

## THE ECONOMICS OF RESALE PRICE MAINTENANCE

Kenneth G. Elzinga and David E. Mills\*

### Abstract

*Resale Price Maintenance (RPM) involves agreements between manufacturers and downstream distributors that set the downstream price of the product, either at a minimum price or a maximum price. Antitrust law, until recently, condemned these vertical price arrangements per se. Now, maximum resale prices are assessed under the rule of reason. Agreements on minimum prices continue to be viewed as per se illegal. Economic analysis reveals the conditions under which RPM can enhance consumer welfare and where it can harm consumer welfare. Because there are so many circumstances in which RPM promotes interbrand competition, the practice should be assessed under the rule of reason, the same way as non-price vertical contracts.*

A resale price maintenance (RPM) agreement is a contract in which a manufacturer and a downstream distributor (hereafter a retailer) agree to a minimum or maximum price the retailer will charge its customers (hereafter consumers). One might wonder why a manufacturer, having sold a product to retailers, would want to exert any influence over resale prices. It might seem, at first glance, that the manufacturer would expect competition among retailers to hold retail prices in check. But there is much more to the story. This chapter explains why a manufacturer might establish and maintain a minimum or maximum retail price, and what the consequences are for consumer welfare when this pricing practice is deployed.

It turns out there are several reasons why a manufacturer might try to maintain resale prices. Some of the reasons indicate that RPM enhances consumer welfare; others indicate the opposite. This means any economic assessment of a particular case must interpret the facts in that situation with competing theories in view.

### 1. Using RPM to Establish a Price Floor

Manufacturers selling undifferentiated products in perfectly competitive markets would never use RPM as a pricing practice. In such markets, manufacturers have no unilateral

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\* University of Virginia. The authors thank Tyler A. Baker, Roger D. Blair, Wayne Dale Collins, Frank Mathewson, Howard P. Marvel, and Ralph A. Winter for helpful comments.

influence over prices at either wholesale or retail levels. But in many transactions involving branded products, RPM can have a constructive role. To understand why, two economic concepts must be understood: (1) consumer demand for a differentiated product can depend on retail “service” as well as the product’s price; (2) retail service can be an occasion for what economic theory calls “market failure.”

### *1.1. Retail Services and the Free Rider*

In markets for differentiated consumer products, demand is a function of product features and quality as well as the price of a product. Demand also can be affected by retail service, defined broadly to include pre-sale display, product-specific information, store hours, adequate inventory, post-sale service, the reputation of the retailer as a certifier of product quality, and other shopping amenities. Consumers value retail service, so better retail service raises consumer demand. In some instances, an increase in demand caused by increased retail service can increase unit sales and make consumers better off, even if accompanied by a price increase.

If consumers value retail service such that better service raises consumer demand, should we not expect retailers to provide adequate retail service without being nudged by the manufacturer? The answer is “no” where one retailer’s service invites a competing retailer to become a free rider. A free rider is someone who enjoys the benefits of someone else’s investment without having to pay compensation. The iconic free riding example in the RPM literature is the high-tech, information-intensive consumer durable good (think of high-end audio equipment), where pre-sale assistance by a knowledgeable salesperson at a retail establishment is required to inform and persuade a consumer of the product’s merits.<sup>1</sup> Upon getting the requisite information from the full-service retailer, the shopper leaves the store, without making a purchase, and visits a discount store to buy the product for a lower price. The discount store, which can offer the lower price because it does not employ knowledgeable salespersons, gets a free ride from the full-service retailer who incurs costs to promote the product.

The state of affairs just described is unsustainable for the full-service retailer. It cannot continue to employ knowledgeable salespersons and still match the discounter’s low price. The full-service retailer must curtail service to survive. In the end, the free rider prevents consumers from having access to retail services for which they are willing to pay. Those consumers must decide what brand of good to buy, or whether to buy a good at all, with less than optimal information about their choice set. Products that require retail service become less available. The consequences are bad for consumers and bad for the manufacturer.

The possibility that free riders may extinguish retail service altogether, in a market without RPM, requires that allowable non-price vertical restraints are not up to the task. It also requires that retailers cannot separate those aspects of retail service that build demand for the manufacturer’s product from other retailer activities and “sell” them to consumers, or the

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<sup>1</sup> What is high-tech depends upon the time of reference. In the early days of the automobile industry, Henry Ford used RPM to protect the retail margins of automobile dealers who needed to teach customers how to drive. Economists should be aware that Alfred Marshall’s classic text, *Principles of Economics*, was the first product “in the English speaking world to be sold under a scheme of resale price maintenance.” See William Breit, *Resale Price Maintenance: What do Economists Know and When did They Know It?* 147 *J. INSTITUTIONAL & THEORETICAL ECON.* 72 (1991).

manufacturer, on a stand-alone basis. In many instances, transaction costs appear to prevent separate service sales from eliminating all free riding.

### *1.2. RPM Induces Efficient Retail Services*

Manufacturers with RPM policies that establish retail price floors may be trying to remedy a market failure.<sup>2</sup> That is, by selling its brand to retailers on the condition that each retailer's price not fall below some minimum level, the manufacturer prevents any retailer from taking sales away from another by charging a lower price. Also, by exerting control over the retail price of its brand, as well as the wholesale price, the manufacturer can affect the amount of retail service by providing the necessary retail "margin" to pay for it. With retail price competition for the product thwarted, once prices settle to the minimum level specified in the RPM agreement, retailers compete with each other for sales by offering valuable retail service to consumers.

