

RPM as Exclusion: Did the U.S. Supreme Court Stumble Upon the Missing Theory of Harm?

Timothy J. Brennan*

Canadian Economic Association

University of British Columbia
Vancouver, BC

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Abstract

Until the recent U.S. Supreme Court decision in the Leegin case, resale price maintenance (RPM) had been per se illegal in the US for nearly 100 years. It continues to be illegal under Sec. 61 of the Competition Act. Despite this record, economic analyses of RPM have generally found it to be a benign method for inducing retailer marketing effort. Arguments for its harm have been based on its potential value as a tool for protecting collusion among manufacturers or among intrabrand retailers—a theory with few if any known examples. In Leegin, however, the U.S. Supreme Court, in a sentence, and virtually out of nowhere, invoked a different theory—that RPM might be an exclusionary device for inducing retailers not to carry competing products. Recent analyses of exclusionary conduct generally as the monopolization of distribution, retailing, or other complement or input markets are applied to RPM to see whether there are any circumstances necessary or sufficient for RPM to be a means for exclusion rather than for facilitating collusion. Such theories differ from arguments that RPM enforces implicit contracts with retailers to deny access to rivals.

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* Professor, Public Policy and Economics, University of Maryland, Baltimore County; Senior Fellow, Resources for the Future. Email: brennan@umbc.edu. I want to thank Tom Ross and the Sauder School of Business at UBC for facilitating my participation at the CEA meetings.

I. Introduction and background

Resale price maintenance—the practice whereby upstream wholesalers or manufacturers fix the prices at which their products can be sold at retail—has been a matter of economic and legal debate for at least a century. Until very recently in the U.S., resale price maintenance (RPM) had been *per se* illegal, albeit with an expanding set of qualifications. In 1911, the U.S. Supreme Court found that a manufacturer of “proprietary medicines, prepared by means of secret methods and formulas, and identified by distinctive packages, labels, and trademarks,” could not fix wholesale and retail sales prices for its products.¹ The court found that this practice, later to be called RPM,

falls within the principle which condemns contracts of this class [combinations between dealers, having for their sole purpose the destruction of competition and the fixing of prices]. It, in effect, creates a combination for the prohibited purposes. No distinction can properly be made by reason of the particular character of the commodity in question. It is not entitled to special privilege or immunity. It is an article of commerce, and the rules concerning the freedom of trade must be held to apply to it.²

The manufacturer, Dr. Miles Medical Company, argued that fixing downstream prices was necessary to prevent discounting which (with the Court quoting Dr. Miles’s arguments)

caused “much confusion, trouble, and damage” to the complainant’s business, and “injuriously affected the reputation” and “depleted the sales” of its remedies; that this injury resulted “from the fact that the majority of retail druggists as a rule cannot, or believe that they cannot, realize sufficient profits” by the sale of the medicines “at the cut-prices announced by the cut-rate and department stores,” and therefore are “unwilling to, and do not keep” the medicines “in stock,” or, “if kept in stock, do not urge or favor sales thereof, but endeavor to foist off some similar remedy or substitute, and from the fact that in the public mind an article advertised or announced at

¹ *Dr. Miles Medical Co. v. John D. Park & Sons*, 220 U.S. 373 (1911). The focus here is entirely on fixing minimum resale prices. In the U.S., the *per se* rule against maximum resale prices was dropped by the Supreme Court in *State Oil Co. v. Kahn*, 522 U.S.3 (1997).

It may be worth observing that in the U.S., competition law is essentially a common law process, carried out under the very terse and broadly worded antitrust laws, chiefly the Sherman Act (1890) making illegal “restraint of trade” and “monopolization,” and the Clayton Act (1914) that, with some subsequent refinements, prohibits mergers where the “effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.” 15 U.S.C. §§ 1, 2, 18. The U.S. does not have legislation similar to Canada’s *Competition Act* (R.S., 1985, c. C-34), which specifies in detail anticompetitive practices and conditions for illegality.

² *Id.* at 408.

