unrelated to widespread dealer collusion in most instances”). See also Stanley I. Ornstein, *Resale Price Maintenance and Cartels*, 30 ANTITRUST BULL. 401, 430–31 (1985) (analyzing Justice Department and FTC cases and concluding that vertical restraints may have been used to support manufacturer cartels in only four percent to thirty-three percent of the cases); but see 8 AREEDA & HOVENKAMP, *supra* note 19, ¶ 1606f, at 91 (criticizing Ornstein study).

⁷⁰ OVERSTREET, *supra* note 27, at 163 (“Theory suggests that RPM can have diverse effects, and the empirical evidence suggests that, in fact, RPM has been used in the U.S. and elsewhere in both socially desirable and undesirable ways.”).

cannot support the view that RPM is, more often than not, anticompetitive.⁷¹

⁷¹ In surveying the empirical studies of RPM, Overstreet examined price surveys (i.e., studies examining the effect of RPM on consumer prices), *id.* at 106–19, a number of case studies, *id.* at 119–29, two prior FTC studies of RPM, *id.* at 129–48, and several accounts of the use of RPM in foreign countries, *id.* at 148–60. As he correctly explained, price surveys are inapposite to the question of whether RPM has pro- or anticompetitive effects, for higher prices are consistent with both sorts of effects. *Id.* at 106, 116–17, 160.

Of the eleven case studies he reviewed, only two suggested a collusive explanation for RPM. *Id.* at 119–29 (summarizing case studies of RPM on light bulbs (two studies), china, televisions, jeans (two studies), shoes, stereo components, beer, bread, and various products sold in Rhode Island; finding evidence of collusion in only one of the light bulb studies and the bread study). By contrast, six suggested that use of the practice may have been procompetitive. *Id.* (finding some evidence of procompetitive effect from use of RPM on china, jeans, shoes, stereo components, beer, various products in Rhode Island).

The two prior FTC studies Overstreet examined did not conclude that RPM is anticompetitive more often than not. In the first, submitted to Congress in two parts in 1929 and 1931, FEDERAL TRADE COMM'N, REPORT ON RESALE PRICE MAINTENANCE (Part I submitted Jan. 30, 1929; Part II submitted June 22, 1931), the Commission surveyed manufacturers, wholesalers, retailers, consumers, and economists as to their perceptions of the advantages and disadvantages of RPM. OVERSTREET, *supra* note 27, at 129–34. The results were mixed. *Id.* at 134 (“The conclusion which it now seems warranted to draw from this inquiry is that some advocates of RPM were motivated by efficiency considerations, and others were not.”). The second study, submitted to Congress in 1945, FEDERAL TRADE COMM'N, REPORT OF THE FEDERAL TRADE COMMISSION ON RESALE PRICE MAINTENANCE (submitted Dec. 13, 1945), considered price and volume effects following the imposition of RPM in regions where it was permitted pursuant to fair trade laws. OVERSTREET, *supra* note 27, at 135–48. Price effects and effects on volume per retail outlet are irrelevant to the competitive analysis because price increases and reductions in per-retailer volume can be consistent with procompetitive effects. *Id.* at 140. While the effect on *manufacturer* sales volume is relevant, the data on that point were inconclusive. *Id.* The 1945 study also included a detailed account of the involvement of various trade groups in advocating for fair trade laws (i.e., state laws insulating RPM from liability; federal statutes authorized such state laws from 1937 to 1975; see Miller-Tydings Act, 50 Stat. 693, 15 U.S.C. § 1 (1937); McGuire Act, 66 Stat. 631, 15 U.S.C. § 45 (1952); Consumer Goods Pricing Act of 1975, Pub. L. 94-145, 89 Stat. 801 (1975)) and seeking imposition of RPM. *Id.* at 140–44. The study found that some, but not all, retailer

Examination of litigated RPM cases suggests that most instances of RPM are, in fact, procompetitive. In a 1991 study, Pauline Ippolito examined all 203 reported RPM cases from 1975 through 1982,⁷² the period during which the prohibition against RPM was most strict⁷³ so that one would expect firms to employ the practice only when they expected it to be especially profitable.⁷⁴ By looking at the theories asserted in the 203 litigated cases, Ippolito sought to determine *why* RPM was perceived by the parties to RPM agreements to be so profitable (i.e., in how many cases might the profitability of the practice have stemmed from its facilitation of manufacturer or dealer collusion?).⁷⁵ Because horizontal price fixing, which would include any dealer or manufacturer collusion, is per se illegal, Ippolito hypothesized that “if the plaintiff had any evidence that the practice at issue in the litigation was used to support collusion, we would expect to see horizontal price-fixing allegations in these cases, in addition to the RPM allegation.”⁷⁶

associations were successful at persuading manufacturers to impose RPM. *Id.* Given the degree to which some retailers had taken the lead in seeking RPM under fair trade, the 1945 study concluded that the fair trade statutes and RPM were contrary to the public interest. *Id.* at 144–48. It highlighted particular aspects of state fair trade statutes that made them particularly useful as devices for facilitating retailer collusion. *Id.* at 146–47. Notably, those specific statutory defects do not exist under the post-*Leegin* regime, which simply brings RPM under the rule of reason. *Id.* at 148.

Finally, Overstreet considered evidence that retailer groups in foreign countries had attempted to utilize RPM to achieve collusive ends. *Id.* at 149–57. Because he did not consider possible procompetitive effects from the use of RPM in those foreign countries, this portion of his report is not probative of the degree to which RPM is generally pro- or anticompetitive.

⁷² Pauline M. Ippolito, *Resale Price Maintenance: Empirical Evidence from Litigation*, 34 J.L. & ECON. 263 (1991).

⁷³ *Id.* at 266. This was the period after fair trade laws were revoked (so all RPM was per se illegal) and before the Supreme Court decided *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984), which increased the difficulty of establishing the agreement element of a section one violation premised on RPM.

⁷⁴ Ippolito, *supra* note 72, at 264.

⁷⁵ *Id.* at 265.

⁷⁶ *Id.* at 281.

As it turned out, allegations of collusion were rare. Only 9.8% of the private cases and 13.1% of the entire sample of cases included allegations of dealer or manufacturer collusion.⁷⁷ By contrast, a large percentage of the cases featured characteristics that were more consistent with procompetitive uses of RPM than with anticompetitive collusion. For example, up to 65% of the private cases and up to 68% of the government cases involved products for which consumer demand would likely be significantly affected by the provision of “special services” susceptible to free-riding.⁷⁸ Approximately 43% of the private cases and 28% of the government cases involved products for which the dealer’s role in product quality determination is important.⁷⁹ And in twenty-four of the twenty-eight “simple goods” cases (in which special services are not as likely to be demand-enhancing), the facts were consistent with the use of RPM to enhance dealers’ sales efforts.⁸⁰ Based on these findings, Ippolito concluded that “service and sales-enhancing theories, taken together, appear to have greater potential to explain the [RPM] practices” than do collusion-based explanations.⁸¹

This evidence is admittedly limited. Because the then-existing theories of anticompetitive harm stemming from RPM focused primarily on the practice’s potential to facilitate collusion, the Overstreet and Ippolito studies did not investigate the incidence of RPM that could enable a dominant dealer to maintain or enhance its market power or a dominant manufacturer to foreclose rivals from available marketing outlets. Neither study’s findings suggested, however, that the use of RPM to achieve such ends is common. Moreover, retailing trends suggest that anticompetitive uses of RPM—including exclusionary uses by dominant dealers or manufacturers—are even less likely now than they were during the periods analyzed by Overstreet and Ippolito.

⁷⁷ *Id.*

⁷⁸ *Id.* at 282–85.

⁷⁹ *Id.* at 285–89.

⁸⁰ *Id.* at 289–91.

⁸¹ *Id.* at 291–92.

In the last couple of decades, large discount retailers have proliferated throughout the United States,⁸² and the breadth of their product offerings has expanded significantly.⁸³ Thus, large discount retailers, which compete primarily on price and would be unlikely to alienate their core customers by demanding that manufacturers set minimum retail prices or by avoiding brands that are not subject to RPM, have become both more ubiquitous and more expansive in their product offerings since the studies by Overstreet and Ippolito. Given these retailers' prominence and breadth of offerings, most manufacturers confronted with a demand for RPM from a dominant dealer or group of dealers would have the option of refusing that demand and distributing their products through the major discounters' well-established networks. And RPM could hardly be used to foreclose new brands from ubiquitous discount retailers, for such retailers—vigorous price competitors—would be unlikely to agree implicitly to carry only higher-priced brands that are subject to RPM. The potential for RPM to facilitate retailer collusion or exclusionary conduct by a dominant retailer or manufacturer has therefore diminished since the Overstreet and Ippolito studies.⁸⁴

⁸² Discount giant Wal-Mart, for example, grew from 125 outlets in 1975 to 4300 by September 2009. See Wal-Mart Stores, Inc., Unit Count and Square Footage, <http://investors.walmartstores.com/phoenix.zhtml?c=112761&p=irol-unitcount> (last visited Oct. 19, 2009).

⁸³ Beginning in the late 1980s, the major national discounters, along with a number of other discounters, began operating so-called hypermarkets, enormous retail stores carrying a vast range of products under one roof, including full lines of groceries and general merchandise.

⁸⁴ Justice Breyer therefore erred in his *Leegin* dissent when he pointed to retailing trends to suggest that anticompetitive harms from RPM are becoming *more* likely. He reasoned:

Concentration in retailing has increased. That change, other things being equal, may enable (and motivate) more retailers, accounting for a greater percentage of total retail sales volume, to seek resale price maintenance, thereby making it more difficult for price-cutting competitors (perhaps internet [sic] retailers) to obtain market share.

Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 127 S. Ct. 2705, 2733 (2007) (Breyer, J., dissenting).

Absent from Justice Breyer's analysis was any consideration of the *composition* of the more concentrated retailer market. Justice Breyer referred to

In addition, as discount retailers have expanded product offerings and gained a larger proportion of retail distribution, manufacturer-level collusion has become less likely. Given the breadth of their store networks, large discount retailers offer manufacturers especially attractive distribution outlets. The prospect of tremendous sales through a massive discount-retailer chain would create a strong and constant temptation for any participant in a manufacturer-level cartel to secure placement in the chain by cheating on the fixed price. That temptation has grown (and, conversely, the chance of successful manufacturer collusion has shrunk) as the proportion of total retail sales by discount retailers has increased.

It seems, then, that both economic theory and empirical evidence, including evidence of retailing trends, suggest that more instances of RPM will be procompetitive than anticompetitive. That suggests that, all else being equal, the governing rule of reason should approve of most instances of RPM and should burden the RPM challenger to establish the less likely case for anticompetitive harm.

B. Magnitude of losses from errors

An assessment of the likelihood of various errors is not the end of the inquiry in a decision-theoretic analysis. It is possible that one type of error—say, a false acquittal—will impose a greater social cost than its converse. If such incommensurate harm is possible, then, all else

evidence that “the combined sales of the 10 largest retailers worldwide has grown to nearly 30% of total retail sales of top 250 retailers,” *Leegin*, 127 S. Ct. at 2733 (Breyer, J., dissenting) (citing DELOITTE & TOUCHE LLP, 2007 GLOBAL POWERS OF RETAILING (2006) [hereinafter DELOITTE STUDY]), but he failed to mention that the six American retailers in the global top ten are Wal-Mart, Home Depot, Kroger, Target, Costco, and Sears Holdings (the operator of Kmart stores). See DELOITTE STUDY, *supra* at 7. All of those retailers are vigorous price competitors, and four of them—Wal-Mart, Target, Costco, and Sears (operating as Kmart)—have positioned themselves as low-price discounters. It is highly unlikely that they have the motivation, much less the ability, to pressure manufacturers to impose RPM, and their growth and expansion of product offerings reduces the chance that any manufacturer will find itself without access to efficient retailers that are willing to compete on consumer prices. Thus, the use of RPM to facilitate retailer-level collusion is increasingly unlikely.

being equal, the liability rule should be structured so as to avoid the higher-cost mistake.⁸⁵

While the decision theory analysis can get quite complicated when the liability judgment that is more likely to be correct is also likely to cause greater harm if rendered incorrectly, that is not a concern when it comes to RPM. Rather, analysis of the likelihood of various effects points in the same direction as analysis of the expected magnitude of loss from different types of errors: Both analyses call for the liability rule to acquit more often than it convicts. That is because the harm from wrongly acquitting an anticompetitive instance of RPM is likely to be less significant than the harm from wrongly convicting a procompetitive instance of the practice.

When an anticompetitive instance of RPM is improperly approved, social cost (allocative inefficiency) may result from market power that is created or maintained. When a procompetitive instance of RPM is improperly condemned, the social cost consists of the immediate benefit forgone by stopping the challenged instance plus any future benefits that are thwarted because of the precedent condemning that particular type of efficient conduct. Whereas the former harm—market power—is generally self-correcting by entry or, in the case of collusion, cheating, the latter harm—economy-wide thwarting of an output-enhancing practice—may be undone only by a court decision (or legislative or regulatory development) that corrects the bad precedent.⁸⁶ False convictions are therefore more likely to

⁸⁵ See generally Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 2–3 (1984).

⁸⁶ As Judge Easterbrook explained:

If the [antitrust] court errs by condemning a beneficial practice, the benefits may be lost for good. Any other firm that uses the condemned practice faces sanctions in the name of stare decisis, no matter the benefits. If the court errs by permitting a deleterious practice, though, the welfare loss decreases over time. Monopoly is self-destructive. Monopoly prices eventually attract entry. True, this long run may be a long time coming, with loss to society in the interim. The central purpose of antitrust is to speed up the arrival of the long run. But this should not obscure the point: judicial errors that tolerate baleful practices are self-correcting while erroneous condemnations are not.

Id.

cause greater and more durable harm than false acquittals and should thus be more stridently avoided by the governing liability rule.

C. *Decision costs*

The final consideration in the decision-theoretic analysis is the expected cost of administering the liability rule. In order to minimize those so-called decision costs, the governing rule of reason should focus the liability test so that the parties and the court know precisely what facts are outcome determinative.⁸⁷ In addition, it should clearly allocate proof burdens so that the appropriate outcome is apparent upon a failure of proof. The rule should also provide clear guidance to business planners so that they can easily assess the liability risk associated with various courses of action. If possible, it should provide safe harbors for conduct that presents a very low risk of anticompetitive harm.⁸⁸ Finally, to the extent that it can do so without significantly increasing error costs, the rule should place the burden of producing information on the party to whom that information is most easily accessible.⁸⁹

⁸⁷ Such focusing will reduce administrative costs by preventing parties from gathering, and courts from examining, irrelevant facts.

⁸⁸ Cf. Thomas A. Lambert, *Evaluating Bundled Discounts*, 89 MINN. L. REV. 1688, 1741–42 (2005) (discussing the value of clear guidance to business planners and reliable safe harbors).

⁸⁹ There may be some tension between the need to place the burden to produce information on the party to whom it is most accessible and the need to allocate proof burdens in a manner that will minimize error costs. For example, if (as with minimum RPM) procompetitive uses of a practice are more common than anticompetitive uses and the costs of false conviction exceed those of false acquittal, the burden of proving facts suggesting anticompetitive potential should generally be on the plaintiff. If, however, some of the information relevant to determining anticompetitive potential is more accessible to the defendant, concerns about administrative costs would call for placing the burden to produce the information on that party. To determine which concern should govern, the court should assess whether the enhanced error costs from placing the proof burden on the defendant are likely to exceed the administrative cost savings from placing it on the plaintiff. The burden should be allocated so as to minimize the likely sum of error and decision costs.

With these decision-theoretic criteria in mind, we turn to the various rules of reason that have been proffered for evaluating instances of RPM.

III. PROPOSED APPROACHES AND THEIR PROBLEMS

Following the *Leegin* Court's directive to "establish the litigation structure" for RPM cases and to "devise rules for offering proof" concerning potential competitive effects,⁹⁰ the commentators, regulators, and courts that have weighed in on the appropriate rule of reason for RPM have generally agreed that the evaluative approach should involve some sort of burden-shifting regime. Under each proffered approach, one party bears the initial burden of establishing a set of facts suggesting that the challenged instance of RPM is or is not anticompetitive, and the other party then has an opportunity to present some other set of facts that would rebut the presumption resulting from the first showing. The proposed approaches can be divided into four groups, each of which is analyzed below and found to be deficient.

A. *Focusing on consumer prices*

One set of approaches would begin by asking whether the RPM at issue raised consumer prices from what they otherwise would have been and, if so, would require the defendant to rebut a presumption of anticompetitive harm by showing that the RPM generated a procompetitive effect that could not have been achieved less restrictively. At the time of this writing, the American Antitrust Institute (AAI) is advocating this sort of price-effects approach in the *Leegin* remand.⁹¹ AAI recently filed an amicus brief arguing that "[a]n increase in prices paid by consumers, at least absent other information, constitutes an actual anticompetitive effect,"⁹² so "[p]arties engaged in resale price maintenance should have the initial

⁹⁰ *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2720 (2007).

⁹¹ See AAI Brief, *supra* note 16, at 5–11.

⁹² *Id.* at 7 (emphasis omitted).

burden of justifying it.”⁹³ Once an RPM-induced price increase is established, AAI maintains, the defendant should be required to “come forward with evidence sufficient to establish that RPM was adopted to achieve one of the procompetitive purposes identified by *Leegin*, or some other legitimate purpose that benefits consumers, and that RPM is reasonably necessary to serve that purpose.”⁹⁴

The attorneys general of twenty-seven states advocated a similar price-effects rule in urging the FTC to evaluate instances of RPM under a version of the analytical approach endorsed by the D.C. Circuit in its *Polygram Holding* decision.⁹⁵ The *Polygram* approach, which builds on the so-called “quick look” rule of reason the Supreme Court began to apply in its 1978 *Professional Engineers* decision,⁹⁶ presumes any “inherently suspect” trade restraint to be illegal unless the defendant identifies either “some reason the restraint is unlikely to harm consumers” or “some competitive benefit that plausibly offsets the apparent or anticipated harm.”⁹⁷ A practice is deemed “inherently suspect” if it bears a “close family resemblance . . . [to] another practice that already stands convicted in the court of consumer welfare.”⁹⁸ According to the twenty-seven states, RPM bears a “close family resemblance” to horizontal price fixing because both practices involve an agreement that tends to raise consumer prices.⁹⁹ Thus, the states argued, any instance of RPM should be presumed illegal unless the defendant demonstrates a procompetitive benefit that offsets the anticompetitive harm.

⁹³ *Id.* at 5.

⁹⁴ *Id.* at 10–11.

⁹⁵ *Polygram Holding, Inc. v. Fed. Trade Comm’n*, 416 F.3d 29 (D.C. Cir. 2005). The attorneys general staked their position in written comments urging the FTC not to modify a 2000 consent order precluding women’s footwear manufacturer Nine West from any activity that might constitute RPM. See Amended States’ Comments, *supra* note 16.

⁹⁶ *Nat’l Soc’y of Prof’l Eng’rs v. United States*, 435 U.S. 679 (1978).