The free rider problem is not confined to high-tech, information-intensive consumer durables. RPM occurs in markets where goods do not require detailed information, extensive product demonstration, or significant post-sale service commitments. Such products include women's fashion accessories, shoes, candy, and designer jeans. In the case of such products, retailers may use RPM-protected margins to invest in retail services like longer hours of operation, more attractive store furnishings, and other amenities that owe little to specialized information. Besides shopping amenities, retailers with reputations for selling high-quality merchandise provide what has been called a "quality certification" service to manufacturers.<sup>3</sup> A manufacturer may use RPM to insure that reputable retailers – those who help the manufacturer build and maintain a good reputation for its brand – carry its brand by affording those retailers protection from free-riding discounters.

RPM is not a panacea for the manufacturer in every circumstance. If retailers are better informed about retail demand than the manufacturer, an agency problem may interfere with the manufacturer setting the appropriate retail price. If there are retailers who compete in retail markets with different demands, with or without retail services, setting a single minimum retail price for all retailers may not be appropriate. Needless to say, a product whose quality is low cannot survive long in the marketplace just because it carries a high retail price and appears in reputable retail stores. An RPM policy does not enable a manufacturer to make a silk purse out of a sow's ear.

### *1.3. RPM Reaches Beyond the Free Rider*

RPM also may be used to induce efficient retail services when the source of market failure is not a free-riding discounter. Klein and Murphy interpret RPM not so much as a method to foil free riders but rather as a device to make retailers comply with incomplete performance contracts aimed at stimulating and securing retail services that build demand for the

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<sup>2</sup> Lester G. Telser offered this explanation for RPM in his path-breaking article on protected retail margins. See *Why Should Manufacturers Want Fair Trade*, 3 J.L. & ECON. 86, 91 (1960).

<sup>3</sup> See Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346 (1984).

manufacturer's product.<sup>4</sup> Economic theory indicates that a manufacturer cannot rely on the retailer to provide optimal retail service when the manufacturer captures some of the benefits of that service. The manufacturer, hypothetically, might enter into a contract with the retailer that specifies exhaustively what services the retailer must provide – how the product is to be displayed, hours of operation, sales presentations, inventory levels, etc. But incomplete information makes writing and enforcing such thorough contracts problematic.

RPM spares the manufacturer the task of specifying and monitoring the retailer's performance along multiple service dimensions. This is because RPM induces retail services without their being specified exhaustively. The retailer provides the sought-after, but difficult-to-specify, retail services to avoid termination and to capture the protected retail margin. Klein and Murphy's important insight extends the role of RPM well beyond the case of a free-riding discounter. Mathewson and Winter second this when they write that "[t]he use of resale price maintenance as a means of competing through enhanced service is much more general than free-riding . . . ."<sup>5</sup>

The motivation of a manufacturer using RPM is not to enable retailers to raise prices and gouge consumers. The economic logic of using RPM to induce efficient retail service is for the manufacturer to impose a price floor to restrain downstream *price* competition in order to foster *service* competition. Note that a manufacturer has no incentive to overcompensate its retailers; doing so would reduce the manufacturer's profits *and* would make the manufacturer's product line less competitive in the marketplace. Instead, the manufacturer wants its retailers to make just enough money to market its brand effectively, and no more.

By redirecting retailers' competitive activities from prices to retail service, RPM limits *intra*brand competition in prices (among retailers for sales of the same brand). But this limitation has the effect of enhancing *intra*brand competition along other dimensions of rivalry among retailers. RPM also has the effect of enhancing *inter*brand competition among manufacturers and retailers alike for sales of different brands because retail service affects consumers' choices among competing brands. It is interbrand competition that disciplines a manufacturer who has adopted an RPM policy and ultimately establishes retail prices in the marketplace. In this respect, the argument that RPM restrains retail price competition at the expense of consumers is deceiving.

There is another potentially procompetitive use of RPM that reaches beyond the free rider. This is where retailers must order inventories of a manufacturer's product periodically before demand for the product is known. If retailers are free, once demand becomes known, to raise or lower prices to liquidate their inventories, the result may be substantial price fluctuations. In low demand periods, prices may fall precipitously. In this environment, Raymond Deneckere, Howard P. Marvel and James Peck show that a manufacturer may use RPM profitably to keep retail prices from falling below some floor during periods of unexpected slack demand. In some instances, consumer welfare would be higher with RPM performing this task even though RPM may prevent the liquidation of inventories. RPM may benefit consumers

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<sup>4</sup> See Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988).

