

Comments of

THE AMERICAN ANTITRUST INSTITUTE

On the

EUROPEAN COMMISSION'S PROPOSED

BLOCK EXEMPTION REGULATION AND GUIDELINES

ON VERTICAL RESTRAINTS

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I. Introduction

The American Antitrust Institute (AAI) is an independent nonprofit education, research, and advocacy organization. Its mission is to promote vigorous antitrust enforcement, advance the role of competition in the American and global economies, and protect consumers. AAI's Advisory Board consists of over 90 prominent antitrust lawyers, law professors, economists, and business leaders.¹ AAI's Board of Directors has approved the filing of these comments because of AAI's intense interest in helping courts and competition law authorities develop an appropriate approach to the vertical intrabrand restraint that poses the greatest threat to competition, resale price maintenance (RPM).²

AAI has been deeply involved in the effort to fashion an appropriate approach to RPM and the closely related issue of buyer power. AAI submitted friend-of-the-court briefs to both the Supreme Court³ and the Fifth Circuit⁴ in the landmark *Leegin* litigation discussed below. AAI fellows and advisors have written numerous articles on RPM,⁵ and

¹ For a description of AAI's activities and personnel, see <http://www.antitrustinstitute.org>.

² AAI is managed by its Board of Directors, which alone has authorized this filing. The individual views of members of the Advisory Board may differ from the positions taken by AAI.

³ Brief of the American Antitrust Institute as *Amicus Curiae* in Support of Respondent, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, No. 06-480 (S. Ct. Feb. 26, 2007).

⁴ Brief for the American Antitrust Institute as *Amicus Curiae* in Support of Appellant and Reversal, *PSKS, Inc. v. Leegin Creative Leather Products, Inc.*, No. 09-40506 (5th Cir. Aug. 14, 2009).

⁵ See, e.g., Warren S. Grimes, *The Path Forward After Leegin: Seeking Consensus Reform of the Antitrust Law of Vertical Restraints*, 75 ANTITRUST L.J. 467 (2008); Marina Lao, *Resale Price Maintenance, The Free-Rider Explanation, and United States Antitrust Policy*, in HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (Robert Pitofsky ed., 2008); Richard M. Brunell, *Overruling Dr. Miles: The Supreme Trade Commission in Action*, 52 ANTITRUST BULL. 475 (2007); F.M. Scherer, *Comment on Cooper et al.'s "Vertical Restrictions and Antitrust Policy"*, 1 COMP. POLICY INT'L 65 (Autumn 2005); Robert L. Steiner, *How Manufacturers Deal With the Price-Cutting Retailer: When Are Vertical Restraints Efficient?*, 65 ANTITRUST L.J. 407 (1997); William S. Comanor, *Vertical Price Fixing and Market Restrictions and the New Antitrust Policy*, 98 HARV. L. REV. 1990 (1985); William S. Comanor & John B. Kirkwood, *Resale*

AAI's Director of Legal Advocacy has testified before Congress on legislation addressing RPM.⁶ AAI is now sponsoring research on RPM that will draw on new insights from the marketing literature and current distribution practices.⁷ An AAI Senior Fellow is editing a special issue of the *Antitrust Bulletin* on RPM,⁸ and AAI has sponsored two major symposia on buyer power.⁹ Because of this extensive engagement with RPM, other vertical restraints, and buyer power, AAI hopes that these comments will be especially useful to the European Commission.

We begin by commending the Commission for revising and updating its Block Exemption Regulation and Guidelines on Vertical Restraints, since vertical restraints, and particularly RPM, remain an important and controversial area of competition law. We also endorse the Commission's proposal to limit the block exemption to situations in which there is no significant market power at either the seller *or the buyer* level. This change is plainly desirable. The Commission should not exempt a vertical restraint from the coverage of Article 81 simply because there is no market power at the seller level. Even if no seller has significant power, a vertical restraint would harm consumers if a

Price Maintenance and Antitrust Policy, 3 CONTEMP. POLICY ISSUES 9 (1985); F.M. Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983).

⁶ Statement of Richard M. Brunell before the Senate Judiciary Committee, Subcommittee on Antitrust, Competition Policy, and Consumers Rights, regarding the Discount Pricing Consumer Protection Act, S. 148, May 19, 2009.

⁷ Gregory T. Gundlach, Joseph Cannon & Kenneth Manning, *Understanding the Antitrust Implications of Resale Price Maintenance: Insights from Marketing Research and Practice*, American Antitrust Institute Working Paper (in progress).

⁸ *Antitrust Analysis of Resale Price Maintenance After Leegin*, ANTITRUST BULL. (Gregory T. Gundlach ed., forthcoming 2010).