⁹⁷ *Polygram Holding*, 416 F.3d at 36.

⁹⁸ *Id.* at 37.

⁹⁹ Amended States’ Comments, *supra* note 16, at 8 (“If consumers pay more because of vertical price-fixing, the restraint should be ‘inherently suspect.’”).

To discharge the burden placed on it by a showing of increased prices, the states argued, the defendant should have to show that the RPM at issue increased total sales of the covered product.¹⁰⁰ Such a showing would suggest that the RPM arrangement generated demand-enhancing dealer conduct that offset the incremental price increase it occasioned. If the defendant successfully proved that the RPM at issue enhanced total sales, the burden should shift to the plaintiff to establish that the output enhancement could have been achieved less restrictively.¹⁰¹ For example, the plaintiff might contend that the manufacturer could have avoided using a guaranteed retail margin to encourage demand-enhancing retailer services and instead either mandated that retailers provide those services or paid them for doing so. If the plaintiff showed the possibility of a less restrictive means of inducing the demand-enhancing services, and thus the output increase, then the defendant should have to show that the purportedly less restrictive alternative was actually a less efficient means of achieving the retail services at issue.¹⁰²

From a decision-theoretic perspective, the price-effects approaches proposed by AAI and the twenty-seven states are troubling. That is because virtually every instance of RPM, whether pro- or anticompetitive, raises consumer prices.¹⁰³ Indeed, each of RPM's procompetitive benefits—avoidance of price-cutting free-riders, motivating output-enhancing services that are difficult to specify and observe, facilitating entry, encouraging retailers to carry untested products—requires a guaranteed retail margin and, consequently, higher consumer prices. Because higher consumer prices are as consistent with procompetitive benefit as with anticompetitive harm, it is inappropriate to place any proof burden on the defendant simply because prices are higher than they would be absent RPM.

Moreover, the specific burden the price-effects approaches would place on the defendant would be quite difficult to discharge. The

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.* at 8–9 & n.14.

¹⁰³ See OVERSTREET, *supra* note 27, at 116–17, 160.

defendant would always have to establish both that the RPM induced retail services that enhanced total sales and (because a challenger could always argue that the services at issue could have been procured less restrictively via contract) that the manufacturer could not have induced those services as efficiently by expressly contracting for them.¹⁰⁴ Each showing would be difficult to make. The first would require the defendant to establish that sales figures following the imposition of RPM were more favorable than they would have been absent the RPM. To make that showing, the defendant would have to employ sophisticated statistical methods to separate out conflating influences and thereby isolate the effects of RPM.¹⁰⁵ The second showing would require the defendant to establish the high costs of contracting *ex ante* for the provision of desired services. Evaluating matters in hindsight, factfinders (especially jurors with little business experience) often have a hard time recognizing the practical difficulties associated with drafting and enforcing completely specified performance contracts.

¹⁰⁴ In the case in which the twenty-seven states submitted their comments, for example, the states shifted the burden back to the defendant to show the nonexistence of a less restrictive alternative by simply asserting:

Vertical price-fixing is not invariably the most efficient way to achieve procompetitive effects. The manufacturer could require its distributors to provide services as a matter of contract and even pay separately for those services. In that circumstance, the manufacturer could terminate or threaten to terminate the relationship if the retailer did not live up to those obligations. That alternative way of fostering services for consumers is more effective and efficient than threatening to terminate the relationship because the retailer is not charging consumers a higher price.

Amended States' Comments, *supra* note 16, at 9. Any party challenging RPM could simply parrot these precise words in order to shift the burden to the defendant to prove that the output enhancement could not have been achieved as efficiently using a less restrictive means.

¹⁰⁵ See Posner, *supra* note 10, at 21 (noting that proving output enhancement following use of RPM "requires controlling for the effects on the firm's output of exogenous factors, that is, those unrelated to the challenged practice itself. There are statistical methods for doing this, but they are not fool-proof in application, nor are they easy for judges and juries to understand.").

Because both showings that would be required of defendants under the price-effects approaches are difficult to make, most challenges to instances of minimum RPM would succeed. The price-effects approaches are thus inconsistent with decision theory, which calls for a liability rule that acquits more often than it convicts.¹⁰⁶

B. Focusing on the identity of the initiator

A second proposed approach for evaluating instances of RPM would focus on the identity of the party or parties initiating the RPM arrangement. The approach would generally condemn instances of RPM instigated by dealers while subjecting manufacturer-initiated instances of RPM to further scrutiny that may result in acquittal. At first glance, the “identity of initiator” approach seems consistent with the *Leegin* Court’s observations that

[i]f there is evidence retailers were the impetus for a vertical price restraint, there is a greater likelihood that the restraint facilitates a retailer cartel or supports a dominant, inefficient retailer. If, by contrast, a manufacturer adopted the policy independent of retailer pressure, the restraint is less likely to promote anticompetitive conduct.¹⁰⁷

Upon closer scrutiny, however, it seems an approach assigning liability based on the identity of the initiator would, like the price-effects approaches, be overly prohibitory.

One version of the initiator-focused approach was presented to the *Leegin* Court by amici William S. Comanor and Frederic M. Scherer,¹⁰⁸ economists who have separately questioned the purported procompetitive benefits of RPM.¹⁰⁹ In an amicus brief “supporting neither party,” Professors Comanor and Scherer attempted to set forth “a tractable approach for implementing antitrust standards on

¹⁰⁶ See *supra* notes 26–86 and accompanying text.

¹⁰⁷ *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2719 (2007) (citation omitted).

¹⁰⁸ See Comanor/Scherer Brief, *supra* note 16.

¹⁰⁹ See, e.g., SCHERER & ROSS, *supra* note 1, at 541–48; William S. Comanor, *Vertical Price Fixing and Market Restrictions and the New Antitrust Policy*, 98 HARV. L. REV. 990 (1985); F.M. Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L. J. 687 (1983).

RPM”¹¹⁰ and “to suggest . . . guidelines” for implementation of a rule of reason by the lower courts.¹¹¹

The structured rule of reason Professors Comanor and Scherer proposed would begin with a “quick look” to determine whether the restraint was instigated by the manufacturer or its distributors.¹¹² Evidence that distributors were the impetus for the restraint would result in its condemnation, unless the defendant could show “credible contradictory evidence” undermining that finding.¹¹³ If the initial inquiry revealed that the restraint was instigated by the manufacturer, then the legality of the RPM would turn on “a test of quantitative substantiality.”¹¹⁴

¹¹⁰ Comanor/Scherer Brief, *supra* note 16, at 1.

¹¹¹ *Id.* at 3.

¹¹² *Id.* at 8–9.

¹¹³ *Id.* at 9 (“Evidence from a quick look that the restraint was induced by distributors should lead to the presumption of a *per se* violation, rebuttable on the presentation of credible contradictory evidence.”).

¹¹⁴ *Id.* A party challenging RPM would have two options for establishing a prima facie case for liability under the proposed quantitative substantiality test. First, the challenger could show (1) that at least fifty percent of sales in the relevant product market were subject to RPM (presumably including sales by manufacturers that have vertically integrated forward into retailing); and (2) that the challenged RPM extended the practice’s coverage by at least ten percent of relevant sales. *Id.* Alternatively, the challenger could show (1) that the product market at issue is oligopolistic, with a Herfindahl-Hirschman index (HHI) exceeding 1800; and (2) that the challenged RPM was being implemented by a manufacturer with at least a ten percent share of the relevant market. *Id.* at 10. If the challenger made either of those two-pronged showings, then the RPM would be deemed illegal unless the defendant could prove either “that the relevant market [was] improperly defined, . . . or that the restraints were necessary to sustain the provision of services valuable to consumers.” *Id.* The second and third of these options would presumably require some sort of proof that the RPM enhanced total sales relative to what they would have been absent the restraint and that the RPM was more efficient than less restrictive means at inducing the dealer services that generated those enhanced sales—the same showing required of defendants under the states’ proposed approach. I have elsewhere criticized this quantitative substantiality test. See Lambert, *supra* note 13, at 1977–79.

A federal district court recently endorsed the Comanor/Scherer initiator-focused approach in ruling on a motion for class certification. The plaintiffs in *McDonough v. Toys "R" Us, Inc.*,¹¹⁵ purporting to represent a class of consumers, claimed anticompetitive harm resulting from RPM policies on a number of items produced by different manufacturers and sold by the retail chain Babies "R" Us (BRU).¹¹⁶ Plaintiffs averred that BRU, which allegedly possesses significant market power in the retailing of baby products, demanded that certain manufacturers whose products it carries adopt policies preventing discounting by Internet retailers. Those manufacturers, plaintiffs claimed, were effectively "forced" to adopt such policies because of BRU's alleged market power.¹¹⁷ The BRU-initiated RPM, in turn, forced members of the plaintiff class to pay higher prices than they otherwise would have paid.¹¹⁸

In contesting plaintiffs' motion for class certification, defendant BRU argued that nonprice factors such as RPM-induced retailer services would preclude plaintiffs from offering common proof of anticompetitive harm, for different consumers ascribe different valuations to such nonprice factors.¹¹⁹ Implicit in defendants' argument was the claim that the RPM at issue promoted competition by inducing demand-enhancing services or product certifications. The district court rejected that claim. Crediting the testimony of Professor Comanor, who served as plaintiff's expert, the court reasoned that "when a dominant distributor coerces a manufacturer to implement resale price maintenance—rather than the manufacturer adopting it unilaterally—the restraint has only anticompetitive effects."¹²⁰ The court accepted Professor Comanor's claim that whereas "[m]anufacturer interests may be associated with procompetitive effects (creating demand for their products), . . . distributor interests

¹¹⁵ No. 06-0242, 2009 WL 2055168 (E. D. Pa. July 15, 2009) (describing action and granting plaintiffs' motion for class certification).