<sup>5</sup> Frank Mathewson & Ralph Winter, *The Law and Economics of Resale Price Maintenance*, 13 REV. OF INDUS. ORG. 57, 72 (1998).

in these instances because it encourages retailers to distribute the manufacturer's product when otherwise the risk of plunging prices might curtail their enthusiasm. In other words, RPM's "guarantee of a stable market may induce retailers to order larger inventories than they would have had retail markets been permitted to clear."<sup>6</sup>

## 2. When Might RPM Harm Consumers?

Having set forth the standard economic arguments supporting RPM, it is appropriate at this juncture to consider conditions where RPM does not increase consumer welfare. Economic analysis suggests three ways in which RPM can contravene antitrust's fundamental goal of promoting consumer welfare. Two ways in which RPM might have anticompetitive effects involve the formation and maintenance of *cartels*. In the first instance, the cartel is formed among retailers; in the second, the cartel is formed among manufacturers. The likelihood of RPM being used to fix prices at either stage in an industry with many competitors is not high, absent evidence of formal cartel mechanisms. Where RPM facilitates the organization and operation of a cartel, its use is unlawful under the antitrust laws.

### 2.1. RPM-Induced Retailer Cartels

In the case of a cartel among retailers, those firms conspire to get manufacturers to set resale prices at monopoly levels.<sup>7</sup> Because it is the manufacturer who appears to be setting retail prices, this kind of collusion diverts attention from the collective price-setting by the retailers. Furthermore, by inducing manufacturers to "impose" an RPM policy upon them, retailers in effect deter themselves from cheating on the agreement and discounting prices. In this scenario, retailers use manufacturers' RPM policy as a cover for their own price-fixing shenanigans. Retailers thereby delegate both the implementation and the enforcement of the cartel to the manufacturer so they need not enter into a direct price fix. The manufacturer becomes the cat's paw for the retail cartel. Consumers are made worse off, the same as they would be if the cartel were operated directly by retailers without the participation of a manufacturer.

For RPM to arise in this manner, retailers must possess monopsony power, either unilaterally or by means of a common agency (like a trade association), to make the manufacturer go along, even though this practice reduces its sales. A manufacturer is driven to cooperate with the colluding retailers by the stick of a threatened boycott rather than the carrot of increased sales. The story is easy enough to tell, but finding real world examples is not so easy.

If retailers must get together to coerce manufacturers to engage in RPM, they should leave the same trail of evidence as a direct price fix. The textbook example of an RPM-induced retailer cartel involves retail druggists who, working through a trade association, cajoled a manufacturer of toothpaste to implement RPM. But there is no evidence that retailer cartels held together by RPM are common. One reason for this is that the retailer cartel story does not account for how retailers could avoid their cartel being undermined by other forms of

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<sup>6</sup> Raymond Deneckere, Howard P. Marvel & James Peck, *Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition*, 87 AM. ECON. REV. 619 (1997).

<sup>7</sup> When we use the term "retailers" in the following discussion, we really mean horizontally arranged firms anywhere downstream from the manufacturer. The analysis would not change if we were to use wholesalers or other agents located somewhere in the distribution channel between the manufacturer and consumers.

competition, such as non-price rivalry. Another difficulty facing such a cartel is that retailing is an industry with comparatively easy entry. If incumbent retailers tried to raise prices using RPM, this would create an opportunity for new entrants. Also, manufacturers often have several distribution channels for their products. If retailers in one channel attempted a price increase using RPM, consumers might be easily diverted to other channels.

## 2.2. *Manufacturer Cartels Shored Up by RPM*

In the usual manufacturer cartel, sellers collude on the price they charge their customers and do not endeavor to set the resale price of their product. For example, in the international vitamins cartel, participants agreed upon the prices they charged, but did not try to influence the prices their customers charged. Nonetheless, a cartel of manufacturers might use RPM to help monitor and enforce the cartel's agreement. Once cartelists reach an agreement to raise prices, each of them has a strong incentive to cheat on that agreement by shading price and expanding output. Incremental sales that stem from furtive discounts can be very remunerative if the cartel has jacked up prices well above incremental costs.

To rein in this kind cheating, the manufacturers in this scenario agree among themselves to implement RPM policies with retailers to reduce the incentives to cheat. Here is how it would work. Suppose it is easier for manufacturers to observe the retail prices of their competitors' products than the prices those manufacturers charge retailers. RPM agreements establish minimum retail prices for every manufacturer's products. If these agreements are enforced, they take away the profitability of secret upstream discounts by manufacturers because retailers are not able to pass those discounts on to consumers in the form of lower retail prices. Without lower retail prices, retailers sell no more of the cheating manufacturer's product than before. By secretly cutting its prices below the cartel level, the manufacturer merely sells the same quantity at a lower price, which is not a recipe for making money. The only way the price-chiseling manufacturer could profit from lower prices would be if the firm did not enforce its RPM policy so that its retail price would fall and sales would increase. But this would be more easily detected by the other cartelists than a secret upstream price cut and could elicit an unfriendly response. This is not a recipe for making money either. In short, under this scenario, manufacturers agree to fix prices to retailers and then, to make cheating on that agreement unprofitable or more easily detectable, they agree to fix retail prices as well.