‘cut’ or ‘reduced’ price from the established price suffers loss of reputation and becomes of inferior value and demand.”³

Dr. Miles Medical’s arguments were insufficient to overcome the Court’s determination that “no distinction can properly be made by reason” from illegal price fixing. The Court also was not swayed by Justice Holmes’s dissenting observation that

a slight change in the form of the contract the plaintiff can accomplish the result in a way that would be beyond successful attack. If it should make the retail dealers also agents in law as well as in name, and retain the title until the goods left their hands, I cannot conceive that even the present enthusiasm for regulating the prices to be charged by other people would deny that the owner was acting within his rights.⁴

Since *Dr. Miles*, economists have generally taken issue with its findings, largely elaborating decades later on the points Dr. Miles made in 1911. The most prominent and effective argument, made by Lester Telser in 1960, noted that RPM *prima facie* reduces an upstream firm’s profits, by raising retail prices and thus depressing sales of its products, given a wholesale price charged.⁵ To justify this reduction in demand, countervailing efficiencies must be present.⁶ That Telser identified was point-of-sale service. The incentives of a retailer to expend effort to inform potential buyers of the features of a product would be undercut if the buyers, once informed, could pick the item off the shelf in a discount house that offers no customer service.

Subsequent analyses have offered additional free-rider rationales. Marvel and McCafferty noted the role of quality certification, in that efforts by retailers to establish a product’s desirable characteristics, either tangible or related to fashion, would be simi-

³ Id. at 375.

⁴ Id. at 411.

⁵ Telser, Lester, “Why Should Manufacturers Want Fair Trade,” *Journal of Law and Economics* 3 (1960): 86-105.

⁶ As an aside, an irony in recent discussions of exclusionary conduct and monopolization is that the widely endorsed “profit sacrifice” test for illegal conduct presumes that lost profits indicate anticompetitive effects, not previously unidentified efficiencies. Brennan, Timothy, “Bundled Rebates as Exclusion Rather than Predation,” *Journal of Competition Law and Economics* (2008); doi: 10.1093/joclec/nhn001 at 36-37. This article also suggested the possibility that RPM could be exclusionary along the lines elaborate here; Id. at 28-29.

larly undercut if consumers could purchase these products at a discount house.⁷ One could see that Nieman Marcus stocks the product and then buy it at Wal-Mart. Deneckere, Marvel and Peck observed that RPM could also provide an incentive to induce retailers to maintain inventories when demand may be variable.⁸ Mathewson and Winter pointed out that RPM can alleviate a host of externalities dealing with both spillovers of advertising effort.⁹ Notably, Mathewson and Winter found that RPM and non-price restraints are substitutes for coping with these externalities, calling into question the difference at the time between *per se* illegality of RPM and “rule of reason” treatment of non-price restraints.¹⁰ Klein and Murphy showed that providing retailers profits through RPM could help enforce contracts by giving, in effect, a bond that retailers would forego if they breached the contract and were cut off by the manufacturer.¹¹

Despite these arguments, RPM has continued to have its detractors. Robert Pitovsky recently noted arguments against it.¹² A first, which he grants is outside the scope of antitrust, is that RPM strips dealers of their own right of alienation, i.e., to choose for themselves the terms at which they sell products they have bought from others.¹³ Specifically regarding competition, Pitovsky makes three points. First, and most important, RPM is “the equivalent of a horizontal dealer cartel” in the product itself. Second, RPM might facilitate an upstream cartel, as it prevents gaining market share by cutting wholesale

⁷ Marvel, Howard and Stephen McCafferty, “Resale Price Maintenance and Quality Certification,” *RAND Journal of Economics* 15 (1984): 346-59.

⁸ Deneckere, Raymond, Howard Marvel & James Peck, “Demand Uncertainty, Inventories, and Resale Price Maintenance,” *Quarterly Journal of Economics* 111 (1996): 885-913. These authors also find that RPM can allow manufacturers with better information on variable demand to tailor prices accordingly. Deneckere, Raymond, Howard Marvel and James Peck, “Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition,” *American Economic Review* 87 (1997): 619-41.

⁹ Mathewson, G. Frank and Ralph Winter, “An Economic Theory of Vertical Restraints,” *RAND Journal of Economics* 15 (1984): 27-38.

¹⁰ *Continental T.V., Inc. vs. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

¹¹ Klein, Benjamin and Kevin Murphy, “Vertical Restraints as Contract Enforcement Mechanisms,” *Journal of Law and Economics* 31 (1988): 265-97.

