Supreme Court Overrules *Per Se* Rule Against "Vertical" Minimum Price Agreements between Manufacturers and their Distributors

TYLER A. BAKER AND CHRISTOPHER S. WALTON

June 28, 2007

On June 28, 2007, the Supreme Court issued its decision in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, No. 06-480, addressing the proper antitrust analysis of resale price maintenance under Section 1 of the Sherman Act, one of the most important federal antitrust statutes. In a 5-4 opinion by Justice Kennedy, the Court concluded that such arrangements must now be evaluated under a "rule of reason" standard, under which a plaintiff must demonstrate actual harm to competition from the challenged practice. In the process, the Court overruled one of its longest standing antitrust precedents, the *Dr. Miles* decision from 1911, which held that minimum resale price agreements between a manufacturer and its retailers are illegal *per se* (that is, without the need to prove actual harm to competition) under the Sherman Act. A team from Fenwick & West LLP led by Tyler Baker, Co-Chair of our Antitrust Group, represented Leegin in the Eastern District of Texas, the United States Court of Appeals for the Fifth Circuit, and in the Supreme Court

Leegin, the defendant in this case, is a small, family-owned manufacturer of women's fashion accessories under the "Brighton" trademark. Leegin sells its products primarily through a large number of small independently owned retail shops around the country. Leegin established a policy of only dealing with retailers who followed its suggested resale prices. Leegin felt that the policy was important because it gave the retailers the incentive to provide more promotion and service and because it assured customers that they could buy something that they liked without worrying about whether they would see it on sale somewhere else the next day. Following the adoption of the policy, Leegin's sales increased significantly.

PSKS, the plaintiff in the case, was a retailer of women's clothes and accessories in a Dallas suburb. It began to discount all of Leegin's products in violation of Leegin's policy. After being terminated by Leegin, PSKS claimed that the termination was the result of a *per se* illegal price fixing agreement between Leegin and its retailers in violation of Section 1 of the Sherman Act.

At trial, the jury found that Leegin's policy had become enshrined in several agreements, thus converting Leegin's *per se* legal "policy" into a *per se* illegal price fixing "agreement." In a very brief opinion, the Fifth Circuit affirmed, explaining that "[b]ecause the Court has consistently applied the *per se* rule to such agreements, we remain bound by its holding in *Dr. Miles & Co*." The Supreme Court then granted Leegin's petition for *certiorari* which urged the Court to reconsider and overrule *Dr. Miles*.

It is well-established that *per se* treatment is appropriately applied only to restraints "that would always or almost always tend to restrict competition and decrease output." If the type of restraint at issue would not be invalidated in almost all instances under the rule of reason, then *per se* treatment is inappropriate. Finding that the *Dr. Miles* Court justified its decision based on "formalistic" legal doctrine rather than "demonstrable economic effect," the majority examined the economic effects of resale price restraints to determine whether such agreements satisfy the demanding prerequisites for *per se* treatment.

The Court carefully studied academic economic literature, finding it "replete with procompetitive justifications for a manufacturer's use of resale price maintenance." Most significantly, it can stimulate inter-brand competition; that is, competition among manufacturers selling the same type of product. Resale price maintenance encourages retailers to invest in services they might otherwise find unprofitable because of other free-riding retailers able to charge lower prices by foregoing the same investments. Second, it can facilitate market entry by new manufacturers and brands, who can utilize price maintenance to induce the promotion and service necessary to establish products customers are unfamiliar with. Moreover, the risk of anticompetitive harm is reduced because consumers and manufacturers' interests are aligned. Manufacturers generally prefer low costs of distribution and will take steps to increase retailers' margins only where doing so makes the manufacturer's goods more attractive. Leegin's position was supported by briefs from a large number of leading antitrust economists and both federal enforcement agencies, the FTC and the Antitrust Division of the Department of Justice.

While recognizing that vertical price agreements can have procompetitive effects, the Court nonetheless acknowledged that "the potential anticompetitive consequences of vertical price restraints must not be ignored or underestimated." Resale price maintenance might also be used improperly by competing manufacturers or retailers to facilitate a horizontal cartel. Moreover, a powerful retailer might try to shield itself from innovative new distribution methods by demanding resale price maintenance.

Against this backdrop of competing economic effects, the majority had no trouble concluding that resale price maintenance fails to meet the qualifications necessary to justify *per se* treatment, and that such restraints are properly analyzed under a rule of reason.