The assumption in this story that retail price cuts are more visible than upstream price cuts is plausible in some situations. But just as real world examples of retailer cartels stitched together by RPM are not common, real world examples of manufacturer cartels that used RPM to curtail cheating are uncommon. Indeed, the economic nexus between cartels and RPM is not robust. Pauline Ippolito's study of RPM litigation found that fewer than 10 percent of private cases involve even the *allegation* of collusion among manufacturers or retailers. Andrew Kleit's research into cases before the legal status of RPM was clear found no evidence of RPM as a cartelization strategy.<sup>8</sup>

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<sup>8</sup> Pauline M. Ippolito, *Resale Price Maintenance: Empirical Evidence from Litigation*, 34 J.L. & ECON. 263 (1991); Andrew N. Kleit, *Efficiencies without Economists: the Early Years of Resale Price Maintenance*, 59 S. ECON. J. 597 (1993). See also THOMAS OVERSTREET, *RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE*, Federal Trade Commission (1983)

One reason the manufacturer cartel story has limited explanatory power is that cartels work best when manufacturers' products are homogeneous. RPM is used when products are differentiated. Product differentiation engenders all kinds of non-price competition among the cartel members that would be difficult for a cartel to squash, especially in an environment where contracts cannot be enforced in a court of law.

### 2.3. *RPM-Augmented Foreclosure*

There is another theory as to how RPM might have anticompetitive effects. This is a theory of RPM-augmented foreclosure. Since RPM permits a manufacturer to control its retailers' profit margins, this practice might facilitate an implicit contract between the manufacturer and those retailers of the following nature. The manufacturer assures retailers of an attractive profit margin on sales of its own brand in exchange for their refusing to take on the distribution of competing brands, including brands offered by new entrants.<sup>9</sup> Rather than jeopardize their attractive RPM-protected profit margins on sales of the incumbent manufacturer's product, retailers decline the opportunity to introduce competing products. If the retailers thus bound to the manufacturer via RPM agreements comprise a sufficiently large share of the relevant market, competing manufacturers may find distribution more costly and new entrants may be deterred. This 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.

The *per se* rule against RPM, perversely, can thwart new entry or make it more difficult. For many consumer products, the difficulty a new entrant faces is the marketing advantages large incumbent firms may have in network television advertising (e.g., beverage companies) or through vertical integration into retailing (e.g., clothing chains). To secure entry, a new entrant may seek to gain retail distribution by offering independent retailers protection against discounting, in the hope that margin protection will induce retailers to market and promote the new product. The *per se* rule against RPM thwarts new entrants and smaller manufacturers from directly using, through contract, this marketing strategy.

### 2.4. *RPM Pits the Interests of Consumers Against Each Other*

The main economic objections to RPM are when it is used to enable or facilitate cartelization of markets or to foreclose competition. But even where RPM is used to stimulate retail service, the effects on consumers can be mixed. Mathewson and Winter observe that "the general 'service hypothesis' is that the increase in demand resulting from enhanced service, elicited through a protected retail margin, will more than offset a negative impact on demand of a higher . . . retail price."<sup>10</sup> But if RPM raises retail prices to finance enhanced service, and if that service is more valuable to some consumers and less valuable to others, the result may be that some consumers gain when RPM is imposed while others lose.

Although the net effect of RPM on consumers is no doubt positive in many instances, there is no assurance that the net effect is *necessarily* positive whenever a manufacturer finds it profitable to implement RPM. It is possible, hypothetically, that a manufacturer would find it

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<sup>9</sup> See BASIL S. YAMEY, *RESALE PRICE MAINTENANCE* (1966).

<sup>10</sup> See Mathewson & Winter, *supra* note 5, at 67 (internal footnote omitted).

profitable to use RPM to kindle too much retail service. The reason, as Marvel and McCafferty explain, is that “[m]anufacturers, in their desire to maximize profits, focus on the margin, while allocative efficiency incorporates effects on inframarginal customers . . . . The additional customers attracted by the services must be better off as a result of the service provision. But if some of the additional receipts are derived from higher prices charged to inframarginal customers who do not value the services, the benefits to society of the services provided need not justify their cost.”<sup>11</sup> In general market failure, and an attending loss in consumer welfare, can arise whenever the welfare effects of prices, quality, or retail services on the seller’s *marginal* consumer are not the same as those on *inframarginal* consumers. This is because the marginal consumer affects the quantity of goods sold without internalizing the effects of her decision on other consumers.

Consider a simple example in which there are two kinds of consumers: those who value enhanced retail service because they are ill-informed about the manufacturer’s product, and those who are already knowledgeable and do not value enhanced service. If the manufacturer implements RPM to bring about better retail service, and if the retail price increases as a result, the beneficiaries of RPM are ill-informed consumers who buy the firm’s product. Some of these customers might not have bought the product had they remained ill-informed, while others might have bought the product but underutilized it for lack of specialized knowledge. Knowledgeable consumers who buy the product are harmed because the price increase is not accompanied by anything they value. In fact some consumers, whether knowledgeable or not, might be deterred by the price increase.

In a market with lots of knowledgeable consumers, and few consumers who are ill-informed, RPM can reduce overall consumer welfare. On the other hand, if most consumers are ill-informed, RPM can increase overall consumer welfare. Assessing the impact of RPM upon consumers as a whole would seem to involve balancing aggregate gains and losses for different consumer types, which is no easy task.<sup>12</sup>

However a manufacturer that has competitors to contend with would be unlikely to implement an RPM policy that reduces overall consumer welfare. Unless the manufacturer was a monopolist, consumers would continue to have the benefit of *interbrand* competition even if RPM curtails *intra*brand competition. To the extent one manufacturer’s RPM policy induces retailers to provide costly retail service that knowledgeable consumers do not value, an opportunity is created for other manufacturers to sell “plain vanilla” merchandise at lower prices to attract knowledgeable consumers. Consequently, to use antitrust to curtail RPM because of its consequences for inframarginal consumers is a strained application of trade regulation.

