

Economists' Corner: Weighing the Procompetitive and Anticompetitive Effects of RPM Under the Rule of Reason

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Antitrust policy toward minimum resale price maintenance (RPM)—an agreement between a manufacturer and retailers to sell the manufacturer's product at or above a specified retail price—has shifted over the past hundred years from one of *per se* illegality to rule of reason assessment. In 1911, *Dr. Miles* established that RPM agreements were *per se* illegal under Section 1 of the Sherman Act.¹ Over time, the courts have shifted to a rule of reason assessment for other types of vertical restraints, including non-price restraints² and maximum resale price maintenance.³ However, it was not until 2007 that the Supreme Court ruled in *Leegin* that minimum RPM (henceforth referred to as "RPM") agreements should be evaluated under the rule of reason, acknowledging that RPM may in fact have procompetitive benefits that should be weighed against any alleged anticompetitive harm.⁴

Despite *Leegin*, the legal landscape on RPM is still far from clear. As of yet, no federal court has issued a decision involving a full rule of reason analysis of the merits in an RPM case. A number of states have continued to follow pre-*Leegin* precedent (e.g., California) or even issued new statutes expressly treating RPM as a *per se* violation (e.g., Maryland), while others have declined to revisit pre-*Leegin* decisions.

In this article, we discuss the potential procompetitive benefits and anticompetitive harms contributing to the debate over RPM. In addition, we

outline methods to evaluate these effects in practice using case-specific facts.

Potential Benefits of RPM to Consumers

Competition between manufacturers that sell their products through multiple independent downstream retailers is characterized by both intrabrand competition (i.e., competition among sellers of the same product) and interbrand competition (i.e., competition among different products). Intrabrand competition may lead to freeriding by some retailers, which can discourage other retailers from providing valuable information and services, decreasing non-price competition between products and diminishing interbrand competition.

RPM can be a means for firms to reduce intrabrand freeriding and promote interbrand competition by preventing retailers from undercutting the price charged by retailers offering demand-inducing services.⁵ The ability of a manufacturer to set a minimum resale price can preserve a retailer's incentive to invest in and provide such services, which may be underprovided in the absence of RPM. For instance, low margins resulting from freeriding may cause some retailers to cut back on demand-inducing services, whereas higher margins under RPM may encourage retailers to promote a product over its rivals or offer more promotion and servicing of the product. Therefore, RPM may increase the sales of the manufacturer's product relative to other brands, enhancing interbrand competition.

¹ *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 200 U.S. 373 (1911).

² *Continental T.V. Inc v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

³ *State Oil Co. v. Khan*, 522 U.S. 3 (1997).

⁴ *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 887 (2007).

⁵ The Supreme Court states in *Leegin* that "Minimum resale price maintenance alleviates [freeriding] because it prevents the discounter from undercutting the service provider." *Leegin*, 551 U.S. 887 (2007) at 888.

Intrabrand freeriding may occur when there are heterogenous retailers selling the same product. Consider, for example, running shoes that are sold at both a brick-and-mortar retail store and through a competing online retailer. The brick-and-mortar store may invest in training its salespeople to assess a customer's running gait so they can recommend an appropriate shoe. This investment benefits consumers, who receive valuable services and information, as well as the manufacturer, who benefits from the salesperson conveying information about its product's attributes to the end customer. However, since these services are costly to provide, the brick-and mortar-retailer will only choose to do so if the investment increases the product's profitability.

An online retailer may engage in intrabrand freeriding by selling the same shoes at a lower price than the brick-and-mortar store, while relying on the services of the brick-and-mortar store to promote and stimulate demand for the shoes. If customers learn which shoe is best for them from the brick-and-mortar store but then purchase it from the lower-priced online retailer, the online retailer benefits from the investments made by the brick-and-mortar store at no cost. However, this freeriding diminishes the incentive for the brick-and-mortar store to provide the welfare-enhancing services described above. Over time, this can lead the brick-and-mortar store to drop the product, which ultimately means less retail competition among competing products sold by different manufacturers.

More generally, manufacturers may use RPM to encourage non-price competition among retailers in instances when retailers may lower prices at the expense of services, resulting in their under-provision, even in the absence of freeriding. For instance, RPM may facilitate market entry by new firms. By implementing an RPM agreement, a new manufacturer may be able to induce retailers to make investments in the promotion and distribution

of its product, which reduces the incumbent's advantage.