⁹ *Buyer Power in Antitrust*, 53 ANTITRUST BULL. 233 (Gregory T. Gundlach & Albert A. Foer, eds. 2008); *Symposium: Buyer Power and Antitrust*, 72 ANTITRUST L.J. 505 (2005). See also Albert A. Foer, *Mr. Magoo Visits Wal-Mart: Finding the Right Lens for Antitrust*, 39 CONN. L. REV. 3107 (2007).

buyer has substantial power and forced sellers in the market to adopt the restraint in order to insulate the buyer from competition.¹⁰ Buyer-induced restraints are of increasing concern, moreover, since concentration at the retail level is growing and many retailers today possess considerable power.¹¹

Most important, we agree with the Commission’s decision to continue to characterize RPM as a “hardcore restriction” that presumptively violates Article 81(1). In the United States, the Supreme Court recently weakened the law governing RPM by overruling *Dr. Miles*,¹² discarding the long-standing per se rule, and substituting the more permissive rule of reason.¹³ AAI opposed that change¹⁴ and recently testified in support of legislation that would overturn *Leegin* and restore the per se ban.¹⁵ In the absence of such legislation, AAI will urge the lower courts to take up the Supreme Court’s invitation to “establish the litigation structure to ensure that the rule [of reason] operates to eliminate anticompetitive restraints from the market.”¹⁶ One way to establish such a structure, as the Court noted, is to create presumptions.¹⁷ The Commission’s

¹⁰ See PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1620.1 (Supp. 2008) (“in a case of RPM imposed by a powerful dealer, the relevant power is that of the dealer in the market in which it purchases”).

¹¹ See *The New Kid on the Block: Buyer Power, in THE NEXT ANTITRUST AGENDA: THE AMERICAN ANTITRUST INSTITUTE’S TRANSITION REPORT ON COMPETITION POLICY TO THE 44TH PRESIDENT* (Albert A. Foer, ed. 2008). See also *Toys “R” Us, Inc. v. Fed. Trade Comm’n*, 221 F.3d 928 (7th Cir. 2000) (condemning a nonprice vertical restraint initiated by a retailer with market power).

¹² *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

¹³ See *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007).

¹⁴ See *supra* note 3.

¹⁵ See *supra* note 6.

¹⁶ *Leegin*, 127 S. Ct. at 2720. For AAI’s first effort in this regard, see note 4 *supra*.

¹⁷ *Id.*

presumption of illegality, therefore, is not only an appropriate standard on the merits but can also serve as a model for the U.S. courts,¹⁸ especially if it is strengthened as we recommend in these comments.

A presumption of illegality is appropriate for RPM because it frequently poses a significant threat to competition and its efficiency benefits, if any, can often be achieved through less restrictive alternatives. It is entirely reasonable, therefore, to presume that the practice is anticompetitive unless the seller can justify it. While a seller may be able to do so in some instances, we demonstrate in these comments that the necessary showing is often quite difficult to make. As a result, we recommend that the Commission make clear in the final version of its Guidelines not only that RPM is presumptively illegal but also that the presumption is strong and that the Commission will approach with skepticism any claim that RPM is desirable. This change would enhance enforcement of Article 81, improve the protection of consumers, and align the Commission's Guidelines more closely with its actual practice.¹⁹

In the remainder of these comments, we analyze the justifications for RPM set forth in the proposed Guidelines – the specific justifications for RPM in ¶ 221 and the general justifications for all vertical restraints, including RPM, in ¶ 103. We conclude that most of these justifications are questionable, at least for RPM. Some do not apply to

¹⁸ See Luc Peepkorn, *Resale Price Maintenance and Its Alleged Efficiencies*, 4 EUR. COMP. J. 201, 204 (2008) (“the *Leegin* judgment opens up the possibility for the lower courts in the US to follow the EU practice”).

¹⁹ See Peepkorn, *supra* at 212 (describing the presumption of illegality for RPM as “strong”) & 204 (stating that in the case of a hardcore restriction, the EC takes a “critical look at the claimed efficiencies”). In these comments, we will refer to a single presumption of illegality even though the proposed Guidelines sometimes refer to two presumptions – a presumption that an agreement containing a hardcore restriction “falls within Article 81(1)” and a presumption that such an “agreement is unlikely to fulfill the conditions of Article 81(3).” See, e.g., ¶ 47. We combine these two presumptions into one because it simplifies the discussion and matches the Commission's usage at other points. Later in ¶ 47, for example, the Commission refers to a single “rebuttable presumption” of illegality.

RPM at all or are so weak that they should be rejected unless the seller presents compelling evidence of consumer benefit. The most frequent justification in the literature (free riding) appears unlikely to excuse RPM in many cases, either because there are no free-rideable services involved, because the free riding is not so extensive that it undermines the incentives of other distributors to provide services, or because free riding can be forestalled more effectively and with less threat to competition through alternative means. Finally, while some justifications are plausible (e.g., the promotion of new entry), they are temporary in nature and can often be achieved without RPM. Our analysis indicates, in short, that the Commission should strongly presume that RPM is illegal and should regard all but a few limited justifications as dubious.