Using antitrust to regulate RPM agreements that a manufacturer implements to induce retail services would be similar to using antitrust to govern the firm’s advertising and new product introduction policies. Manufacturers who buy media advertising impose costs on customers who are already persuaded; manufacturers who upgrade product features impose costs

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<sup>11</sup> Howard P. Marvel & Stephen McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J.L. & ECON. 363, 370 (1985); A. Michael Spence, *Monopoly, Quality and Regulation*,” 6 BELL J. OF ECON. 417 (1975).

<sup>12</sup> See William B. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983 (1985). See also Don Boudreaux & Robert B. Ekelund, Jr., *Inframarginal Consumers and the Per Se Legality of Vertical Restraints*, 17 HOFSTRA L. REV. 137 (1988).

on customers who prefer (but are no longer offered) the older, less expensive model. But antitrust does not challenge these policies.<sup>13</sup>

Note that assessing the impact of RPM on consumers is easy if the manufacturer's implementation of RPM does *not* increase the retail price of its product, but only the quantity of sales. Marvel and McCafferty explain that if the effect of RPM-induced retail service is an isoelastic shift in market demand, and if the cost of providing service is fixed rather than variable in the long run, then the retail price the manufacturer would seek to impose is the same as without RPM and enhanced services.<sup>14</sup>

To sum up, the main reason a manufacturer would implement RPM to induce retail service is if the enhanced service increases product sales. The incremental sales come from consumers who value those services, not consumers who gain nothing from them. If putting an RPM policy in place boosts total sales noticeably, this strongly suggests that consumers, on net, have benefited. One antitrust authority considers this to be the *key indicator* of procompetitive RPM. Richard A. Posner explains:

If [the defendant firm's] output expanded, the restriction must have made the firm's product more attractive on balance, thereby enabling the firm to take business from its competitors. This is an increase in interbrand competition and hence in consumer welfare, which is the desired result of competition. The increase *must* exceed any net reduction in intrabrand competition considered in both its price and service aspects. Any reduction in intrabrand competition, viewed by itself, would increase the price to the consumer and hence make the product less attractive to him. If, on balance, the product is more attractive to consumers, as demonstrated by the fact that more of it is sold, the net effect of the restriction on competition must be positive.<sup>15</sup>

## 2.5. *RPM and Snobbery*

There is a non-economic argument against RPM, one rooted in what Thorstein Veblen called "conspicuous consumption." This argument attributes to RPM the financing of retail service that appeals to consumers merely because it is expensive and extravagant. That is, RPM-induced service costs a lot of money but does not enhance the instrumental value of the product. This kind of service (so the argument goes) only appeals to consumers who are in search of ways to signal their elite status. Critics of RPM who object to conspicuous consumption might grant the case for RPM when used to sell information-impacted goods like audio equipment, but not for status goods such as designer jeans or athletic shoes. If mass merchandisers could sell designer jeans at discount prices in a world without RPM, then consumers purportedly would be better off. What would be lost would be the boost in status enjoyed by those who flaunt expensive clothing in front of people who cannot afford the high, RPM-enhanced prices. Whether this argument has merit is outside the scope of this article, since judging the praiseworthiness of different kinds of consumer benefits is not the task antitrust has taken on.

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<sup>13</sup> See Frank R. Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J. 135 (1984).

<sup>14</sup> See Marvel & McCafferty, *supra* note 11, at 371.

<sup>15</sup> Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 21 (1981) (emphasis in original).

### 3. The Legal Status of RPM

Antitrust law applies to situations where there has been a distortion in market outcomes that harms consumers. In economic parlance, consumer harm means consumer welfare is reduced.<sup>16</sup> For some business practices, the harm to consumers is so transparent that courts consider the conduct to be *per se* illegal. Economic logic suggests that the *per se* category of antitrust offense should be for business conduct so unlikely to ever confer consumer benefits that a full-blown “rule of reason” inquiry into the practice is not worth the candle.

#### 3.1. Squaring Price and Non-Price Vertical Arrangements

At one time a number of vertical contracts between manufacturers and retailers were thought to be so unlikely to generate consumer benefits that they were considered *per se* violations of antitrust law. RPM agreements are an example, but so were agreements that assigned dealers to exclusive geographic territories. Exclusive territory agreements prevent a dealer in one territory from undercutting the prices of a dealer in a nearby territory and curtail free riding and promote downstream services. As courts discovered the procompetitive benefits associated with exclusive territories, this practice was removed from the *per se* bin and placed in the rule of reason bin.<sup>17</sup> Today, all non-price vertical arrangements are sorted into the rule of reason bin, leaving only price-related vertical arrangements like RPM in the *per se* bin.