¹¹⁶ *Id.* at *1.

¹¹⁷ *Id.* at *2.

¹¹⁸ *Id.* at *3–*6.

¹¹⁹ *Id.* at *21.

¹²⁰ *Id.*

are associated only with anticompetitive effects (restricting price competition)."¹²¹ It thus concluded that "when a distributor coerces the imposition of resale price maintenance (satisfying its interest but not the manufacturer's interest), only anticompetitive effects will follow."¹²² Such reasoning effectively endorses a rule of per se illegality for dealer-initiated RPM, even when the initiator is a single, dominant dealer rather than a group of smaller dealers who may be seeking RPM in order to shore up a cartel.

Such an approach rests on unsound premises and is overly prohibitory. The intuition behind it is that, whereas manufacturers may be motivated to implement RPM to achieve an output-increasing objective (e.g., the inducement of demand-enhancing retail services), retailers' only reason for seeking RPM would be for an output-reducing end (i.e., the facilitation of a retailer-level cartel or the maintenance of market power by a dominant retailer). That intuition is mistaken. High-service retailers, who generally must charge higher prices to cover the

¹²¹ *Id.*

¹²² *Id.* The court claimed that

the Supreme Court in *Leegin* agreed that when a dominant distributor instigates a vertical price restraint, "the manufacturer does not establish the practice to stimulate services or to promote its brand" but instead "supports a dominant, inefficient retailer."

Id. That statement, which strung together disparate snippets from *Leegin*, represents a gross misreading of the Court's opinion. Rather than stating that RPM cannot be aimed at stimulating services or promoting a brand "when a dominant distributor instigates a vertical price restraint," the *Leegin* Court actually stated:

A group of retailers might collude to fix prices to consumers and then compel a manufacturer to aid the unlawful arrangement with resale price maintenance. *In that instance* the manufacturer does not establish the practice to stimulate services or to promote its brand but to give inefficient retailers higher profits.

Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 127 S. Ct. 2705, 2717 (2007) (emphasis added). There is, of course, a world of difference between a single dominant dealer who instigates RPM for an undisclosed reason and "[a] group of retailers [who] collude to fix prices to consumers and then compel a manufacturer to aid the unlawful arrangement with resale price maintenance." The latter is undoubtedly anticompetitive; the former is not.

costs of the demand-enhancing services they provide, are the most direct victims of free-riding by low-service, low-cost dealers. While the manufacturer, who wants to ensure point-of-sale services, certainly has an interest in preventing free-riding, so do high-service retailers, who bear the immediate costs of providing the demand-enhancing services. Moreover, the retailers are likely to discover free-riding more quickly than the manufacturer; they will immediately notice when they are losing sales to no-frills dealers. Thus, it should not be surprising that retailers would request RPM to prevent free-riding by low-service dealers and that the manufacturer, seeking to ensure that all dealers earn a margin sufficient to finance desired services and certifications, would grant their request.¹²³ In short, the identity of RPM's initiator (retailer or manufacturer) says nothing about the RPM's dominant rationale (to facilitate retailer collusion or the maintenance of retailer market power, or to protect manufacturer and retailer interests in avoiding free-riding). And the fact that an instance of RPM was retailer-initiated by no means suggests that it was imposed for an illicit purpose.¹²⁴

¹²³ The Supreme Court has long recognized that dealer complaints about price-cutting, low-service rivals may induce a manufacturer to impose RPM as a means of encouraging efforts that will enhance demand for its products. *See* *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 727–28 (1988) (observing that “price cutting and some measure of service cutting usually go hand in hand”); *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 762 (1984) (“[I]t is precisely in cases in which the manufacturer attempts to further a particular marketing strategy by means of agreements on often costly nonprice restrictions that it will have the most interest in the distributors’ retail prices.”).

¹²⁴ An analogy may help explain why the identity of the instigating party does not reveal the dominant motivation for an instance of RPM. Suppose a homeowner has a large, old tree on the edge of her property. The tree’s massive branches extend over both the owner’s house and her neighbor’s fence. When the neighbor discovers that the tree is rotting, he asks the owner to cut it down to protect his fence. While the owner loves the old tree and would rather pay to replace her neighbor’s fence than to chop down the tree, she realizes that her failure to remove the tree endangers her own house. She therefore chops down the tree. While her neighbor’s complaint/request *instigated* her decision to chop down the tree, it was not the *motivation* for her action. Similarly, while a retailer’s (or retailer group’s) request for RPM may *induce* a manufacturer to impose such a policy, the request may not be the *motivation* for the policy if the manufacturer adopts it to encourage product promotion efforts.

The RPM in the BRU case, even if retailer-initiated, was likely procompetitive. According to the court's recitation of the facts, every manufacturer asked by BRU to forbid Internet discounting complied with the retailer's request.¹²⁵ Because (1) manufacturers make more money as more units are sold to consumers and (2) more units will be sold to consumers as the retail price is reduced (all else being equal), BRU's manufacturers had no interest in having a retail mark-up higher than that necessary to motivate optimal retail service.¹²⁶ So why did they give in to BRU's demand? The plaintiffs' theory, which the district court accepted, was that they were "forced" to do so because of BRU's market power in the retailing of baby products.¹²⁷ But that is hardly plausible. Each of the products on which BRU sought RPM is, or easily could be, sold by discount retailers like Wal-Mart, Target, and Kmart. While there are currently fewer than 270 Babies "R" Us stores in the United States,¹²⁸ Wal-Mart alone boasts 4300 domestic outlets.¹²⁹ The claim that BRU's allegedly put-upon manufacturers would be unable to get their products to consumers absent BRU's cooperation is simply incredible.

A far more plausible theory is that the manufacturers at issue gave in to BRU's demands because they wanted their products to

¹²⁵ *McDonough v. Toys "R" Us, Inc.*, No. 06-0242, 2009 WL 2055168, at *3-*6 (E. D. Pa. July 15, 2009).

¹²⁶ As the *Leegin* Court explained:

A manufacturer has no incentive to overcompensate retailers with unjustified margins. The retailers, not the manufacturer, gain from higher retail prices. The manufacturer often loses; interbrand competition reduces its competitiveness and market share because consumers will "substitute a different brand of the same product."

Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 127 S. Ct. 2705, 2718-19 (2007) (citing *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 52 n.19 (1977)).

¹²⁷ *McDonough*, 2009 WL 2055168, at *2 ("Manufacturers were forced to acquiesce because industry-dominant BRU had become their most prized customer.").

¹²⁸ See *Toys "R" Us, Inc.*, About Toys "R" Us, Inc., <http://www2.toysrus.com/about/> (last visited Oct. 19, 2009).

¹²⁹ See *supra* note 82.

bear the quality certification or prestige stamp that comes from being sold at a trendy Babies "R" Us store. Conferral of such a seal of approval is a *service* that BRU provides—a service that is conferred at considerable expense and that can be easily appropriated by low-cost dealers like Internet retailers.¹³⁰ It thus makes perfect sense that BRU would endeavor to protect itself from no-frills dealers seeking to free ride off its costly certification (not to mention its attractive product displays, its knowledgeable sales staff, and the opportunities it provides consumers to handle products) and that the manufacturers would give in to BRU's demands, expecting that the value increase in their products resulting from BRU's certifications and services would offset the higher prices occasioned by the requested RPM and would enhance total output. This output-enhancing theory is significantly more plausible than the competing theory that the manufacturers were forced to give in to a relatively small retail chain's demands because of its market power in retailing.

A particularly troubling aspect of the initiator-focused approach in the BRU case is that it resulted in automatic condemnation of RPM instigated not by a group of nondominant dealers (who might be seeking to shore up a retailer-level conspiracy) but by a single, dominant dealer acting unilaterally. An initiator-focused approach, which, as explained above, always threatens to harm competition by precluding output-enhancing instances of dealer-initiated RPM,¹³¹ offers very little in the way of procompetitive benefit when the initiator is a single, dominant retailer. First, RPM imposed at the request of such a dealer does not usually *expand* market power. When imposed at the request of a group of nondominant dealers (or their representative) RPM may easily create market power by facilitating price-fixing among those dealers—i.e., helping them act "as one." By contrast, when a single, dominant retailer demands RPM and the manufacturer complies not because it seeks to ensure demand-enhancing services but because it needs access to the dominant retailer's facilities, market power is *exercised*, but it is not usually created. Only if certain difficult-to-satisfy criteria are met can such

¹³⁰ See *supra* notes 38–39 and accompanying text.

¹³¹ See *supra* notes 123–24 and accompanying text.

RPM create (or maintain) market power.¹³² Thus, less benefit results from a rule automatically condemning instances of RPM initiated by a single, dominant retailer.¹³³

Moreover, any such rule could be easily evaded and would likely lead to even more restrictive distribution policies. Under the BRU approach, if a dominant dealer demands (and the manufacturer agrees to) a policy forbidding other dealers from selling the manufacturer's product below a certain price level, the policy is automatically illegal. If, however, the dealer were to demand that the manufacturer refuse altogether to sell its products through other retailers—i.e., that the dealer be named the exclusive distributor—that arrangement would *not* be automatically illegal. Indeed, exclusive distributorships are presumptively legal, for they may encourage demand-enhancing services by protecting the exclusive distributor from free-riding by low-service rivals.¹³⁴ An arrangement in which the dominant dealer prevents other retailers from selling the manufacturer's product *on any terms*—i.e., an exclusive distributorship—is necessarily more restrictive than a policy permitting other dealers but precluding them from selling below a fixed price level. It therefore makes little sense to ban the less restrictive practice, and if courts were to follow the BRU rule, dominant dealers would likely just demand exclusive distributorships, which are easy to defend, rather than less restrictive RPM policies.