II. Specific Justifications for RPM

In the proposed Guidelines, the Commission addresses RPM in ¶¶ 219-225. In ¶ 221 the Commission identifies three possible justifications for this hardcore restriction: (1) introduction of a new brand or entry of a new firm, (2) coordination of a low price campaign in a franchise system or similar distribution system, and (3) prevention of loss-leader pricing. As we explain, the Commission need not approach the first two justifications with skepticism, since they are time limited, can be valid in some cases, and are unlikely to involve significant competitive risks. The third justification, however, is quite weak and should not be accepted without convincing evidence of consumer benefit.

A. New Brand or New Entry

The proposed Guidelines state that “where a manufacturer introduces a new brand or enters a new market, RPM may be helpful to induce distributors to better take into

account the manufacturer's interest [in] developing demand for the product."²⁰

Distributors may be reluctant to carry a new brand without RPM because they must promote it in order to help it become established. But if their promotions are successful, other distributors will also want to carry the product and they did not incur the initial promotional costs. As a result, they could undercut the initial distributors and prevent them from recouping their outlays. RPM can forestall this inefficient scenario by inhibiting, as Steiner puts it, "Johnny-come-lately" stores from siphoning off the rewards that pioneering dealers need for their "missionary work."²¹

This justification, a specific manifestation of the free rider justification discussed below, is plausible and appealing. Even some proponents of a per se prohibition on RPM are willing to create an exception for new entry.²² After all, the exception is time limited (it would allow RPM only until the new brand or new firm is established);²³ it is relatively easy to identify; and it is unlikely to permit many firms in a market to use RPM at the same time, thus reducing the danger of collusion.

The Commission need not, therefore, approach this justification with skepticism. But it should ask, as it must ask with any free rider justification, whether and to what degree the problem could be solved through a less restrictive alternative. Many commentators have observed that free riding on pioneering dealers' promotional efforts can be reduced, if not eliminated, through nonprice restraints such as selective

²⁰ Draft Guidelines ¶ 221.

²¹ Steiner, *supra* at 430.

²² See, e.g., Robert Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing*, 71 GEO. L.J. 1487, 1495 (1983).

²³ Peepkorn, *supra* at 211 ("this is not a justification to allow RPM for a long period, or . . . for established brands").

distribution²⁴ or through up-front payments or other incentives to the pioneering dealers.²⁵ In addition, rather than relying on dealers to create demand, manufacturers may create demand for a new product themselves, through advertising or other consumer-directed marketing.

B. Coordination of Low Price Campaign

The proposed Guidelines also state that “fixed resale prices . . . may be necessary to organize in a franchise system or similar distribution system a coordinated short term low price campaign which will . . . benefit the consumers.”²⁶ This justification is also plausible: without RPM some of the members of the distribution system might charge less than the advertised price, which could diminish the impact of the campaign. Like the new brand/new entry justification, moreover, this potential efficiency is time limited,²⁷ and is unlikely to involve many sellers in a market at the same time. Here too, however, the Commission must ask whether a franchisor or other seller could implement a low price campaign without RPM, since if the distributors normally charge a price substantially above the price the seller wants to advertise, the seller could bring its dealers into line by fixing a *maximum* resale price rather than a *minimum* price.²⁸

²⁴ See, e.g., VIII PHILLIP A. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1617a3 (2d ed. 2004) (while the new entry rationale makes sense as a justification for exclusive territories, it “seems presumptively inapplicable to resale price maintenance”).

²⁵ See, e.g., Peepkorn, *supra* at 212 (“it seems more efficient, both for the manufacturer and for the consumers, if the manufacturer rewards the investments made by the first distributor through a lump sum payment”).

²⁶ Draft Guidelines ¶ 221.

²⁷ See *id.* (such a campaign would last no more than “2 to 6 weeks in most cases”).

²⁸ Unlike RPM, maximum resale price fixing is not a hardcore restriction. See Article 4(a) of the proposed Block Exemption Regulation.

C. Prevention of Loss-Leader Pricing

Finally, the proposed Guidelines indicate that RPM may be justified where it forecloses “a large distributor [from using] a particular brand as a loss leader.”²⁹ Unlike the two prior justifications, however, this asserted efficiency is highly questionable. In the first place, as the Guidelines acknowledge, loss-leader pricing brings direct benefits to consumers. It lowers the price of the loss-leading product, and like other forms of promotion, it can lead consumers to make beneficial purchases of other products.