The legal status of RPM has vacillated between a strict proscription and explicit tolerance. The antitrust case that left the longest-lasting imprint upon trade regulation and RPM is *Dr. Miles Medical*.<sup>18</sup> Here, a manufacturer of patent medicine entered into contracts with hundreds of wholesalers and thousands of retailers that specified minimum resale prices. The Supreme Court ruled in this case that an agreement on price between a manufacturer and a retailer “can fare no better” under the Sherman Act than an agreement on price among competitors put vertical price-fixing on the same plane as horizontal price-fixing.<sup>19</sup> This established RPM as a *per se* antitrust offense. Later, the *Miller-Tydings Resale Price Maintenance Act (1937)* and the *McGuire Act (1952)* ushered in the “fair trade” era by removing RPM contracts from the reach of the Sherman Act if such contracts were valid under state laws. In 1975, these acts were repealed effectively returning the law to the pre-1937 status quo.<sup>20</sup> The Court’s opinion in *Dr. Miles Medical*, over ninety years ago, remains the taproot for the *per se*

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<sup>16</sup> Economists monetize the notion of a consumer’s welfare. A consumer’s welfare in any purchase is measured as the difference between the *most* the consumer would pay for a product, rather than do without it, and the product’s price. By this definition, any reduction in a product’s price, *other things remaining unchanged*, adds to the consumer’s welfare. Similarly, higher quality and easier availability increase the value of the product to the consumer so that, at the same price, the consumer’s welfare increases. To monetize the value of higher quality or easier availability, an economist calculates the price reduction on the unenhanced product that would be necessary to make the consumer indifferent to getting the enhanced product at the original price.

<sup>17</sup> The decision by the Supreme Court that accomplished this move was *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

<sup>18</sup> *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

<sup>19</sup> In Europe, RPM also is generally condemned “as being particularly serious” and seldom would “produce any beneficial effects.” See [http://ec.europa.eu/comm/competition/general\\_info/h\\_en.html#t117](http://ec.europa.eu/comm/competition/general_info/h_en.html#t117). However, the European Commission allows various work-arounds for manufacturers to implement RPM short of direct contract.

<sup>20</sup> See THOMAS OVERSTREET, *supra* note 8 for an historical account of RPM.

rule against RPM. This rule is at odds with the economic theory of vertical relationships that has developed over the ninety years since.

Economic analysis makes clear that vertical price-fixing, unlike horizontal price-fixing, can remedy market failure and promote consumer welfare. Yet, thus far, the Supreme Court has not placed RPM (for minimum price arrangements) under the rule of reason. Prominent antitrust commentary has suggested such a change. The Areeda-Hovenkamp antitrust treatise concludes: “To the extent that *Dr. Miles* rests on the false categorical propositions that resale price maintenance never benefits manufacturers and always has the same effects as an illegal dealer cartel, its ruling is ripe for reexamination the Supreme Court has never given it.”<sup>21</sup> Posner’s antitrust treatise concludes: “The *per se* rule against resale price maintenance remains. It is a sad mistake. There is neither theoretical basis, nor empirical support, for thinking the practice generally anticompetitive.”<sup>22</sup>

If prevailing antitrust law governing non-price vertical arrangements is properly calibrated, this means that a *per se* rule against RPM fails to apply the economic logic of *GTE Sylvania* to price-related vertical arrangements. In other words, if the *per se* rule is reserved for conduct that is nearly always anticompetitive, then why should it apply to RPM? Just as economic analysis is required to distinguish those circumstances when territorial restraints reduce or increase consumer welfare, it also is required to tell when RPM reduces or increases consumer welfare. The economics of RPM does not warrant the presumption that RPM nearly always causes antitrust injury.

In the early days of antitrust, RPM was viewed as nothing more than an attempt to fix retail prices at monopoly levels. This doctrine was especially perverse in the case of “maximum RPM,” where the manufacturer imposes a price *ceiling* on its retailers. Precisely why a self-interested manufacturer would want to constrain retailers to raise retail prices instead of just setting wholesale prices at profit-maximizing levels (and relying on intrabrand competition among retailers to set the retail price) was a question that went ignored. The common law doctrine against restraints on alienation also helps account for the early hostility to RPM. RPM agreements never were given the opportunity to be assessed on the basis of their effects on consumers. To square the status of RPM with that of other vertical practices, RPM should be subjected to a rule of reason inquiry like non-price vertical arrangements.

A rule of reason inquiry need not be an expensive, time-consuming task for the court deliberating about a manufacturer’s use of RPM. Unless there is independent evidence of collusion among retailers, and that at a manufacturer’s RPM agreements are involuntary and not motivated by retail services, the retail cartel theory of RPM should be discounted. This theory casts RPM in a supporting role played by a reluctant manufacturer. The lead role is the retail cartel itself.

Similarly, unless there is independent evidence that a manufacturer using RPM is in cahoots with its rivals, each of whom also uses RPM, the manufacturer cartel theory of RPM should be discounted. Finally, where a manufacturer does not possess enough market power to trigger concerns about the exclusion of rivals (i.e., where there is abundant interbrand competition), the RPM-augmented foreclosure theory should be discounted.

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<sup>21</sup> See VIII PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 217 (2d ed., 2004).

<sup>22</sup> RICHARD A. POSNER, ANTITRUST LAW 189 (2d. ed., 2001), footnote omitted.