¹³² See *supra* notes 58–59 and accompanying text and *infra* notes 182–84 and accompanying text.

¹³³ Cf. Dennis Carlton & Kenneth Heyer, *Extraction Versus Extension: The Basis for Formulating Antitrust Policy Toward Single-Firm Conduct*, GCP: THE ONLINE MAGAZINE FOR COMPETITION POLICY (Nov. 1, 2008), <https://www.competitionpolicyinternational.com/extraction-vs-extension-the-basis-for-formulating-antitrust-policy-towards-single-firm-conduct> (arguing that antitrust law should police single firm behavior that extends monopoly power but not that involving merely the extraction of surplus using existing, legitimately attained monopoly power).

¹³⁴ See, e.g., *E&L Consulting, Ltd. v. Doman Indus., Ltd.*, 472 F.3d 23, 30 (2nd Cir. 2006) (observing that exclusive distributorships are presumptively legal because a monopolist manufacturer “would prefer multiple competing buyers unless an exclusive distributorship arrangement provides other benefits in the way of, for example, product promotion or distribution”).

C. Focusing on the potential for free-riding

A third proposed approach for evaluating RPM would focus on whether the covered product is one sold with retailer services that are susceptible to free-riding by other retailers. The influential *Antitrust Law* treatise sets forth one version of this approach.¹³⁵ Under its proposal, a plaintiff challenging an instance of RPM could establish its prima facie case by proving at least one of eight sets of facts.¹³⁶ If

¹³⁵ 8 AREEDA & HOVENKAMP, *supra* note 19, ¶ 1633, at 328–29. The *Antitrust Law* treatise is so extensively relied on by antitrust lawyers and judges that U.S. Supreme Court Justice Stephen Breyer once remarked that most lawyers would prefer to have on their side “two paragraphs of Areeda on antitrust than four Courts of Appeals and three Supreme Court Justices.” *Langdell’s West Wing Renamed in Honor of Areeda*, HARV. GAZETTE, Apr. 25, 1996, available at <http://www.news.harvard.edu/gazette/1996/04.25/LangdellsWestWi.html>.

¹³⁶ The eight possible sets of facts that would establish a plaintiff’s prima facie case under the *Antitrust Law* approach are:

1. The manufacturer’s market is concentrated (HHI > 1200), and RPM arrangements or their equivalent cover a substantial portion of total sales (at least fifteen percent). 8 AREEDA & HOVENKAMP, *supra* note 19, ¶ 1633c1(A), at 330;
2. The dealer market is concentrated (HHI > 1200). *Id.* ¶ 1633c1(B), at 331. (The treatise deems a retailer market concentrated if the HHI exceeds 1200. See *id.* ¶ 1633c1(A), at 330.);
3. RPM arrangements or their equivalent are widespread throughout the product market, covering at least fifty percent of sales. *Id.* ¶ 1633c1(C), at 331;
4. The RPM arrangement was dealer-initiated, meaning that it was adopted after “demand by dealers acting collectively” (defined as two or more dealers acting in concert or an association of dealers) or a “request by a ‘dominant dealer’ ” (defined as one that accounts for thirty percent of the manufacturer’s local or total sales of a brand—local when restraint is employed only in that dealer’s locality). *Id.* ¶ 1633c1(D), at 331;
5. The RPM arrangement covers a powerful brand, meaning that the manufacturer’s brand comprises at least thirty percent of total sales in the product market. *Id.* ¶ 1633c1(E), at 331;
6. There is a dominant dealer responsible for at least thirty percent of the manufacturer’s sales within the area covered by the restraint. *Id.* ¶ 1633c1(F), at 331;

the plaintiff made any of seven of those prima facie showings, the defendant would have the opportunity to rebut the presumption of illegality.¹³⁷ One of the eight possible showings, however, would create an *irrebuttable* presumption of illegality. That showing is that the covered product is homogeneous so that there is an “obvious absence” of any need for special promotional efforts by retailers because the product is not that different from competing brands.¹³⁸

Professor Marina Lao has similarly focused on free-riding potential in recommending what she calls a “very sensible approach that could be used in RPM rule of reason cases, post-*Leegin*”:

Courts could first see if there is a credible procompetitive justification for the resale price maintenance. Specifically, is there an apparent substantial free rider problem that is being addressed by the vertical price-fixing? Is the producer a new entrant to the market, introducing a new product, or expanding into a new regional market? If no valid free riding claim or procompetitive justification is apparent, then the existence of a private restraint limiting intrabrand price competition (RPM) should be sufficiently suspect to warrant condemnation.¹³⁹

Because the use of RPM to facilitate entry is ultimately an effort to avoid free-riding (i.e., by later-appointed dealers who capture the benefits of pioneer dealers’ brand-promotion efforts),¹⁴⁰ Professor Lao’s proposed approach focuses entirely on free-riding potential.

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7. The manufacturer imposes the RPM arrangement selectively (in only one or a few geographic markets). *Id.* ¶ 1633c1(G), at 331; or
 8. The covered product is homogeneous so that there is an “obvious absence” of any need for special promotional efforts by retailers because the product is not that different from competing brands. *Id.* ¶ 1633c1(H), at 331–32.

¹³⁷ To rebut the presumption of illegality, the defendant would have to show that: (1) it has a legitimate business problem; (2) the problem “is significant in the sense of being nontrivial”; (3) the RPM “is reasonably connected to [the problem’s] solution”; and (4) “any less restrictive alternative suggested by the challenger is significantly less effective or significantly more costly.” *Id.* ¶ 1633e3(B), at 338.

¹³⁸ *Id.* ¶ 1633c1(H), at 331–32; ¶ 1633e3(A), at 338.

¹³⁹ Lao, *supra* note 16, at 215–16.

¹⁴⁰ See *supra* notes 45–46 and accompanying text.

The primary problem with any approach focusing exclusively on whether the RPM is applied in a context in which free-riding may be a problem is that it ignores the substantial procompetitive benefits RPM may provide *even absent* the potential for free-riding. As explained above, many demand-enhancing retailer services that are not susceptible to free-riding are difficult to secure contractually because of the challenges involved in specifying desired services *ex ante*, monitoring performance along multiple service dimensions, and enforcing retail service contracts.¹⁴¹ RPM may provide manufacturers with an efficient means of motivating such services.¹⁴² By coupling RPM's guaranteed profit margin with a liberal right of termination, manufacturers may motivate retailers to provide all sorts of demand-enhancing services—e.g., longer store hours, prestigious store locations, convenient parking, more enthusiastic and better-trained employees, and favorable shelf-space—that might otherwise be difficult to secure. If the legal rule were to focus exclusively on whether an instance of RPM addresses potential free-riding, it could condemn, and would therefore tend to chill, an efficient means of securing such services.

Advocates of stringent RPM regulation maintain that dealers have an independent incentive, apart from RPM, to provide any “non-free-rideable” demand-enhancing services and that courts therefore need not worry about chilling RPM in the absence of free-riding potential. Professor Lao, for example, writes that:

¹⁴¹ See *supra* notes 40–45 and accompanying text.

¹⁴² As the *Leegin* Court explained:

Resale price maintenance can also increase interbrand competition by encouraging retailer services that would not be provided even absent free riding. 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. 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 services.

Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 127 S. Ct. 2705, 2716 (2007).

As long as free riding is not a likely risk, then, in a free market, we would expect dealers to *voluntarily* invest to provide the enhancements truly valued by consumers, without the need for RPM. Prospective buyers who attribute substantial value to a pleasant shopping experience would presumably be willing to pay a higher price for the product in order to enjoy the added value. And, dealers can be expected to compete for sales by providing the enhanced value these consumers desire, as efficiently as possible.¹⁴³

In his *Leegin* dissent, Justice Breyer expressed similar skepticism about RPM's role in securing demand-enhancing services that are not susceptible to free-riding. Responding to "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 allowing it to use its own initiative and experience in providing valuable services,'" ¹⁴⁴ Justice Breyer wrote:

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?¹⁴⁵

In a recent submission made in connection with an FTC hearing on RPM,¹⁴⁶ economist Benjamin Klein answered Justice Breyer's question. Professor Klein demonstrated that RPM may be necessary to motivate the *optimal* level of demand-enhancing retailer services, despite retailers' independent incentive to attract business, because manufacturers and their dealers often have divergent incentives with respect to such services. Quite often, Professor Klein explained, a manufacturer stands to gain more from its dealers' promotional efforts than do the dealers themselves.¹⁴⁷ In such cases, a strategy combining RPM with a liberal right of termination may efficiently

¹⁴³ Lao, *supra* note 16, at 203.

¹⁴⁴ *Leegin*, 127 S. Ct. at 2733 (Breyer, J., dissenting) (quoting *Leegin*, 127 S. Ct. at 2716).

¹⁴⁵ *Leegin*, 127 S. Ct. at 2733 (Breyer, J., dissenting).

¹⁴⁶ Klein, *supra* note 41.

¹⁴⁷ *Id.* at 441-44.

motivate dealers to provide demand-enhancing services they otherwise would not provide.¹⁴⁸

A number of commonly existing economic conditions create the sort of incentive divergence that warrants RPM. First, manufacturers frequently enjoy a larger per-unit profit margin than do their retailers.¹⁴⁹ Because manufacturers' products tend to be more highly differentiated than the services retailers provide, and because the ability to charge prices in excess of one's costs is a function of the uniqueness of whatever one is providing, manufacturers will generally earn higher per-unit profits on their products than will the retailers who resell those products. Accordingly, a manufacturer stands to gain more from each incremental sale of its product than do its retailers, and it may therefore need a way to give its retailers an extra incentive to promote its products. By providing retailers with a guaranteed profit margin, RPM may provide that extra incentive.