As the draft Guidelines also note, loss-leader pricing may cause retailers who specialize in this category of products to delist the loss-leader brand, reducing consumer choice. If that happens, moreover, the retailers who still carry the brand may be able to collude, tacitly or expressly, to raise the brand’s price above the competitive level. There is no evidence, however, that such harms frequently occur or, if they do, that they outweigh the benefits to consumers of loss-leader pricing. Areeda and Hovenkamp state: “[N]o one has yet adduced any empirical evidence that the hypothesized evils of loss-leader selling occur with any frequency. Vague complaints of ‘unfair loss-leader tactics’ are much more common than actual examples of consumer acceptance being destroyed, rival dealers ruined, or manufacturers prejudiced.”³⁰

For this reason, we recommend that the Commission refuse to accept the avoidance of loss-leader pricing as a justification for RPM absent a demonstration by the firm that (1) such pricing is likely to injure consumers in the long run by reducing their options or raising the prices they pay, and (2) this long-run injury is likely to outweigh

²⁹ Draft Guidelines ¶ 221.

³⁰ VIII AREEDA & HOVENKAMP, *supra* at ¶ 1619; *see also id.* at ¶ 1633d (rejecting loss leading as a justification for RPM, at least presumptively).

the short run gains from loss-leader pricing. In short, this asserted justification is weak and should not be accepted without compelling evidence of net consumer benefit.

III. General Justifications for Vertical Restraints

Under the proposed Guidelines, the specific justifications identified in ¶ 221 are not the only possible efficiency justifications for RPM. In ¶ 47, the Guidelines make clear that a seller using a hardcore restriction like RPM may rebut the presumption of illegality by establishing an efficiency defense under Article 81(3), and footnote 25 indicates that the seller may do so through proof of any of the “general possible efficiencies related to vertical restraints” in ¶ 103.

In ¶ 103, the draft Guidelines list nine possible efficiencies that could “justify the application of certain vertical restraints.”³¹ One, “open up or enter new markets,” is the same as the second specific justification for RPM in ¶ 221. The other eight potential justifications are not mentioned in ¶ 221, suggesting that all eight can be achieved without RPM.³² In the following sections, we show that these eight efficiencies can in fact be promoted by nonprice restraints. Then we show that such nonprice restraints typically pose less of a threat to competition than RPM. Together, these two propositions indicate that in most cases, RPM is unlikely to be justified by one of the eight efficiencies, either because the efficiency does not apply or because a less restrictive alternative is available.

³¹ The Guidelines also state that while the list is not “complete or exhaustive,” it does try to “give a fair overview of the various justifications for vertical restraints.” Draft Guidelines ¶ 103.

³² Indeed, in explaining how vertical restraints can promote the efficiencies described in ¶ 103, the proposed Guidelines do not even mention RPM, even when discussing the new entry justification. That underlines the point we made earlier that RPM may not be necessary to promote new entry.

In some cases, of course, RPM may be more effective than any nonprice restraint in achieving a particular efficiency. In these or other cases, moreover, the competitive risks may be low because only a few sellers use RPM and neither they nor their distributors have significant market power. Because of these possibilities, it is reasonable to allow a seller to rebut the presumption of illegality by demonstrating that its adoption of RPM is likely to be procompetitive and superior to any alternative. In general, however, the prospects of a net procompetitive effect are sufficiently unlikely that the Commission should be wary of accepting any of the eight potential efficiencies as a justification for RPM.

A. The Efficiencies in ¶ 221 Can Often be Achieved, Sometimes Much More Effectively, Through Nonprice Restraints

1. Economies of Scale in Distribution

We begin with this possible efficiency not only because it can be attained by a variety of nonprice restrains, but also because it *cannot* be attained by RPM, absent some other efficiency. If there is no other efficiency at work, the imposition of RPM by a seller will simply cause its distributors to raise their prices, which will hurt their sales and make it more difficult for them to achieve economies of scale. If a seller wants to help its dealers exploit economies of scale in distribution, it must take steps to increase their output, not reduce it. As the proposed Guidelines point out, these steps include “exclusive distribution, quantity forcing in the form of a minimum purchasing requirement, selective distribution containing such a requirement or exclusive sourcing.”³³

³³ Draft Guidelines ¶ 103 (7).

