THE LAW AND ECONOMICS OF RESALE PRICE MAINTENANCE

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November 13, 2012

Presentation at University College, London

The Two Economics of Vertical Restraints*

- The first economics concerns restraints imposed by manufacturers on their distributors.
  - imposed on distributors to maintain margins for the purpose of gaining increased sales.
- The second economics deals with restraints coerced by leading distributors.
  - imposed on their suppliers to limit competition from rivals.
- This distinction depends on the source of the restraints.

* William S. Comanor, "The Two Economics of Vertical Restraints," Review of Industrial Organization, Summer 1990, Vol. 5, pp. 99-125.

2

The First Economics: Manufacture Imposed RPM

- Without RPM, the manufacturer plays no direct role in the retail market.
  - the distributor pays the manufacturer's price for the product; he considers that payment as a cost; and then sets his own price.
- Generally, the manufacturer's interests are served when there is maximum competition in the retail market, which limits distribution margins, lowers consumer prices and increases the quantities sold.
- That account assumes that distributors are passive and distribution services have no effect on quantities sold.
- In those circumstances, manufacturers would never limit competition among their distributors and adopt RPM, which has the direct effect of limiting intra-brand competition.

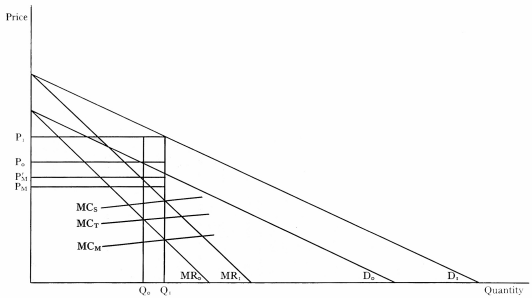
3

How RPM Leads to Increased Manufacturer Profits

- However, suppose distributors are not passive and consumers respond to particular distribution services:
  - enhanced information about the product;
  - greater convenience in purchasing the product;
  - improved credit terms to facilitate their purchase;
  - more fashionable products.
  - greater selling efforts.
- And suppose consumers are willing to pay more for products which embody these characteristics.
- Then the retail demand curve for a product which includes these services lies to the right of the one which refers to the product alone. See the following diagram.

4

A Diagrammatic Analysis (1)



5

A Diagrammatic Analysis (2)

- When certain distribution services are provided, let the demand curve shift outwards from D_0 to D_1, along with a corresponding shift in marginal revenues from MR_0 to MR_1.
- There are costs of providing these additional services. As a result, distribution costs rise from (MC_T – MC_M) to (MC_S – MC_M). The manufacturer's costs are unchanged.
- Price increases from P_0 to P_1; and Quantities increase from Q_0 to Q_1.
- With the provision of additional distribution services, both prices and quantities increase. Prices rise to cover higher distribution costs; and quantities increase to make supplying these services profitable for the manufacturer.
- Supporting distributor efforts can lead to consumer gains and increased competition.

6

The Second Economics: Distributor Instigated RPM

- The earlier results apply only to manufacture instigated RPM. Where RPM is instigated by large distributors, their economic implications are very different.
- Large distributors gain directly when their smaller rivals are prohibited from charging lower prices. In that case, they are freed from competition arising from those rivals.
- That result can be achieved when large distributors can require their supplying manufacturers to impose RPM policies on their smaller rivals.
- Consumers are harmed by the higher prices, and there is no improvement in distribution services. Leads directly to reduced economic efficiency.

7

Competitive Implications of the Two Models of RPM

- Prices rise under both circumstances.
- Increased quantities follow from the first model, while lower quantities follow from the second model.
- Increased competition can result from the First Economics, while reduced competition results from the Second Economics.
- These divergent explanations have led to a contentious debate over competition policy towards RPM.

8

The Leegin* Case Reached the US Supreme Court in the Midst of this Debate

- The issue raised in that case was the jurisprudence to be applied.
- Beginning with the Dr. Miles decision of 1911,** RPM had been considered a per se violation of the Sherman Act.
- That rule was inconsistent with the growing economic literature extolling the pro-competitive effects of vertical restraints.
- The issue faced by the Court was whether these restraints should now be evaluated under the Rule of Reason despite the precedent of nearly 100 years of case law.

* Leegin Creative Leather Products v. PSKS, 127 S Ct. 2705 (2007).
** Dr. Miles Medical Co. v. John D. Park & Sons, 220 U.S. 373 (1911).

9

The Leegin Decision (1)

- RPM would henceforth be evaluated under the Rule of Reason, which required determining the economic consequences of the specific restraints.
- The vote was 5 to 4.
  - majority decision by Justice Kennedy.
  - minority decision by Justice Breyer.
- Both opinions are instructive as they both deal with the economic effects of RPM.
  - issues which were not raised under a per se standard.
  - courts did not reach those issues before.

10

The Leegin Decision (2)

- The language of the decision became a critical factor for determining how the new law would actually be applied.
  - the Rule of Reason is an empty box without specifying the circumstances where RPM is "reasonable" and where it is not.
  - and Justice Kennedy's decision seeks to do so.
- The first part of his decision covers the First Economics, while the latter part deals with the Second Economics.
- What the decision does not do is suggest which result is more likely.

11

Relevant Passages for the Second Economics

- Justice Kennedy wrote:
  - "A dominant retailer, for example, might request resale price maintenance to forestall innovation that decreases cost. A manufacturer might consider it has little choice but to accommodate the retailer's demand for vertical price restraints if the manufacturer believes it needs access to the retailer's distribution network." (p. 2717)
- He continued:
  - "The manufacturer does not establish the practice to stimulate services or to promote its brand" but rather "supports a dominant, inefficient retailer." (pp. 2717, 2719)

12

The "Babies R Us" (BRU) Case (1)

- First case brought on these issues following the Leegin decision.
  - a class action brought against BRU and various suppliers of certain baby products for enforcing Resale Price Maintenance.*
- The first question to be decided was whether the class should be certified.
  - answering that question required a more extended analysis than when the case was first brought in 2007.
  - a subsequent decision ruled that trial courts "must resolve all factual and legal disputes relevant to class certification, even if they overlap with the merits" of the case.
  - more was required than merely a "threshold showing."

* McDonough et al. v. Toys R Us et al., Eastern District of Pennsylvania, 2009.

13

The "Babies R Us" (BRU) Case (2)

- BRU was the dominant re-seller of various "high-end" baby products: strollers, car seats, high chairs, baby carriers and breast pumps. The leading brands were highly advertised with considerable consumer acceptance.
- Other large retailers such as Wal-Mart, Sears and Target did not distribute these brands but emphasized more generic products.
- BRU faced a new set of rivals, internet retailers, who cut prices and increased their quantities sold. In response, BRU pressured its suppliers to impose or enforce RPM restraints.
  - internet prices increased and their sales of these brands declined. The judge found that "the restraints caused higher prices." (p. 35)

14

The "Babies R Us" (BRU) Case (3)

- The judge reached various conclusions on the merits of the case:
- BRU coerced its suppliers to impose RPM to protect itself from price discounting by internet retailers.
- BRU's prices were therefore higher than they would otherwise have been.
- When restraints are coerced by a distributor, they are not established to "stimulate services or promote…[a manufacturer's] brand."
- Since manufacturers paid BRU for many of the services supplied to consumers, and since many were integral to BRU's business model, they did not require restraints to offer them.

15

Conclusions

- The BRU case dealt directly with intertype competition between established distributors and internet retailers.
- Antitrust intervention was needed to maintain the active presence of independent internet retailers.
- The language contained in the Supreme Court's Leegin decision proved essential for this result.

16