Moreover, many manufacturer-specific promotional efforts by a retailer fail to enhance the overall attractiveness of the retailer itself (i.e., the promotional efforts do not have "inter-retailer demand effects").¹⁵⁰ While some retailer promotional efforts, such as convenient free parking or extended store hours, provide competitive advantages to both the manufacturers whose products are carried by the retailer *and* the retailer itself, other retailer promotional efforts, such as prominent placement of the manufacturer's product within the "impulse buy" section of the retailer's store, benefit only the manufacturer and do not significantly enhance demand for the retailer's services over those of its competitors.¹⁵¹ Absent some nudge from the manufacturer, retailers will not be adequately motivated to perform an optimal level of those sorts of services. RPM can provide the needed nudge.

In addition, manufacturer-specific retailer promotional efforts may cannibalize a multibrand retailer's sales of other brands.¹⁵² Many

¹⁴⁸ *Id.* at 449–60.

¹⁴⁹ *Id.* at 446.

¹⁵⁰ *Id.* at 447–48.

¹⁵¹ *See id.*

¹⁵² *Id.* at 448.

retailer services that would promote a manufacturer's brand of a product may reduce the retailer's sales of competing brands of the same product and may therefore provide little, if any, net benefit to the retailer. Granting favorable shelf space to one brand, for example, may require moving a competing brand to less attractive shelf space, thereby reducing sales of that less-favored brand. A manufacturer may induce its retailers to provide it with potentially "cannibalizing" promotional services by employing RPM to guarantee the retailer a higher markup on sales of the manufacturer's brand.

Taken together, these various sources of divergence¹⁵³ provide many manufacturers with an incentive to adopt some sort of RPM policy, even when the product at issue is not one that is sold along with services that are susceptible to free-riding. The RPM policies manufacturers adopt to address incentive divergence enhance the manufacturers' overall output and should thus be assumed to be procompetitive.¹⁵⁴ Accordingly, any

¹⁵³ For more detailed treatment of the various sources of divergence between manufacturers' and retailers' incentives, see Benjamin Klein & Joshua Wright, *The Economics of Slotting Contracts*, 50 J.L. & ECON. 421 (2007).

¹⁵⁴ Some have argued that the mere fact that RPM enhances market output does not mean it is procompetitive, for RPM-induced retailer services, which enhance total sales by motivating *marginal* consumers to purchase the product at issue, may not be valued by *inframarginal* consumers, who will face an incremental price increase that is not offset by services that enhance the value they receive from the purchase. See Comanor, *supra* note 1. But this sort of dynamic is common in highly competitive markets, where all consumers pay for output-enhancing services (e.g., advertising) that disproportionately benefit marginal consumers. As Benjamin Klein recently explained:

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 [or sales assistance], that are not consumed by all customers. . . . 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

Klein, *supra* note 41, at 463.

approach that automatically condemns RPM on products that are not sold along with services that are susceptible to free-riding would be overly prohibitory.

D. Mechanically applying the Leegin factors

A fourth approach for evaluating RPM, the approach apparently favored by the FTC,¹⁵⁵ would deem any instance of RPM presumptively illegal unless the defendant proved: (1) that RPM is not used by manufacturers collectively comprising a significant share of the relevant product market; (2) that the manufacturer, not its dealers, initiated the RPM; and (3) that there is no dominant manufacturer or dealer with market power.¹⁵⁶ These are three factors the *Leegin* Court emphasized as relevant to the question of whether a particular instance of RPM is pro- or anticompetitive,¹⁵⁷ and the FTC reasoned that the defendant should have the burden of proving the nonexistence of each. If the defendant did so, its RPM would be presumed legal for the time being (though subsequent challenges to the RPM could burden the defendant with having to establish continued absence of the *Leegin* factors).¹⁵⁸ If, however, the defendant failed to prove the absence of any of the *Leegin* factors, then its RPM would be found illegal unless the defendant proved that the RPM enhanced its total sales relative to what they otherwise would have been.¹⁵⁹

¹⁵⁵ The FTC adopted the approach described in the text below in its ruling on women's footwear manufacturer Nine West's petition for modification of a 2000 consent order prohibiting it from engaging in resale price maintenance. *See* *Nine West Order*, *supra* note 16.

¹⁵⁶ *Id.* at 14.

¹⁵⁷ *See* *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2719 (2007).

¹⁵⁸ Notably, the Commission required Nine West to file regular reports showing that the *Leegin* factors remain absent and that its use of RPM continues to benefit consumers. *See* *Nine West Order*, *supra* note 155, at 17–18.

¹⁵⁹ *Id.* at 15–16 (“If we were to conclude that Nine West runs afoul of the *Leegin* factors and raises competitive concern, Nine West could also meet its burden by demonstrating that its use of resale price maintenance is procompetitive.”).

While the FTC's approach plays lip service to some of the analysis in the *Leegin* decision, it is troubling from a decision-theoretic perspective and does not follow *Leegin's* directive "to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones."¹⁶⁰ Recall that decision theory calls for RPM, which is more often than not procompetitive, to be evaluated under a rule that acquits more frequently than it convicts.¹⁶¹ The FTC's proposed approach, by contrast, would likely result in conviction more often than acquittal because both the showing required to avoid a presumption of illegality and the showing required to rebut that presumption are difficult to make.

To establish an absence of the first *Leegin* factor, a defendant would initially have to establish the relevant manufacturer market, always a difficult task.¹⁶² The defendant would then have to produce data on the

¹⁶⁰ *Leegin*, 127 S. Ct. at 2720.

¹⁶¹ See *supra* notes 27–86 and accompanying text.

¹⁶² See, e.g., MILTON HANDLER ET AL., *TRADE REGULATION: CASES AND MATERIALS* 210 (4th ed. 1997) ("In theory and practice, relevant market definition is as difficult an undertaking as any in antitrust."). In the *Nine West* case, for example, the FTC required the defendant to provide answers to the following difficult questions about market contours and entry barriers in order to establish the market in which it participates:

Please break out, if possible, *Nine West's* approximate market shares in identifiable segments of the overall market, e.g., dress shoes, casual shoes, walking/light exercise shoes, sandals, etc. Also, state any arguments or evidence about why these lines are or are not antitrust markets.

How difficult is it for a new manufacturer/distributor of women's shoes to develop a brand, i.e., how long does it take, how costly is it to get shelf space in retail locations, does it matter if the distributor has other shoes or is a new entrant, how much cost is involved in brand development, e.g., market studies, advertising, etc., do brand entry conditions vary by type of shoe, e.g., easier to enter with a sandal than a dress shoe?

Letter from Ronald S. Rolfe, Cravath, Swaine & Moore, Counsel to *Nine West Group, Inc.*, to Eric D. Rohlck, Federal Trade Commission (Mar. 26, 2008), *In re Nine West Group, Inc.*, No. C-3937, available at <http://www.ftc.gov/os/caselist/9810386/080326ninewestadditionalinfoltr.pdf>.

use of RPM by other manufacturers in that market and on the market shares of those manufacturers. To establish an absence of the second *Leegin* factor, the defendant would have to prove that the manufacturer, not its dealers, initiated the RPM. That showing would be difficult to make if there was any evidence that high-service dealers had complained about their low-service, presumably cheaper, rivals. Those dealer complaints, which may simply have alerted the defendant to the need to control dealer quality by reducing price competition¹⁶³ (and, as explained above, are perfectly consistent with procompetitive uses of RPM)¹⁶⁴ would suggest that dealers were the impetus for the restraint. Finally, to establish the third *Leegin* factor, a manufacturer defendant would have to prove its own lack of market power and the absence of market power on the part of each of its dealers. The latter showing would presumably require the defendant to establish a second (dealer) market. If the defendant failed to make any of these showings, then it would have to prove (1) that its RPM actually increased output relative to what it would have been absent the pricing policy, and (2) that no less restrictive means could have achieved a similar output enhancement. For reasons explained above,¹⁶⁵ both showings would be quite difficult to make.

Thus, under the FTC's preferred evaluative approach, defendants are likely to lose, and RPM challenges are likely to succeed. Such an outcome is contrary to decision theory's prescription.

IV. A DECISION-THEORETIC APPROACH

Unlike each of the evaluative approaches discussed in part III, a burden-shifting regime tilted slightly in the defendant's favor would minimize the sum of error costs from false acquittals and false convictions, while keeping decision costs in check.¹⁶⁶ Under a decision-

¹⁶³ See *Monsanto Co. v. Spray-Rite Serv. Co.*, 465 U.S. 752, 762–63 (1984) (observing that manufacturers who respond to dealer complaints about price-cutting dealers may be motivated by a concern to preserve or enhance dealer services, not a desire to assist the complaining dealers).

¹⁶⁴ See *supra* notes 123–24 and accompanying text.

¹⁶⁵ See *supra* notes 104–06 and accompanying text.

¹⁶⁶ I originally set forth this sort of decision-theoretic approach in Lambert, *supra* note 13, at 1997–2003.

theoretic approach, a plaintiff challenging an instance of RPM would bear the initial burden either (1) to produce direct evidence of competitive harm by showing that the challenged instance of RPM had caused a reduction in output, or (2) to produce circumstantial evidence of competitive harm by showing that the prerequisites to such harm are satisfied. Once the plaintiff made such a showing, the defendant could avoid liability only by showing that the plaintiff had failed to discharge its initial proof burden or by offering an affirmative defense consisting of a showing that the challenged practice is, in fact, procompetitive. If the defendant made such an affirmative defense, the plaintiff could prevail only if it established that the procompetitive benefits claimed by the defendant were likely illusory.