¹² Pitovsky, Robert, “Are Retailers Who Offer Discounts Really ‘Knaves’? The Coming Challenge to the *Dr. Miles* Rule,” *Antitrust* 21 (Spring, 2007): 61-65.

¹³ As Justice Holmes’s dissent (n. 4 *supra*) illustrates, one of the issues in *Dr. Miles* was whether retailers and wholesalers should probably be regarded as agents of *Dr. Miles*, or independent actors who had purchased goods from *Dr. Miles* and should then be legally free to act as they choose.

prices.¹⁴ Third, in some cases, the manufacturer may also be a retailer, and thus may want to suppress competition with its downstream outlets by forcing competitors to charge a higher price.

In Canada, RPM remains illegal under section 61(1) of the *Competition Act*. Until recently, the debate in the U.S. had changed the status of RPM only at the margins. In 1984, the Supreme Court determined that there “must be evidence that tends to exclude the possibility that the manufacturer and non-terminated distributors were acting independently,” since unilateral pricing decisions by a manufacturer are presumptively legal and do not invoke the “contract, combination . . . or conspiracy” specified in the Sherman Act.¹⁵ Since 1988, the most recent Supreme Court decision on RPM said that *per se* illegality required both an explicit agreement between the manufacturer and the retailer to “terminate a price-cutter”, but that the agreement also had to specify “the price or price levels to be charged by the remaining dealer.”¹⁶

The legal status of RPM changed dramatically in the U.S. in 2007 with the Supreme Court’s decision in *Leegin*.¹⁷ *Leegin*, a leather goods manufacturer, stopped selling to a shoe store that discounted *Leegin*’s shoes. The Supreme Court took the opportunity to decide narrowly (5 to 4) to reverse the *per se* illegality of RPM, even with the requirements above. It instead would have it treated under the same “rule of reason” applied to non-price restraints, explicitly noting the economic arguments cited above.¹⁸ Dissenting arguments in favour of retaining the *per se* prohibition were partly based on competition law—that RPM is equivalent to intra-brand price fixing. Other considerations were largely procedural—that Congress had expressed on numerous occasions its intention that

¹⁴ A secondary related point is that it may prevent cheating when wholesale prices are not observable but retail prices are.

¹⁵ *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 764, 761 (1984).

¹⁶ *Business Electronics v. Sharp Electronics*, 485 U.S. 717, 726 (1988).

¹⁷ *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* 127 S. Ct. 2705 (2007).

¹⁸ “Rule of reason” cases involve, essentially, a cost-benefit test, where the efficiencies or consumer benefits from a practice are weighed against competitive harms. Since the rule of reason was applied to non-price restraints, they have become virtually *per se* legal. Ginsburg, Douglas, “Vertical Restraints: *De Facto* Legality Under the Rule of Reason,” *Antitrust Law Journal* 60 (1991) 67-81.

RPM be banned¹⁹ and that the Court should grant more deference to a nearly hundred-year precedent.²⁰

So far, the arguments are largely familiar. However, the Supreme Court, in keeping the door open to a “rule of reason” case against RPM, stated the following:

Resale price maintenance, furthermore, can be abused by a powerful manufacturer or retailer.... A manufacturer with market power, by comparison, might use resale price maintenance to give retailers an incentive not to sell the products of smaller rivals or new entrants. See, e.g., Marvel 366–368. As should be evident, the potential anti-competitive consequences of vertical price restraints must not be ignored or underestimated.²¹

Although economists and legal commentators differ on the relative likelihood and magnitude of pro-competitive and anticompetitive benefits of RPM, the list of the latter essentially began and ended with concerns regarding cartelization, either creation of intrabrand retailer cartels or facilitating manufacturer cartels.²² Virtually nowhere has the literature considered whether RPM may be exclusionary.²³

Evaluating the Supreme Court’s novel suggestion—whether RPM can be exclusionary and, if so, under what conditions—is the subject of this paper. We first review the authority cited by the Supreme Court to support its assertion that RPM could be exclusionary. This review will be brief by necessity, as so little is there. The next section includes a theory of what makes conduct exclusionary, developed in assessments of mo-

¹⁹ In the early 1980s, the US Congress banned the Antitrust Division from expending any resources to advocate repeal of the *per se* prohibition of RPM.