Potential Harms of RPM to Consumers

On the other hand, RPM may reduce consumer welfare by facilitating a manufacturer cartel. The goal of a manufacturer cartel is to increase wholesale profits through an increase in wholesale price. The efficacy of a cartel depends on its ability to detect and prevent manufacturer price deviations. If wholesale prices are difficult to observe but retail prices are not, an RPM agreement may help manufacturers coordinate wholesale prices. An RPM agreement reduces the incentive for a manufacturer to lower its wholesale price below the price set by the cartel by limiting the ability of retailers to pass wholesale price cuts on to consumers. Absent an increase in retailer services, a wholesale price cut would lead to a decrease in the manufacturer's unit price with no compensating increase in demand. In order to make a deviation from the cartel price profitable, a manufacturer would have to relax its RPM agreement as well, which may be easier for the cartel to detect than a change in wholesale price alone.⁶

Economic Tests to Weigh Competitive Effects

Determining whether a specific application of RPM is anticompetitive requires weighing the benefits and costs to consumers. A case-specific examination of economic data can reveal whether RPM is welfare-enhancing or reducing. In this section, we describe, at a high level, how economic analysis can be used to empirically test whether the motivation for RPM is procompetitive or anticompetitive.

Typically, price effects are one of the main benchmarks used to determine whether conduct is anticompetitive. One difficulty that arises when evaluating RPM is that a minimum RPM agreement may raise retail prices regardless of whether the outcome is procompetitive or anticompetitive, making retail price a poor indicator of

⁶ RPM may also be used to organize a retailer cartel. In this instance, retailers may agree to collude and then encourage

manufacturers to adopt RPM to disguise the cartel and discipline deviation.

anticompetitive conduct. Fortunately, economic theory provides a number of other testable outcomes that can be used to differentiate between the procompetitive and anticompetitive effects of RPM.

First, the impact of an RPM agreement on output can be used to differentiate procompetitive from anticompetitive conduct. As outlined above, a manufacturer may implement RPM to incentivize retailers to increase their investment in the promotion and servicing of its product, which benefits consumers. If the retailers' actions are successful, demand for the product should increase, leading the demand curve to shift out. An outward shift of the demand curve results in an increase in quantity and price, all else equal. On the other hand, if RPM is used to further a cartel, the demand curve is typically unaffected.⁷ Rather, the supply curve shifts in to accommodate the increase in price, which results in a decrease in quantity. Therefore, higher quantity during the period that an RPM policy is in place is evidence that the policy is procompetitive rather than anticompetitive.⁸

Another way to examine the competitive effects of RPM is to analyze the wholesale price charged by the manufacturer. An RPM agreement affects the resale price, which is received by the retailer, but RPM does not directly affect the wholesale price received by the manufacturer. In other words, RPM does not, by itself, indicate that the manufacturer is collecting a higher per-unit profit after implementing RPM. As noted above, a manufacturer's RPM policy may be welfare-enhancing if it increases retailer margin, thus providing retailers with an incentive to offer additional services to customers to stimulate sales of that manufacturer's products. An increase in the wholesale price with the implementation of RPM would, all else equal,

reduce retailer margins, decreasing the potential for RPM to encourage the provision of services and promotion.⁹ On the other hand, a constant or lower wholesale price during the RPM period is consistent with inducement of non-price competition. Thus, an examination of wholesale prices as well as output may indicate whether a specific RPM policy is consumer welfare-enhancing or reducing.

Even when a procompetitive rationale on the part of the manufacturer can be demonstrated, RPM may not ultimately benefit consumers if increases in services or quality do not outweigh the increase in price. It remains to be seen exactly how these factors will be measured and balanced in practice given the dearth of post-*Leegin* court decisions that have evaluated the competitive effects of RPM. However, future decisions may offer guidance.

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⁷ It is possible that an RPM agreement implemented by a cartel could affect the demand curve in some cases. For example, if the RPM price increases retailer margins, this may, as discussed above, incentivize retailers to provide additional services. However, all else equal, the cartel would prefer smaller retailer margins, since they increase the quantity sold and hence overall cartel profits. In addition, this will only have a positive effect on observed quantity if it outweighs the inward shift of the supply curve, which reduces the quantity supplied at a given price.

⁸ The reverse is not necessarily true. A manufacturer may implement RPM to stop an erosion of share, in which case stable

output, or even output that declines at a slower rate, may indicate a positive outcome. In addition, other factors besides RPM may influence volume over the RPM period.

⁹ Manufacturers may use RPM to target certain retailers, leading retailer margins to increase for some retailers and decrease for others. For example, the shoe manufacturer may set RPM to decrease the margins of the online discount retailer, while raising them for the brick-and-mortar store.