When a manufacturer's RPM agreements are motivated by retail service provision, there should be a presumption that those agreements are procompetitive. Interbrand competition among manufacturers renders pricing and service outcomes that promote consumer welfare with or without RPM. Marvel & McCafferty state that "[i]f a manufacturer chooses voluntarily to impose RPM to ensure that services are provided, welfare will almost certainly rise as a result."<sup>23</sup> In fact, Mathewson and Winter have demonstrated that "[e]ven in a market where there is a monopoly – where there is no chance of enhancing interbrand competition – restricting the firm to lower service levels through a prohibition on resale price maintenance is not generally welfare increasing."<sup>24</sup>

### 3.2. *When is an Arrangement an "Agreement?"*

Notwithstanding the *per se* illegality of RPM agreements, the Supreme Court recognized a manufacturer's unilateral right to implement RPM in *Colgate*.<sup>25</sup> The *Colgate* doctrine affords a manufacturer the option to announce a take-it-or-leave-it policy of selling only to downstream vendors whose retail price adheres to the manufacturer's *suggested resale price* (SRP). Here the manufacturer proposes a resale price and may use practices short of private contract enforcement to establish and maintain that downstream price. *Colgate* allows a manufacturer to enforce its SRP policy by refusing to do business with retailers who undercut that price.

The reason a manufacturer may implement RPM unilaterally is that such a policy does not comprise an *agreement* between the manufacturer and its retailers, or the retailers among themselves. The fact that a group of retailers behaves in the same way does not mean they have collectively agreed to behave that way. The distinction between a coincidence of action and an agreement is prominent in economic theory and is a basic principle of antitrust analysis.<sup>26</sup> Parallel behavior is not necessarily collective behavior.

In the economic model of perfect competition, sellers all charge the same price, but not as the result of an agreement. The same holds in other theories of price determination where firms' products are homogeneous. Economists call this the "law of one price." In similar fashion, when a manufacturer unilaterally announces its intention to terminate retailers who do not abide by its retail price requirement, and retailers unilaterally follow suit, this result is not due to an agreement.

For a manufacturer to implement RPM unilaterally, the firm must make good on its threat to terminate retailers who sell the firm's products at discount prices. If the manufacturer continued to supply discounters, adherence to its pricing policy could erode. Where the purpose of the manufacturer's requirement is to elicit enhanced services from retailers, those services would be curtailed if intrabrand price competition breaks out.

The distinction between unilateral action and an agreement is clear in the abstract, but often unclear in ordinary business dealings. Invoking the *Colgate* doctrine carries with it risks for a manufacturer that some aspect of its dealing with its customers could be construed as an

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<sup>23</sup> Marvel & McCafferty, *supra* note 11, at 372.

<sup>24</sup> Mathewson & Winter, *supra* note 5, at 81.

<sup>25</sup> U. S. v. *Colgate & Co.*, 250 U.S. 300 (1919).

<sup>26</sup> See VI PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* 59-66 (2d ed. 2003).

agreement. Consequently, the *Colgate* doctrine does not provide a reliably safe harbor for the manufacturer who wants to induce retail services through RPM.

To implement an RPM policy in compliance with the *Colgate* doctrine means the manufacturer must take care to avoid any appearance of sponsoring an “agreement” among its downstream retailers. Indirect methods include *inter alia* using consignment sales with specified downstream prices, buy-back deals to purchase unsold inventory, markdown allowances offered to retailers whenever demand is unexpectedly low, meeting competition price guarantees to retailers, printing SRP on packaging or sales tags, and making extensive use of buydowns and slotting allowances, all to influence downstream retail prices. If antitrust law acknowledged that explicit minimum price RPM agreements, *sans* indications of a horizontal conspiracy, are mainly procompetitive, many such work-arounds would fade away.

The inadequacy of the *Colgate* doctrine as a substitute for enforceable agreements to induce retail services, and the asymmetric treatment of RPM and non-price vertical arrangements, both augur for changing the legal status of RPM. Antitrust law reserves the category of *per se* offense for business practices that nearly always create antitrust injury. RPM does not qualify for *per se* treatment by this criterion. If RPM were to come under the rule of reason, many benign applications of RPM could go unchallenged and the procompetitive effects of RPM would not have to be achieved by other means.

There is probably not a starker example of antitrust diverting a company from an efficient marketing strategy than Coors. Coors once purchased very little media advertising. Instead the company used resale price maintenance and exclusive territories to preserve the freshness of its non-pasteurized beer and to induce downstream promotion and regular product rotation by its distributors. When the Federal Trade Commission successfully attacked Coors for these distribution arrangements,<sup>27</sup> Coors had more difficulty insuring product freshness -- something that was not as great a concern to its major rivals who pasteurized their beer. In the end, Coors altered its product differentiation strategy and turned to media advertising like its major rivals.

#### 4. “Maximum” RPM

For years, under *Albrecht*, the Supreme Court treated minimum and maximum resale price agreements with the same lack of enthusiasm.<sup>28</sup> It should be evident, however, that using RPM to establish a downstream price *floor* is quite different than using RPM to establish a downstream price *ceiling*. Although the presumption of harm to competition will rarely be justified for RPM-imposed price floors, it is even more likely that prohibiting “maximum” RPM -- the imposition of a retail price *ceiling* -- could harm consumers. The most compelling explanation for a manufacturer restraining retailers from charging high retail prices is one that couples consumers’ interests with those of the manufacturer.

When a manufacturer distributes its product to consumers via a perfectly competitive retail market, competition among retailers will keep retail prices as low as possible, given retailers’ costs and the manufacturer’s wholesale prices. In fact, it is the dependability of price competition among retailers that gives rise to a manufacturer’s using “minimum” RPM to

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<sup>27</sup> ANNUAL REPORT OF THE FEDERAL TRADE COMMISSION, June 30, 1974, p. 5..