²⁰ My sense from some of the commentary was that this particular argument was part of a larger dispute within the court on whether other long-standing precedents should be overturned, most notable the guarantee of a woman’s right to abort a pregnancy.

²¹ *Leegin, slip op.* at 13-14, available at <http://www.supremecourtus.gov/opinions/06pdf/06-480.pdf>. The citation is to Marvel, Howard and Stephen McCafferty, “The Welfare Effects of Resale Price Maintenance,” *Journal of Law and Economics* 28 (1985): 363-379.

²² For an additional review of the arguments, see Spector, David, “Minimum Resale Prices: Is a Ban Justified?” *Concurrences: Revue des droits de la concurrence* (2007, no. 3): 28-32.

²³ An EconLit search turned up no articles or unpublished works with “resale price maintenance” or “RPM” and “exclusion” or “exclusionary” in the abstract.

nopolization law generally and bundled rebates in particular.²⁴ It leads to a two-pronged test based on how much of the retail market the manufacturer covers, and how much RPM increases the costs the manufacturer's rivals would have to pay for retailing. We apply that test in the following section. The paper summarizes and concludes by contrasting this characterization of RPM's potential exclusionary effects with those in a recent working paper by Paldor.²⁵

II. The Supreme Court's authorities

As the quotation from *Leegin* indicates, the Supreme Court's one and only citation for the proposition that RPM could be exclusionary on three pages in a 1985 article by Marvel and McCafferty. Marvel and McCafferty's argument, citing a book by Yamey published three decades prior to their article,²⁶ concerns RPM imposed by the American Sugar Refining Company trust around the turn of the 20th century. As they portray it, the sugar trust imposed RPM, with a threat to raise wholesale prices to violators, as a means

... to secure at least some measure of loyalty from the wholesalers. There is evidence that the trust believed that its agreements with the wholesale grocers would provide it with a substantial advantage over rival refiners, and that the wholesale grocers on occasion refused to deal with new entrants, thereby forcing the entrants to deal directly with retailers (citations omitted).²⁷

The argument is a variation on that Klein and Murphy three years later.²⁸ Klein and Murphy argue that RPM essentially is a payment from the upstream supplier to downstream firms that can help sustain a contract, either explicit (by adding to a court-imposed breach payment) or implicit (by creating an effective breach payment, if the threat is oth-

²⁴ Brennan, n. 6 *supra*; Brennan, Timothy, "Saving Section 2: Reframing U.S. Monopolization Law," in Ghosal, Vivek and Johan Stennek (eds.), *The Political Economy of Antitrust* (Amsterdam: North-Holland, 2007): 417-51.

²⁵ Paldor, Ittai, "RPM as an Exclusionary Practice" (February 2008), available at SSRN: <http://ssrn.com/abstract=1092799>.

²⁶ Yamey, Basil, *The Economics of Resale Price Maintenance* (London: Sir Isaac Pitman & Sons, Ltd., 1954).

²⁷ Marvel and McCafferty, n. 21 *supra* at 367.

²⁸ Klein and Murphy, n. 11 *supra*.

erwise credible). A downstream firm that breaches the agreement runs the risk of losing the profits generated by RPM. While they regard this as a benefit, as contracting generally may be, Marvel and McCafferty's discussion suggests the set of such implicit or explicit contracts would be exclusive dealing.²⁹

Essentially, the Supreme Court, to the extent it was basing its reasoning on Marvel and McCafferty's article, was regarding RPM as exclusionary because it reinforces an explicit or implicit exclusive dealing arrangement. Marvel and McCafferty noted, "The desire to deny distribution to rivals has seemed to careful students the most plausible explanation for the use of RPM in the sugar trade."³⁰ One of those "careful students" cited by Marvel and McCafferty, Richard Zerbe, in discussing the sugar trusts RPM, found that they were imposed at the behest of the wholesalers, giving the trust a "bribe in the form of an agreement by the [wholesale] grocers not to handle anyone else's sugar except American's [the trust]."³¹