2. Free Riding

In contrast, RPM may help in “solving a free-rider problem,” the first potential efficiency listed in ¶ 103 and the most common justification offered in the literature for a variety of vertical restraints. As the Commission and numerous commentators have observed, however, a seller offering free riding as a justification for RPM must overcome two major hurdles.³⁴

First, the seller must show that “there [is] a real free-rider issue.”³⁵ That is, the seller must prove that its dealers actually provide pre-sale services or other promotional activities for which they could not charge separately; that absent RPM, some dealers would free ride on those activities; and that this free riding would be so extensive that it would impair the ability of other dealers to profitably offer the services. As Lao points out, those conditions are not common, since “very few products require dealer demonstrations, consumer education, operational expertise, special showrooms and the like for effective marketing, and few dealers actually provide any such services.”³⁶ Likewise, the Guidelines note that free riding is not possible on “after-sales services for which the distributor can charge its customers individually.”³⁷ Areeda and Hovenkamp declare: “[U]nrestrained intrabrand competition does not lead to substantially detrimental free riding when dealers provide no significant services (such as drugstores selling toothpaste), the services they do provide cannot be utilized by customers who patronize

³⁴ See *id.* at ¶ 103 (1); Lao, *supra*; Grimes, *supra* at 476-79.

³⁵ Draft Guidelines ¶ 103 (1).

³⁶ Lao, *supra* at 201; see also *id.* at 200 (“the classic free rider hypothesis, though theoretically valid, has limited applicability”).

³⁷ Draft Guidelines ¶ 103 (1).

other dealers (luxurious ambience), the services are paid for separately (post-sale repair), the services provided are not brand specific and are fully supported by a wide range of products (high-quality department store), the services can be provided efficiently by the manufacturer (advertising), or a sufficient number of consumers patronize the dealers from whom they receive the service.”³⁸ Grimes agrees and concludes that the “economic evidence suggests that free-riding on pre-sale services is not all that widespread.”³⁹

Second, even if free riding is a legitimate and significant problem, a seller must prove that it cannot solve or substantially mitigate the problem through some arrangement short of RPM. The most obvious step is simply to require dealers, as a condition of retaining their dealerships, to provide the desired services. Alternatively, a seller could agree to pay its dealers – in the form of promotional allowances or other stipends – when they perform the desired services. Either set of contractual arrangements (or a combination of the two) could induce most dealers to furnish the services the seller wants, even if some dealers are willing to free ride.⁴⁰

To be sure, it may be difficult for a seller to identify or specify exactly which services its distributors should perform. As a result, a seller may fail to mandate or pay for all the services it prefers, and free riding on these unspecified additional services may

³⁸ VIII AREEDA & HOVENKAMP, *supra* at ¶ 1601e.

³⁹ Grimes, *supra* at 476. *See also* Brief for William S Comanor & Frederic M. Scherer as *Amicus Curiae* Supporting Neither Party, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, No. 06-480 (S. Ct. Jan. 22, 2007), at 6 (“There is skepticism in the economic literature about how often” RPM “is needed to prevent free-riding and ensure that desired services are provided”). Grimes notes that if free riding is not a significant problem, dealers will have plenty of incentive – without RPM – to provide the services the manufacturer wants, since if those services increase sales, the dealer will profit. Grimes, *supra* at 477 (“if such services really help a dealer make sales, the dealer has a built-in incentive to offer them”).

⁴⁰ *See Toys “R” Us, Inc. v. Fed. Trade Comm’n*, 221 F.3d at 933, 938 (rejecting a free rider defense because the services performed by the retailers, such as advertising, warehousing, and full-line stocking, were compensated by the manufacturers).

discourage its distributors from providing them. But RPM is unlikely to be the answer to this problem, since, as we now understand, distributors subject to RPM can still engage in free riding. While RPM prevents them from lowering the price of the seller's product, it does not require that they perform any services, and does not preclude them from diverting business from other distributors by offering free shipping, free samples of other products, bundled discounts, or other benefits. As a result, a seller cannot rely on RPM to eliminate free riding among its dealers.⁴¹

If free riding is a serious problem, a seller needs to curb all significant forms of it, a goal it can accomplish in many cases by curtailing competition among its dealers through exclusive territories, exclusive distributorships, or other forms of selective distribution. As Grimes points out: "The vertical restraints that are most likely to limit or prevent free-riding on pre-sale promotion are those that narrow or limit distribution, such as location clauses or exclusive territories."⁴² There is no substantial empirical evidence that these alternatives to RPM are more costly or less effective in stimulating dealer services.⁴³

⁴¹ See Peeperkorn, *supra* at 209:

RPM does not take away the underlying free rider problem. The "dominant strategy," as it is called in game theory, is still for each distributor not to invest in promotion but to free ride on possible investments made by others and pocket the higher margin. Instead of using the extra margin for promotion, a distributor will in practice prefer to invest in other means of attracting customers, means not hindered by free riding, such as offering lower-priced after-sales services or lowered prices achieved through bundling.

RPM will thus not lead to extra promotion outlays, or will do so only to a limited extent; it is not an efficient instrument for obtaining the desired efficiency.

⁴² Grimes, *supra* at 477. See also Peeperkorn, *supra* at 209 ("Other vertical restraints, such as providing exclusive territories, are much better equipped to solve the free riding problem" than RPM). A manufacturer can also reduce free riding by distributing different variations of its products through different dealer classes (e.g., one brand for warehouse stores and a variant for full-service retailers).