<sup>28</sup> *Albrecht v. Herald Co.*, 390 U.S. 145 (1968).

prevent price competition from extinguishing efficient retail service. If retailers who distribute the manufacturer's product have substantial market power, the manufacturer cannot rely on competition to discipline retail prices. The imposition of price ceilings keeps such retailers from raising retail prices and reducing quantities sold at the manufacturer's expense. Putting a cap on retail prices also prevents harm to consumers. Ironically, *Albrecht* stood in the way of a business practice with procompetitive consequences.

In November 1997, the Supreme Court overturned *Albrecht* and held that maximum RPM agreements were to be assessed under a rule of reason. In explaining this change in direction, Justice O'Connor, writing for a unanimous Court in *Khan v. State Oil*, stated that "we find it difficult to maintain that vertically imposed maximum prices could harm consumers or competition to the extent necessary to justify their *per se* invalidation."<sup>29</sup>

The plaintiff Khan (a retail gasoline dealer) challenged its wholesale gasoline distributor State Oil's supply contracts. In effect, State Oil's supply contract established the maximum retail prices at which Kahn could sell premium and regular gasoline. It did so by pegging the margin between the wholesale and retail price. For example, if Kahn were to raise its pump price 2 cents/gallon on premium gasoline, but not on regular, State Oil would raise its wholesale price on premium gasoline the same amount. Maximum RPM was important to State Oil in order to deter its gasoline dealers from changing the relative prices of premium versus regular gasoline by raising the price of premium disproportionately. Consumers were beneficiaries of the Court's decision to allow State Oil to limit the mark-ups of its downstream retailers, since this limitation kept premium gasoline prices in check.

## 5. Conclusion

The generally recognized purpose of antitrust economics is to distinguish procompetitive business conduct, which promotes consumer welfare, from anticompetitive behavior, which reduces consumer welfare.<sup>30</sup> Procompetitive conduct by sellers benefits consumers by lowering market prices and/or raising product quality. Anticompetitive conduct harms consumers by raising prices or reducing product quality. Except for instances where it becomes a tool for

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<sup>29</sup> *State Oil Co. v. Kahn*, 522 U.S. 3, 15 (1997). Two scholars whose earlier criticism of *Albrecht* was cited by the Court have criticized Kahn for not simply making maximum RPM *per se* legal. See Roger Blair & John Lopatka, *The Albrecht Rule after Kahn: Death Becomes Her*, 74 NOTRE DAME LAW REVIEW 123 (1998).

<sup>30</sup> Some would argue that advancing consumer welfare is the only goal of antitrust. See ROBERT BORK, *THE ANTITRUST PARADOX* 89 (1978). See also Kenneth G. Elzinga, *The Goals of Antitrust: Other Than Competition and Efficiency, What Else Counts?*, 125 U. PA. L. REV. 1191 (1977); Philip E. Areeda and Herbert Hovenkamp wrote "Today it seems clear that the general goal of the antitrust laws is to promote 'competition' as the economist understands that term. Thus we say that the principal objective of antitrust policy is to maximize consumer welfare by encouraging firms to behave competitively, while yet permitting them to take advantage of every available economy that comes from internal or jointly created production efficiencies, or from innovation producing new processes or new or improved products." PHILIP E. AREEDA & HERBERT HOVENKAMP, 1 *ANTITRUST LAW* 4 (2000). A former chairman of the Federal Trade Commission, testifying before the House Judiciary Committee, put the matter this way: "It is virtually undisputed today that the purpose of antitrust is to protect consumers, that economic analysis should guide decisions, and that horizontal cases involving mergers and agreements among competitors are the mainstays of antitrust." *An Overview of Federal Trade Commission Antitrust Activities: Hearings Before the H. Comm. on the Judiciary Antitrust Task Force*, 108th Cong., 1st Sess (2003) (prepared statement of Timothy J. Muris) (available at [www.ftc.gov/os/2003/07/antitrustoversighttest.htm](http://www.ftc.gov/os/2003/07/antitrustoversighttest.htm)).

cartelization or foreclosure, the practice of RPM often is procompetitive. Imposing minimum retail prices generally elicits efficient retail service and sharpens interbrand competition. It is hard to see how imposing maximum retail prices could be anything other than beneficial to consumers. When there is no remotely plausible (or even alleged) horizontal conspiracy, and the manufacturer is not a monopoly, keeping RPM under the *per se* rule mainly condemns a procompetitive practice.

Bringing RPM agreements that impose maximum retail prices under the rule of reason is a welcome development. One hopes for a similar future development with respect to minimum price RPM agreements. Continuing to treat RPM agreements that impose minimum retail prices as a *per se* offense puts manufacturers in a peculiar position. Since using enforceable contracts with retailers to influence retail prices is off limits, manufacturers must use indirect and less efficient arrangements to exert that influence. Either the *per se* rule about RPM should be reformulated or RPM should be treated under a rule of reason test. The reformulation or test should require independent proof of a manufacturer or retailer cartel, or indications that RPM has a significant exclusionary effect. But for these indications, it should be presumed that RPM is procompetitive.