As we will see, this is consistent with the theory of exclusion here, which is based on suppression of competition among otherwise competing dealers. Whether that theory applies to RPM, particularly when there is already a monopolist in the production chain, will be discussed below. In foreshadowing the likely result, we note the Marvel and McCafferty concluded (albeit reversing the causal chain),

But if the trust's objective in imposing RPM were simply anticompetitive, an attempt to raise barriers to new entry, it must have been disappointed with the results.... Arbuckle was forced to deal directly with retailers in the Boston market and through its own wholesale grocery concern in the Ohio Valley. Nevertheless, Arbuckle was a successful entrant despite this disadvantage and its small scale of entry (citations omitted).³²

²⁹ This "consideration for exclusion" argument is the core of Paldor's argument for why RPM is exclusionary. See n. 25 *supra*.

³⁰ *Id.*

³¹ Zerbe, Richard, "The American Sugar Refinery Company, 1887-1914: The Story of a Monopoly," *Journal of Law and Economics* 12 (1969): 339-375, at 368.

³² Marvel and McCafferty, n. 21 *supra* at 367.

III. Characterizing exclusionary conduct³³

Analysis of exclusion should begin with a truism: To exclude rivals, one has to be able to raise the prices they pay for what they need to compete.³⁴ These can include nominal inputs (e.g., raw materials, labour) or downstream services (e.g., distribution, retailing). To cover all the possibilities, we refer to both types as complements. Thus, to exclude a rival, one has to raise the price of complement above what it would be otherwise. This necessarily entails acquiring sufficient explicit or implicit control of a relevant complement market to increase in the price of the complement sufficiently to have meaningful competitive effects. Exclusion thus depends on reducing competition in a relevant complement market; we call this framework complement market monopolization (“CMM”).

Figure 1 below illustrates how CMM works. Imagine that one has a “bad guy,” whom we will call “3M”, and a smaller rival, “LePage’s,” named after the parties in a famous recent exclusionary monopolization case in the U.S. involving the sale of transparent tape.³⁵ “3M” engages in some practice that excludes “LePage’s” from using some of the retailers to sell transparent tape. These retailers include “CVS,” “Staples,” and another retailer, “R3”. “LePage’s” is forced to turn to retailer R4 and perhaps other inferior retailers as well, as indicated in the box on the bottom right.

A necessary and sufficient condition for “3M’s” practice to be competitively relevant is that if restricting “LePage’s” options forces “LePage’s” to have to pay more for retail outlets for its tape. This could happen because of reduced competition among retailers in the relevant market—here indicated by having only one, R4, available to it—or by forcing it to use retailers either less desirable to final purchasers (e.g., further away) or less

³³ This draws upon a framework set out in the sources at n. 24 *supra*. I will omit many of the details here.

³⁴ An initial description of the implications of this truism is Brennan, Timothy, “Understanding Raising Rivals’ Costs,” *Antitrust Bulletin* 33 (1988): 95-113.

³⁵ *LePage’s v. 3M*, 324 F.3d 141 (3d Cir. Pa., 2003), *cert. denied* 124 S. Ct. 2932 (2004). That case specifically dealt with bundled rebates including “house brand” transparent tape, but we need not get into those specifics here.

efficient operationally, thus requiring higher margins and leaving less for “LePage’s” given any retail price. Either way, because of an increase in the (perhaps quality-adjusted) price of retailing services, “LePage’s” is less able to constrain “3M’s” prices. Equilibrium prices of tape increase, with attendant losses in consumer and (absent countervailing efficiencies) total welfare.