⁴³ See VIII AREEDA & HOVENKAMP, *supra* at ¶ 1632b ("there are few documented instances of significantly impaired distribution" as a result of the per se ban on RPM). To be sure, selective distribution

Given the weaknesses of RPM, the best method of stimulating dealer services may be to combine some form of selective distribution and with some type of contractual requirement or inducement. By coupling nonprice restraints with contractual carrots or sticks, in other words, a seller may be able to maximize its distributors' incentives to provide the desired services. While some commentators have suggested that the ideal in retail markets is a combination of contractual requirements and RPM,⁴⁴ there is no systematic evidence that this route is superior. Further, because it involves RPM rather than nonprice restraints, it is likely in many cases to present greater competitive dangers.⁴⁵

may have its own drawbacks. If most sellers practice selective distribution, for example, some individual dealers may not carry a full array of competing brands, making it more difficult for customers to engage in comparison shopping. In retail markets, moreover, it may not be possible to use one form of selective distribution – exclusive territories. Yet, as our comments demonstrate, the alternative to selective distribution – unrestricted distribution with RPM – is likely in many cases to be less effective in stimulating dealer services and more effective in reducing price competition.

⁴⁴ See Benjamin Klein & Kevin Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. ECON. 265 (1988).

⁴⁵ Research sponsored by AAI appears to be uncovering additional reasons to doubt the free rider justification for RPM. See Gundlach, Cannon & Manning, *supra* (research to date, though tentative, suggests that (1) concerns about free riding by Internet retailers may be misplaced, since more consumers may gather information on the Internet and then purchase at brick-and-mortar stores than the reverse; (2) compared to the benefits of multi-channel marketing, distribution, and retailing, the costs of free riding may be overstated; and (3) the use of RPM to safeguard against free riding may result in more harm than good).

Grimes points out, moreover, that even if RPM is successful in inducing dealers to increase their promotional activity, the consequences may not be desirable. Suppose, for example, that only some manufacturers in a market use RPM and it elevates dealer margins on their brands relative to other brands. This differential may lead dealers to promote the price-fixed brands over other brands, even though there is no difference in quality. The result may be to mislead consumers. See Grimes, *supra* at 485 (when only some brands in a market are subject to RPM, “there is a heightened risk of . . . deceptive or misleading promotion”). Moreover, if other manufacturers respond by adopting RPM themselves and dealers promote their brands as well, the ensuing welter of promotional activity could be self-defeating, generating little increase in overall consumer demand but raising retail prices across the board. See *id.* at 484 (“if the restraint is widely employed, no supplier may benefit from its use”); see also Comanor & Scherer Amicus Brief, *supra* at 9 (widespread dealer promotional efforts would “largely cancel each other out in the aggregate” with “relatively little if any expansion of demand”).

3. Free Riding on Certification

The proposed Guidelines also mention a variant on the free rider problem – the “certification free rider issue” – which arises when certain retailers in an industry have a recognized reputation for stocking only high-quality products. If several of these retailers carry the seller’s product but the seller imposes no restrictions on distribution, other retailers may free ride on the “certifying” retailers’ reputation, diverting business from them and causing them to delist the product.⁴⁶ While RPM might reduce this problem, it is unlikely to be as effective as some form of selective distribution, for the reasons mentioned above. Indeed, the Guidelines already recognize this point. After describing the certification free rider issue, they state that it may provide “a reason for allowing for a limited duration a restriction such as exclusive distribution or selective distribution.”⁴⁷

4. Other Possible Efficiencies

The same analysis applies to the other potential justifications described in ¶ 103: hold-up problems, vertical externalities, capital market imperfections, etc. All can be achieved, generally more effectively, through a nonprice restraint rather than through RPM. Accordingly, because RPM often poses greater competitive risks than a nonprice restraint, the Commission should be reluctant to accept any of the potential efficiencies in ¶ 103 (other than new entry) as a justification for RPM.

⁴⁶ See Draft Guidelines ¶ 103 (3).

⁴⁷ *Id.* See also Lao, *supra* at 204 (“free riding is not harmful to social welfare unless it is so pervasive that it interferes with the availability of the service or product. Whether that happens often with respect to reputation free riding cannot be easily answered empirically. There is certainly no demonstration that it does”).

B. RPM Typically Poses a More Serious Threat to Competition Than Nonprice Restraints

Areeda and Hovenkamp state: “[T]here is a strong consensus that RPM poses greater threats to competition than do most nonprice restraints, perhaps significantly greater.”⁴⁸ The reason is that RPM prevents dealers from lowering product prices and thus directly interferes with their ability to engage in price competition with other dealers, including dealers that sell competing brands. While nonprice restraints limit all forms of competition among dealers *of the same brand*, they do not prevent a dealer in one brand from engaging in price competition with a dealer *of another brand*.⁴⁹ RPM, however, precludes dealers from reducing product prices and as a result, poses the greatest threat to interbrand price competition.⁵⁰

Because of this threat, there is widespread agreement that RPM generally results in higher prices for consumers, has facilitated collusion at the manufacturer or dealer level, and precludes more efficient dealers from passing on their cost savings to consumers in the form of lower product prices.