The Court found reinforcement for this conclusion in its jurisprudence over the last thirty years. During this period, the Court has narrowed the number and scope of *per se* rules of illegality in a number of areas. This development has been particularly evident in the area of "vertical" restrictions between a manufacturer and its distributors. In the seminal decision in *Continental TV v. GTE Sylvania* in 1977, the Court held that vertical non-price restrictions, such as exclusive territories, are to be judged under the rule of reason. The Court's rationale in *Sylvania* was two-fold: First, manufacturers often have legitimate and pro-competitive reasons for wanting to control the distribution of their products. And, second, while such restrictions may harm competition in some circumstances, they are unlikely to do so in many common market conditions. Since *per se* rules are appropriate only where a practice is always or virtually always anti-competitive, the Court overruled an earlier decision imposing *per se* illegality. The reasoning in *Sylvania* led to a number of other important changes in the law. In *State Oil Co. v. Khan* 522 U.S. 3 (1997), the Court held that vertical maximum price agreements should be analyzed under the rule of reason. Similarly, in *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988), it held that agreements between a manufacturer and a retailer to terminate a "discounter" should be analyzed under the rule of reason, so long as there was no agreement as to the specific prices to be charged. The Court in *Leegin* found that these decisions undercut the foundation of *Dr. Miles*, which predated by many decades the modern economic understanding of vertical restrictions.

The Court also found that while manufacturers had options to work around *Dr. Miles*' prohibition on resale price maintenance, in many situations those options imposed unnecessary costs on consumers and risks of antitrust liability on manufacturers. For example, under the so-called *Colgate* doctrine, created by the Court shortly after *Dr. Miles*, a manufacturer can announce its "policy" of dealing only with retailers who follow the manufacturer's suggested prices and can terminate any dealer who fails to do so. This is so even though the purpose and effect of the "policy" is to achieve adherence by the retailers to the "suggested" prices. The danger for manufacturers, as the Court noted, is that a jury might conclude that a firm's policy was in fact an agreement, as happened to Leegin. As a result, manufacturers were led to take wasteful measures such as refusing to discuss pricing policies without aid from lawyers with knowledge of subtle legal intricacies. Likewise, *Dr. Miles* incentivized manufacturers to vertically integrate; not because of real market conditions benefiting consumers, but rather because ownership of distribution avoids the risk of being found to have agreed on prices.

The Court sketched out a few factors that will be important in analyzing vertical price restraints going forward. First, the number of manufacturers in an industry utilizing the practice is probative. If only a small number of manufacturers enter into resale price maintenance agreements, the risk of anticompetitive effect is small, since rival manufacturers will be able to undercut them. Second, courts will analyze whether the restraint originated from the retailer or the manufacturer. If the former, the odds are greater that the restraint exists to facilitate a cartel or entrench a dominant retailer. Finally, if either the manufacturers or the retailers lack market power, the possibility of anticompetitive effect is reduced. Rule of reason analysis is extremely fact-dependent, and no single factor is necessarily determinative. Indeed, the Court invited lower courts to work out the details of this test as it is applied in future cases.

The dissenting Justices did not attempt to justify *Dr. Miles* based on its reasoning in 1911. Rather, they stressed the importance of *stare decisis* (the importance of following existing case law) and the fact that in 1975 Congress had repealed statutes that allowed the states to permit vertical price agreements through so-called Fair Trade Laws. The majority's answer was that antitrust doctrine has always been treated as a common law process for which the Supreme Court is responsible. In repealing the Fair Trade Laws, the Congress had simply returned the law in that area to development by the Court, rather than freezing the law at that moment in time.

Suffice it to say, today's decision is good news for consumers and manufacturers, erasing what the Court described as "a flawed antitrust doctrine that serves the interests of lawyers-by creating legal distinctions that operate as traps for the unwary-more than the interests of consumers-by requiring manufacturers to choose second-best options to achieve sound business objectives." However, companies need to be careful in changing their practices in this area. The antitrust rules under some state laws may still impose automatic liability, and the risk of liability under the rule of reason is not trivial for some companies. Nevertheless, for many manufacturers who desire to control resale prices for legitimate business reasons, *Leegin* changes the legal landscape in a very important way.

Tyler A. Baker, Co-Chair, Antitrust and Unfair Competition Group
tbaker@fenwick.com, 650.335.7624

Christopher S. Walton, Associate, Litigation Group
cwalton@fenwick.com, 650.335.7269