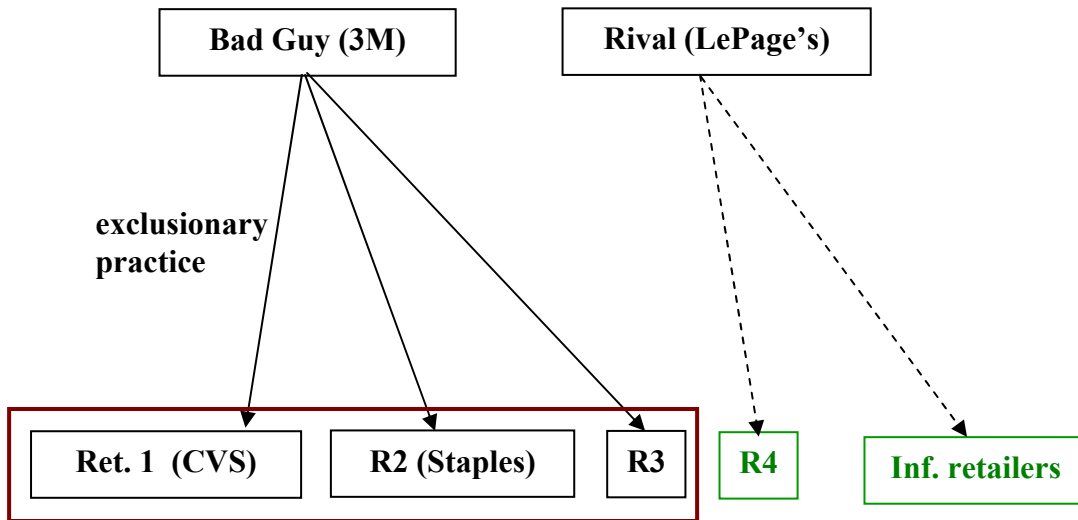


Figure 1: Complement Market Monopolization³⁶

A number of observations relevant to ascertaining anticompetitive exclusion in general, and with respect to RPM, follow from this CMM framework. As the diagram makes clear, the relevant market for ascertaining the competitive effect of the exclusion is neither the primary market usually the focus of these cases—here, it would be transparent tape—nor a “vertical” effect across the markets. Rather, the effect is horizontal, within the market in which competition is being directly reduced because of the restraint, the complement market—here retailing tape. The effect of the restraint is to eliminate the potential for independent competition among complement suppliers covered by the restraint, e.g., those within the rectangle at the bottom of Figure 1, at least in the supply of services to suppliers in the primary market.

This is significant for at least three reasons. First, if the complement market is not adversely affected by the restraints, there is no increase in the price of the complement,

³⁶ The diagram is from Brennan, n. 6 *supra*, Figure 3 at 23.

and thus no harm to rivals and, more important, to economic welfare. Second, if the primary market that usually gets the focus is already a stable monopoly, the marginal effect of eliminating competition in the complement market is smaller. The exclusionary practice will be most effective if the markets—both the primary and the complement market—would be competitive but for the practice.³⁷ The standard requirement of establishing that an upstream firm already has a monopoly, e.g., that entry barriers are high in the primary market, makes the “but for” argument harder, and is thus counterproductive. When it comes to exclusion, the case would be more effectively analyzed as an “abuse creating dominance,” not an “abuse of dominance;” standard nomenclature confuses effect with cause.

Third, if there is a prior monopoly in the primary market, the “Chicago school” argument essentially applies—the effect of monopolizing the complement market through these restraints is more likely to be positive, since eliminating that competition directly reduces, not increases, the profitability of a prior monopoly. Hence, the practice is likely to create some efficiency-related profit opportunity, e.g., improving point-of-sale service. The Chicago argument that these practices are benign fails, though, if they create market power when none existed previously, which here would be monopolizing a complement market where there are no other entry barriers in the vertical production chain.

Related to this observation is the following. Since exclusionary practices essentially eliminate competition among competitors in a complement market, its relative costs of overdeterrence (“false positives”) and underdeterrence (“false negatives”) differ fundamentally from those when predation is alleged. With predatory practices, the concern is that the perpetrator is being too competitive in the short run, e.g., charging excessively low prices or bundling additional features, in order to carry out a strategy that will lead to the subsequent exercise of market power. Since low prices, added features, and improved performance to price, are generally desirable, overdeterrence is a significant concern. This justifies strict tests, e.g., showing that the pricing or bundling at issue would *never*

³⁷ The “but for” test was recently adopted by the Federal Court of Appeal in Canada in *Commissioner of Competition v. Canada Pipe*, 2006 FCA 233 [2006] at ¶¶38-44, available at <http://decisions.fca-caf.gc.ca/en/2006/2006fca233/2006fca233.html>

be a competitive response under any circumstance. This justifies tests such as pricing below marginal (or average variable) cost or that the practice involves a “profit sacrifice” or makes “no business sense.” However, such tests are not justified when the conduct does not involve excessive short-run competition, but directly suppresses rivalry among competitors, here complement providers. The quest for a single test for all forms of monopolization or abuse of dominance is misguided.³⁸