1. Higher Prices

The purpose of RPM is to raise resale prices. All of the asserted justifications for RPM depend on its ability to raise resale prices, and there is little dispute that RPM has

⁴⁸ AREEDA & HOVENKAMP SUPP., *supra* at ¶ 1620.1. *See also* VIII AREEDA & HOVENKAMP, *supra* at ¶ 1630b (“It is . . . entirely reasonable to regard resale price maintenance as a more pervasive threat to competition than nonprice restraints”).

⁴⁹ VIII AREEDA & HOVENKAMP, *supra* at ¶ 1630b (RPM prevents dealers “from engaging resellers of other brands in price competition”).

⁵⁰ As noted earlier, RPM does not completely forestall interbrand price competition. Dealers subject to RPM may be able to offer free shipping, bundled discounts, or free samples of other brands. They cannot, though, practice the most direct and important form of price competition – reducing the price of the product.

generally had this effect.⁵¹ Studies of the “fair trade” era in the U.S. (a period in which states could allow RPM within their borders) show that prices of items subjected to fair trade were significantly higher in states where fair trade was permitted than in states where RPM remained illegal, and that fair trade cost consumers several billion dollars a year.⁵² Other studies have found that when sellers ended RPM in major industries like light bulbs, retail drugs, and blue jeans, consumers realized substantial savings.⁵³ The Federal Trade Commission estimated that record companies’ efforts to restrain resale prices of CDs caused consumers to pay as much as \$480 million more.⁵⁴

To be sure, the higher prices produced by RPM would not harm consumers if the practice was necessary to generate services that most consumers judged to be worth the extra money. But the ample evidence that RPM has consistently raised prices to consumers makes it reasonable to place the burden on the seller of showing that its adoption of RPM actually benefited rather than harmed consumers and that no other method of distribution would have produced greater net benefits.⁵⁵

⁵¹ Brunell, *supra* at 496-97; VIII AREEDA & HOVENKAMP, *supra* at ¶ 1604b (RPM “tends to produce higher consumer prices than would otherwise be the case. The evidence is persuasive on this point”).

⁵² See H.R. Rep. No. 341, 94th Cong., 1st Sess. 3 (1975).

⁵³ See Scherer (2005), *supra* at 72-74.

⁵⁴ See Fed. Trade Comm’n, Record Companies Settle FTC Charges of Restraining Competition in CD Music Market, May 10, 2000, *available at* <http://www.ftc.gov/opa/2000/05/cdpres.htm>.

⁵⁵ See Draft Guidelines ¶ 118 (for a vertical restraint to be excused under Article 81(3), the “agreement must produce objective economic benefits, the restrictions on competition must be indispensable to attain the efficiencies, consumers must receive a fair share of the efficiency gains, and the agreement must not afford the parties the possibility of eliminating competition in respect of a substantial part of the products concerned”).

2. Price Collusion

Because of RPM's adverse impact on interbrand price competition, it may generate anticompetitive effects that exceed any efficiencies it creates. In particular, it may facilitate price collusion among manufacturers or dealers. As the draft Guidelines point out, RPM makes it easier for manufacturers to collude, tacitly or explicitly, in several ways.⁵⁶ One of the most obvious is that RPM greatly reduces the propensity of dealers to engage in price wars among themselves. This helps manufacturers collude because if price wars break out among dealers, they will tend to seek relief by asking for price cuts from their suppliers, undermining price stability at the manufacturing level.⁵⁷ As a Wal-Mart executive observed, "I don't have any question but that competitive pricing at the retail level creates more pressure on manufacturers' factory prices than is present when they're able to set retail prices as well."⁵⁸

RPM is an even more effective tool for cementing collusion at the distributor level, since it eliminates the most direct form of price competition among dealers, price competition on product prices.⁵⁹ Because of its utility as a cartel support tool, a "wealth of history shows that dealers have attempted to use RPM imposed by suppliers to facilitate horizontal dealer collusion."⁶⁰ Indeed, some of the best-documented instances

⁵⁶ See Draft Guidelines ¶ 220 ("RPM may facilitate collusion between suppliers by enhancing price transparency in the market . . . RPM also undermines the incentive for the supplier to cut its price to its distributors").

⁵⁷ VIII AREEDA & HOVENKAMP, *supra* at ¶ 1606c (noting "instances in which intense price competition at the dealer level has led to price cuts at the manufacturing level").