The remainder of this part fleshes out the details of the proposed liability regime—including the plaintiff’s prima facie case, the defendant’s rebuttal opportunity, and the responses available to the challenger—and briefly analyzes the proposed approach in light of decision theory’s prescriptions.

A. *The proposed liability regime*

1. PLAINTIFF’S PRIMA FACIE CASE Because most instances of minimum RPM are procompetitive¹⁶⁷ and the harms from a false conviction are likely to exceed those from a false acquittal,¹⁶⁸ the party challenging an instance of RPM should bear the initial burden to produce evidence that the challenged practice is likely to be output-reducing. The challenger could take either a “direct” or a “circumstantial” approach to discharging that burden.

(a) *Direct approach* Under the direct approach, the plaintiff would have to produce evidence that the RPM at issue had, in fact, reduced the manufacturer’s output of the relevant product relative to what it would have been absent the price restraint.¹⁶⁹ For example, the

¹⁶⁷ See *supra* notes 27–84 and accompanying text.

¹⁶⁸ See *supra* notes 85–86 and accompanying text.

¹⁶⁹ Judge Posner has advocated this direct approach to determining whether a vertical restraint is anticompetitive. See Posner, *supra* note 10, at 21; Richard Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1, 18–19 (1977).

plaintiff could show (1) that the manufacturer's output declined following imposition of RPM, and (2) that the decline cannot be explained by other factors (such as an economy-wide recession or the introduction of a competing product). Given the difficulty of the latter showing, which would be an indispensable part of a plaintiff's direct prima facie case,¹⁷⁰ most plaintiffs would likely opt to discharge their initial proof burden circumstantially.

(b) *Circumstantial approach* Under the circumstantial approach, the plaintiff would initially have to show that anticompetitive harm *could* stem from the challenged RPM. This would require the plaintiff to establish the preconditions for *at least one* of the four types of anticompetitive harm that theoretically may result from RPM—dealer collusion, manufacturer collusion, maintenance or enhancement of a dominant dealer's market power, or anticompetitive foreclosure from a manufacturing market.¹⁷¹

DEALER COLLUSION. RPM can be used to enhance dealer collusion only if dealers seek RPM as a cartel facilitator and the manufacturer, which generally benefits from the lowest possible dealer margins, complies with their demand.¹⁷² Thus, in order to establish a circumstantial prima facie case on a dealer collusion theory, a plaintiff would have to prove both that dealers would be likely to seek RPM for collusive purposes and that the manufacturer would be inclined to honor their request. To establish dealer interest in RPM as a cartel

¹⁷⁰ See Posner, *supra* note 10, at 21 (noting that this method "requires controlling for effects on the firm's output of exogenous factors, that is, those unrelated to the challenged practice itself," and observing that the statistical methods involved "are not foolproof in application, nor are they easy for judges and juries to understand").

¹⁷¹ Herbert Hovenkamp, co-author of the *Antitrust Law* treatise whose proposed evaluative approach is analyzed *supra* notes 135–38 and accompanying text, has elsewhere suggested the sort of circumstantial approach proposed here. See HOVENKAMP, *supra* note 50, § 11.7d, at 493–95. The latter approach involves a more stringent prima facie case than that set forth in the *Antitrust Law* treatise. Compare 8 AREEDA & HOVENKAMP, *supra* note 19, ¶ 1633, at 328–39 with HOVENKAMP, *supra* note 50, § 11.7d, at 493–95.

¹⁷² See generally HOVENKAMP, *supra* note 50, § 11.2, at 449–51 (explaining that dealers must seek, and manufacturers must consent to, RPM if it is to be used to facilitate dealer collusion).

facilitator, the plaintiff would have to show that:

1. the dealer market is susceptible to cartelization because (a) it is relatively concentrated and (b) there are substantial entry barriers¹⁷³; and
2. either (a) the manufacturer has market power in the market for the price-restrained product or (b) RPM is common among manufacturers of that product.¹⁷⁴

To establish manufacturer willingness to comply with a dealer demand for RPM that merely raises retail margins without enhancing overall sales of the manufacturer's product,¹⁷⁵ the plaintiff must prove that it would be difficult for the manufacturer to resist such demand. Accordingly, the plaintiff would have to show that:

1. the dealer or group of dealers seeking RPM comprises a substantial proportion of reasonably available marketing outlets¹⁷⁶; and
2. forward integration into the dealer market would be impracticable for the manufacturer.¹⁷⁷

¹⁷³ These showings are required because dealers presumably would not seek RPM to facilitate collusion in a market that is not susceptible to cartelization.

¹⁷⁴ One of these showings is required because dealers will not seek to raise consumer prices through the imposition of RPM if such higher prices are likely to drive consumers to competing brands of the product at issue.

¹⁷⁵ Such RPM would reduce the manufacturer's sales without increasing its per-unit profit and would therefore lower the manufacturer's overall profits.

¹⁷⁶ If the dealers demanding imposition of RPM do not collectively comprise a substantial proportion of reasonably available marketing outlets, the manufacturer asked to impose output-reducing RPM would likely resist that demand. If the requesting dealers dropped the manufacturer's products, the manufacturer would be able to make up for those dealers' lost sales by increasing its sales through other dealers. Thus, the demanding dealers would have little leverage to demand imposition of RPM.

¹⁷⁷ A manufacturer that could easily integrate forward into retailing would not be easily coerced by dealer demands to impose RPM. One situation in which forward integration into retailing is likely to be impracticable is when the manufacturer's product is not amenable to single-product distribution and is more likely to be purchased from a multiproduct retailer. See HOVENKAMP, *supra* note 50, § 11.2b, at 451.

Absent all four showings, a plaintiff cannot establish a substantial possibility that the challenged RPM could facilitate dealer collusion.

MANUFACTURER COLLUSION. Any attempt by manufacturers to impose RPM to facilitate a manufacturer cartel would be irrational unless the market in which they participate is capable of being cartelized. Moreover, RPM cannot serve as an effective facilitator of manufacturer collusion unless it is utilized by manufacturers collectively representing the bulk of the market being cartelized. Accordingly, a plaintiff seeking to state a circumstantial prima facie case based on a manufacturer collusion theory should have to show that:

1. the manufacturer market is concentrated¹⁷⁸;
2. the product upon which RPM is imposed is relatively fungible¹⁷⁹;
3. there are substantial entry barriers into the manufacturer's market¹⁸⁰; and
4. the use of RPM is widespread among manufacturers of the product.¹⁸¹

¹⁷⁸ Markets containing numerous nonfringe sellers are difficult to cartelize. See POSNER, *supra* note 54, at 66 ("Some degree of concentration thus appears to be a necessary condition of successful collusion in markets subject to the Sherman Act.").

¹⁷⁹ Because of the need to adjust consumer prices to account for differences in features and quality, it is difficult to fix prices on nonfungible products. See *id.* at 75 ("The less standardized (more customized) a product is, . . . the more difficult it will be for the sellers of the product to collude effectively. The heterogeneity of the product will make it impossible for the sellers to agree upon a single price for all orders.").

¹⁸⁰ Because supracompetitive prices attract entry that can render a price-fixing scheme unprofitable, price-fixing is difficult in markets with low entry barriers. See *id.* at 72-75.

¹⁸¹ In order for RPM to substantially facilitate a manufacturer cartel by either dissuading cartel participants from cheating or making their cheating more visible, it must be in widespread use among the colluders. See HOVENKAMP, *supra* note 50, § 11.2b2, at 453 ("The manufacturers' cartel will work, however, only if its members collectively control enough of the market to wield monopoly power.").

MAINTENANCE OR ENHANCEMENT OF A DOMINANT DEALER'S MARKET POWER. In order for RPM to serve as an exclusionary device for enhancing or maintaining a dominant dealer's market power, such a dealer must exercise its market power to induce manufacturers to impose RPM policies on so many brands that more efficient competing dealers are prevented from becoming established in the relevant dealer market. Thus, a plaintiff seeking to establish a circumstantial prima facie case of anticompetitive exclusion from the dealer market should be required to demonstrate that:

1. a dealer initiated the RPM at issue¹⁸²;
2. the initiating dealer had market power, which requires (a) that the dealer control a substantial percentage of available marketing outlets, (b) that there be significant barriers to entry into the relevant retail market, and (c) that forward integration by the manufacturer into product distribution be impracticable¹⁸³; and
3. the brands upon which the dominant retailer procures RPM comprise a significant portion of sales within the relevant retail market,

¹⁸² A manufacturer would be unlikely to initiate RPM that enhanced or maintained dealer market power unless such RPM generated dealer services that enhanced overall output by more than the increase in dealer power reduced it (in which case the RPM would be procompetitive). Thus, manufacturer initiation of RPM is inconsistent with this theory of anticompetitive harm.