Because the crucial market is that for the complement, and because the restraint potentially suppresses competition among the supply of the complement, conventional approaches to horizontal restraints, particularly mergers, apply. One should delineate the complement market as if one were analyzing a merger of the parties, e.g., those within the rectangle in Figure 1, as if one were assessing the unilateral effects on price of suppressing competition among those dealers.³⁹ Following that approach, one should ask if entry is easy (including self dealing by the rivals), and whether complement providers offering close substitutes, e.g., R4 in Figure 1, would be willing and able to expand in response to an attempt by those covered by the practice if as a result they attempted to raise significantly the price of the complement. If they can so expand, or if that market is easy to enter (including self-provision by firms in the primary market, e.g., direct retailing) the restraint is unlikely to be troublesome.⁴⁰ However, if entry is sufficiently difficult and the ability of others in the market to expand is limited, the merger and, accordingly, the restraint can create market power.⁴¹

An additional implication of CMM, particularly its essentially horizontal nature, is that the question of its equilibrium sustainability is less pressing than it might otherwise be. The usual portrayal of exclusionary conduct is that the complement providers are

³⁸ This receives elaboration in Brennan, n. 24 *supra*.

³⁹ The basic analysis of unilateral effects was first set out in the Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (1997), §2.2, available at <http://www.usdoj.gov/atr/public/guidelines/hmg.pdf>.

⁴⁰ Inability to create and exercise market power through exclusive dealing if uncovered complement providers are able to expand or enter easily was pointed out in Fumagalli, Chiara and Massimo Motta, “Exclusive Dealing and Entry When Buyers Compete,” 96 *American Economic Review* 96 (2006): 785-95.

⁴¹ A recent response to Fumagalli and Motta, *Id.*, is Abito, Jose and Julian Wright, “Exclusive Dealing with Imperfect Downstream Competition”, *International Journal of Industrial Organization* 26 (2008): 227-246.

forced into complying, and thus one needs some extra factor, such as scale economies, to ensure that the complement providers go along.⁴² However, the profits of the practice come about because of the reduction of competition in the complement market. The primary market firm that carries out the strategy may be doing little more than overcoming transaction costs (or a finding of illegality) that preclude the complement providers from colluding themselves. In this regard, it may take little more than the “Coase theorem”—that parties who can find a mutually beneficial outcome will do so—to support the outcome in this case. In any event, it is inherently no more mysterious than collusion itself.⁴³

None of this eliminates the possibility that the practice nonetheless creates efficiencies. Exclusive dealing, for example, eliminates free-riding by other manufacturers on support services (instruction on maintenance and marketing) supplied to retailers or distributors.⁴⁴ Efficiencies, however, are typically present to some degree with horizontal restraints, particularly mergers, which is why one requires a demonstration of a likely substantial lessening of competition before preventing them. As with mergers, the appropriate stance to take regarding exclusionary practices is to permit them, but only if they span less than a share of an appropriately delineated complement market necessary to create significant market power. Unfortunately, standard treatment of exclusionary conduct is binary—it is either permissible without limit or permissible nowhere. If such an approach would be bad policy for mergers, it is at least questionable for exclusionary conduct when viewed from a CMM perspective.

To apply that perspective to an exclusionary practice, then, we want to know two things:

⁴² Rasmusen, Eric, J. Mark Ramseyer and John Wiley, “Naked Exclusion,” 81 *American Economic Review* 81 (1991): 1137-45.

⁴³ One might add that one is unlikely to bring an action under competition or antitrust law unless one observes that practice and can show that it has substantially lessened competition. This somewhat obviates a concern as to whether the practice would be observed. It brings to mind a quote from, I believe, Alan Blinder: “An economist is someone who sees something work in practice and wonders if it works in theory.”

⁴⁴ Marvel, Howard, “Exclusive dealing,” *Journal of Law and Economics* 25 (1982): 1–25; Besanko, David and Martin Perry, “Equilibrium Incentives for Exclusive Dealing in a Differentiated Products Oligopoly,” *RAND Journal of Economics* 24 (1993): 646–667.

First, does the practice span a dominant share of a relevant complement market?