⁵⁸ S. Robson Walton, *Antitrust, RPM, and the Big Brands: Discounting in Small-Town America (II)*, 15 ANTITRUST L. & ECON. REV. No. 2, at 11, 16 (1983).

⁵⁹ See Draft Guidelines ¶ 220 ("Strong or well organized distributors may be able to force/convince one or more suppliers to fix their resale price and thereby help them stabilize a collusive equilibrium").

⁶⁰ HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY* 451 (3rd ed. 2005).

of RPM in history have involved dealer cartels, including the well-known retail druggist cartel.⁶¹ In contrast, nonprice restraints, which by definition do not fix product prices, are less effective in facilitating explicit or tacit price collusion at the dealer level.⁶²

3. More Efficient Dealers

RPM inhibits the development of more efficient forms of distribution because it prohibits a more productive or innovative distributor from passing on the benefits of its superior efficiency in lower product prices.⁶³ This obstacle to economic progress has frequently been noted. Steiner observed that “growth of . . . more efficient new retailing forms often has been seriously retarded by their inability to obtain well-known manufacturers’ brands, free of RPM.”⁶⁴ Areeda and Hovenkamp point out that in the absence of RPM, “price competition among dealers favors the expansion of those with efficient scale and methods, thus lowering the cost of distribution.”⁶⁵ Sullivan and Grimes agree: “Preserving entry opportunities for new retailers and new retailing approaches is a critical component to the dynamic growth of our economy. Intrabrand competition serves this goal by preserving one of the new entrant’s more competitive

⁶¹ See Thomas R. Overstreet Jr. & Alan A. Fisher, *Resale Price Maintenance and Distributional Efficiency: Some Lessons from the Past*, 3 CONTEMP. POL’Y ISSUES 43, 49-50 (1985) (retail druggists cartel “achieved virtually universal compliance with a price-fixing policy – despite very large numbers and an extremely unconcentrated market”).

⁶² VIII AREEDA & HOVENKAMP, *supra* at ¶ 1630b (“Historically . . . price rather than nonprice restraints have been the vehicle chosen by dealer organizations to limit competition among their members”). It is worth noting that dealer collusion can harm consumers even if the colluding dealers carry only a single seller’s brand. As long as that brand is differentiated from other brands, RPM imposed on a seller by colluding (or otherwise powerful) dealers can force up the price of the brand and reduce the welfare of consumers. In short, a restraint directly primarily at intrabrand competition can still injure the competitive process. See Grimes, *supra* at 472-73.

⁶³ Brunell, *supra* at 501-02.

⁶⁴ Steiner, *supra* at 424 & n. 47.

⁶⁵ VIII AREEDA & HOVENKAMP, *supra* at ¶ 1632c4.

tools: the ability to discount popular branded items that draw customers.”⁶⁶ The Office of Fair Trading recently studied the elimination of RPM on books in the United Kingdom and concluded that it contributed to the entry and rapid growth of innovative forms of book retailing – Internet sellers and supermarkets.⁶⁷

VI. Conclusion

Resale price maintenance is the most competitively dangerous vertical intrabrand restraint. It alone affects resale prices directly, and history shows that when it is employed at the retail level, it typically raises prices to consumers. Because of its direct impact on price, moreover, it is the vertical restraint that most easily and effectively facilitates price collusion, tacit or explicit, at either the manufacturer or dealer level. Further, unlike most nonprice restraints, it can prevent a more efficient – or more innovative – distributor from passing on the benefits of its superior performance to consumers in the form of lower product prices.

Because of these competitive dangers, the Commission is correct to characterize RPM as a hardcore restriction and to presume that it is illegal. Further, it is entirely appropriate to conclude that it is anticompetitive unless the seller can justify the restraint. As we have acknowledged repeatedly, of course, not every instance of RPM poses a significant threat to competition or lacks an efficiency justification. But as we have also shown, procompetitive uses of RPM are likely to be uncommon, not only because of its competitive dangers but also because its efficiency benefits, if they exist at all, are often

⁶⁶ Lawrence A. Sullivan & Warren S. Grimes, *THE LAW OF ANTITRUST: AN INTEGRATED HANDBOOK* 335 (2d ed. 2006).

⁶⁷ See OFFICE OF FAIR TRADING, *AN EVALUATION OF THE IMPACT UPON PRODUCTIVITY OF ENDING RESALE PRICE MAINTENANCE ON BOOKS* (2008), available at http://oft.gov.uk/shared_oft/economic_research/oft981.pdf.

attainable through other means. For these reasons, we recommend that the Commission make clear in the new Guidelines that the presumption of illegality is strong and that it will approach any asserted justification with skepticism. This step would more closely reflect the Commission's current practice and better protect consumers.