¹⁸³ As explained *supra* notes 123–30 and accompanying text, a dealer's initiation of RPM may be procompetitive when, for example, the dealer complains to a manufacturer about other dealers' free-riding on services and certifications and the manufacturer responds by implementing price restraints. Thus, a plaintiff seeking to establish the theory of anticompetitive harm discussed here must prove more than the simple fact that a dealer initiated the RPM at issue. To weed out instances in which the manufacturer imposed RPM because its incentives were aligned with those of the initiating dealer (e.g., both sought to avoid free-riding), the plaintiff should be required to show that the initiating dealer at least had the power to induce the manufacturer to act contrary to its economic interest (i.e., to impose RPM that would reduce total retail sales). Unless the initiating dealer controlled a substantial percentage of available marketing outlets, barriers to entry into the retail market were significant, and forward integration by the manufacturer into product distribution was impracticable, the dealer would not have such power.

so that more efficient competing retailers are unable to gain a foothold in the retail market.¹⁸⁴

ANTICOMPETITIVE FORECLOSURE FROM A MANUFACTURING MARKET. The theory that RPM may cause anticompetitive foreclosure assumes that the manufacturer imposes RPM, thereby guaranteeing a minimum retail mark-up on its brand, as an inducement to its retailers not to carry rival brands of the product at issue. In order to make out a prima facie case for liability on a foreclosure theory, a plaintiff challenging an instance of RPM should therefore have to prove that:

1. the RPM at issue is likely to induce such discrimination against other brands; and
2. the retailers subject to RPM on the defendant's brand constitute a substantial percentage of the available marketing outlets for the product at issue.¹⁸⁵

The challenger could establish the first prong by showing that the manufacturer requires exclusive dealing in exchange for the RPM. Alternatively, it could do so by showing that dealers carrying the defendant's price-restrained brand generally do not carry other brands. With respect to the second prong, "substantial" foreclosure of marketing opportunities should resemble the level of foreclosure required to establish liability for exclusive dealing, which threatens a similar sort of anticompetitive effect.¹⁸⁶

¹⁸⁴ As explained *supra* notes 58–59 and accompanying text, if RPM policies are not imposed on a significant percentage of brands sold within the relevant dealer market, more efficient competing dealers could become established selling other brands and, given their superior efficiency, should gain enough market share to induce the manufacturer to drop any output-reducing RPM policies.

¹⁸⁵ See *Elzinga & Mills*, *supra* note 46, at 7 (observing that RPM-augmented foreclosure theory "cannot apply where manufacturing competitors and entrants retain access to the market via competing retailers or alternative channels of distribution. Nor can it apply where the manufacturer using RPM does not control a large share of the relevant market in spite of using this practice.").

¹⁸⁶ See *HOVENKAMP*, *supra* note 50, § 10.9a, at 436–37 (discussing anticompetitive foreclosure effect of exclusive dealing); *id.* § 10.9e, at 441–45 (discussing foreclosure levels required to establish liability based on exclusive dealing).

2. DEFENDANT'S REBUTTAL OPPORTUNITY Once the challenger produced evidence that the challenged RPM resulted in reduced output (the direct approach) or that the preconditions for one of the aforementioned theories of anticompetitive harm are satisfied (the circumstantial approach), the defendant should have two potential rebuttal opportunities. First, it could attempt to show that the evidence produced does not establish the plaintiff's prima facie case. If the plaintiff attempts the direct approach of showing an actual output reduction, the defendant may attack the evidence attributing reduced output to the imposition of RPM.¹⁸⁷ If the plaintiff instead pursues the circumstantial approach, the defendant may show that one of the prerequisites to anticompetitive harm has not been proven. Because the plaintiff bears the full burden of proof on its prima facie case, the defendant will prevail if it convinces the fact-finder that there is a deficiency in the plaintiff's evidence.

Besides attacking the plaintiff's prima facie case, the defendant should be allowed to mount an affirmative defense. The type of defense would vary based on the nature of the plaintiff's prima facie case (i.e., direct or circumstantial). To counter a plaintiff's direct showing of an actual output reduction, the defendant would have to produce its own evidence (i.e., an alternative study) showing that its output was enhanced, not reduced, by the imposition of RPM. To counter a circumstantial prima facie case, the defendant would have to show that the RPM at issue had a procompetitive effect. It could make that showing by demonstrating (1) that it faced a significant business problem (e.g., free-riding on the provision of dealer services, difficulty in contracting over dealer performance, a need to gain new entry, unpredictable consumer demand); and (2) that the RPM at issue was used to remedy that problem.¹⁸⁸

3. RESPONSES AVAILABLE TO PLAINTIFF If a plaintiff took the direct route in establishing its prima facie case and the defendant

¹⁸⁷ For example, the defendant may show that the challenger failed to account for the effect on output of exogenous factors. See Posner, *supra* note 10, at 21.

¹⁸⁸ This is similar to the affirmative defense set forth in the *Antitrust Law* treatise. See 8 AREEDA & HOVENKAMP, *supra* note 19, ¶ 1633e3(B), at 338, discussed *supra* note 137 and accompanying text.

made an affirmative defense by producing its own study showing an output enhancement, the task would fall on the finder of fact to determine which of the parties offered the more persuasive account of actual output effects and to find for that party.¹⁸⁹ If, as is more likely, the plaintiff chose instead to set forth a circumstantial *prima facie* case and the defendant made the affirmative defense set forth above, then the plaintiff should be entitled to one more bite at the apple: It could prevail if, but only if, it persuaded the factfinder that either (1) the purported procompetitive benefit is pretextual or (2) the benefit could have been achieved as efficiently using a less restrictive means.

B. Evaluation of the proposed rule

Few challenges to instances of minimum RPM will succeed under the proposed rule. A challenger must either (1) produce convincing evidence that RPM resulted in an output reduction that cannot be attributed to another cause or (2) first demonstrate the existence of all the prerequisites to one of RPM's potential anticompetitive harms and then rebut any claim that the RPM was imposed as the most efficient means of securing a procompetitive end. These proof burdens are difficult to satisfy. Still, the proposed rule should deter blatantly anticompetitive instances of RPM, particularly since successful challenges will result in treble damages,¹⁹⁰ which are not justified by the clandestine nature of the offense and thus result in some measure of overdeterrence.¹⁹¹ Given that most instances of RPM are procompetitive,¹⁹² that the costs of false

¹⁸⁹ If the factfinder concludes that the parties' accounts concerning output effects are equally persuasive, the defendant should prevail. The challenger bears the burden of proving anticompetitive effect.

¹⁹⁰ 15 U.S.C. § 15 (2008).

¹⁹¹ Damages for antitrust violations are trebled in order to account for the fact that many antitrust violations (e.g., horizontal price-fixing conspiracies) are hidden and thus likely to escape successful prosecution. For blatant antitrust violations—those not conducted in secret—damages trebling results in some degree of overdeterrence. Because RPM is not a “secret” business practice, a measure of overdeterrence is already built in to the prohibition on anticompetitive uses of the practice. See HOVENKAMP, *supra* note 13, at 66–68; POSNER, *supra* note 54, at 272.

¹⁹² See *supra* notes 27–84 and accompanying text.

convictions generally exceed those of false acquittals,¹⁹³ and that damages trebling for RPM violations already creates a measure of overdeterrence,¹⁹⁴ the slightly prodefendant proposed rule would seem to strike the proper balance for minimizing error costs.

In addition, the proposed rule would keep administrative costs in check. Because the rule calls for a focused inquiry and clearly allocates proof burdens, it would be relatively easy for courts to apply. The substantial burden the rule places on plaintiffs would deter frivolous lawsuits. By laying out essential elements of a plaintiff's prima facie case, the rule creates de facto safe harbors (e.g., no liability on a manufacturer or dealer collusion theory if the defendant lacks market power and RPM is not widespread among manufacturers) and thereby lowers the cost of providing guidance to business planners.

The only potential difficulty in terms of administrative costs is that the proposed rule would burden the RPM challenger to produce evidence that may be more accessible to the defendant manufacturer. For example, a plaintiff pursuing a direct prima facie case would have to produce data on the defendant's total output, data that would be more accessible to the defendant. If the plaintiff pursued a circumstantial prima facie case, it might (depending on the theory of anticompetitive harm it pursued) have to establish the defendant's market power; the defendant may be in a better position to produce relevant evidence concerning the contours of the relevant market, its share of that market, and entry barriers into the market. In the end, though, the administrative cost savings from reallocating proof burdens from the challenger to the defendant would be unlikely to outweigh the increased error costs resulting from enhancing the risk of costly false positives by making the plaintiff's prima facie case easier to establish.¹⁹⁵ Thus, the proposed evaluative approach would minimize the sum of error and decision costs, thereby maximizing the net social benefits of RPM regulation.

¹⁹³ See *supra* notes 85–86 and accompanying text.

¹⁹⁴ See *supra* note 191.

¹⁹⁵ See *supra* note 89 (discussing tradeoff between allocating proof burdens to parties with most accessible information and creating liability test that will minimize error costs).

V. CONCLUSION

In overruling *Dr. Miles* and directing courts to evaluate instances of RPM under the rule of reason, the Supreme Court made significant strides in its century-long journey toward a rational policy on vertical restraints. Yet, much work remains. The key task now is to craft a structured rule of reason that reflects economic learning on RPM and is sensitive to both the likelihood and magnitude of errors in adjudging liability and the administrative costs of doing so. Unfortunately, the liability rules thus far proposed by courts, regulators, and commentators fall short. In particular, evaluative approaches narrowly focused on price effects, the identity of the party initiating RPM, or whether the product subject to RPM is accompanied by services susceptible to free-riding would tend to condemn too many instances of RPM and would thus impose large error costs. So would the FTC's preferred approach, which mechanically applies factors the *Leegin* Court mentioned as relevant but fails to structure proof burdens in a fashion that will minimize error costs.

This article has set forth an alternative evaluative approach that recognizes the limitations of antitrust adjudication (i.e., the inevitability of some mistakes), accounts for both the theoretical output effects of RPM and the empirical evidence of those effects, and assigns proof burdens in a manner calculated to minimize the sum of decision and error costs stemming from RPM adjudication. Judicial adoption of the approach set forth herein would maximize the net social benefits of RPM regulation.