Answering this question entails not just a simple share test, but inquiring about the relative ease of entry and expansion in response to an attempt to impose higher complement prices on rivals. If the answer to this question is “no,” there is no reason to proceed further. If the answer to this question is “yes,” we then ask:

Second, does the practice significantly raise the price of the complement?

This, too, has two aspects. First, is that the practice itself need not increase significantly the price rivals pay covered providers for the complement. It is important to note that this price effect is never infinite. For explicit exclusive dealing contracts, the effect on the price rivals have to pay for the complement from covered providers includes paying the penalty for breach. For bundled rebates, depending on their structure, the payment includes compensating complement providers for foregone discounts.⁴⁵ Second, even if that price is large, turning to providers not covered may not lead to significantly higher complement prices. This, of course, is part of the inquiry regarding appropriate delineation of the complement market, but depending on how the inquiry is approached, it may be worth noting here for completeness.

For RPM to be exclusionary, we have to ask under what circumstances it might lead to affirmative answers to both of these questions.

IV. Applying CMM to RPM

The first question to address whether RPM sufficiently covers a relevant market in wholesaling or retailing—how big is the rectangle in Figure 1, relative to the size of the relevant market. This introduces a number of novel considerations.

First, the span of the RPM has to be that of a single upstream supplier. This is not because that supplier needs to have market power as such. Rather, the suppression of competition among the downstream wholesalers or retailers requires that their practices

⁴⁵ Brennan, n. 6 *supra* at 31-33.

induced by RPM be under singular control. This differs from the “facilitating collusion” theory, which requires that a dominant share of upstream suppliers employ RPM, but no one of them need cover a dominant share of the retailers.

Second, to span a dominant share of a relevant downstream market, it may not be enough to cover just those retailers that provide point-of-sale service. If a single manufacturer’s RPM covers most of those retailers, discount outlets and online retailers would still be available. Unless such outlets, for reasons specific to a particular product, are not suitable substitutes for rivals, the ability of rivals to employ those outlets would be preserved. No upstream competitor who could use such outlets would face higher retailing costs, and there would be no exclusionary effect. Any effect would have to be on rivals who needed the high-service retailers, but were less able to access them because of the upstream firm’s RPM.

This leads to the second question—the effects of imposing RPM on a retailer’s ability to offer services to the upstream firm’s rivals. Such an effect may be less apparent than a first glance would suggest. Just because one firm imposes RPM on a retailer does not necessarily reduce that retailer’s ability to supply its services to rivals. The retailer may have the option of giving rivals shelf space, without the services RPM induces—in effect, offering the same services a discount outlet would offer. Moreover, even if the rival wants the services RPM induces, a rival could, in principle, offer the same deal to the retailer in exchange for those services.

For RPM to limit a retailer’s ability to serve rivals, something else must be in place. Explicit exclusive dealing contracts would have this effect, but that takes us out of the realm of RPM and into exclusive dealing itself, where the potentially anticompetitive exclusionary effects are relatively well understood, as described above. Absent such contracts, the particular argument for RPM being exclusive has to be that if one firm gives the retailer a margin exceeding marginal retailing costs, it will reduce that retailer’s incentive to offer its services to that firm’s rivals. That the retailer finds it worth more to serve the firm with RPM is not sufficient, since it could find it nevertheless profitable to

supply its retailing services to others who seek such services, including the RPM-adopting firm's rivals, in the overall retailing service market.

Hence, for RPM to be exclusionary, one needs some kind of capacity limitation on the retailers. Inducing the retailer to give the firm more shelf space, by overpaying for it through RPM, excludes rivals only by creating an opportunity cost. Devoting shelf space or services to rivals has to sacrifice at the margin the opportunity to earn the RPM-created margin on selling products by the firm. This requires limited capacity—something that may be difficult to show. Because retailers typically carry a number of product lines, the marginal cost of supplying shelf space, and perhaps services, will be relatively constant over the entire store, thus creating no apparent capacity limitation.

To establish an exclusionary effect of RPM for a particular retailer, one will have to show that the capacity of shelf space within the store for a particular line of products is limited. This will be easier to show if the RPM induces not just carrying a product but sales efforts, as retailers may have limits in the ability to provide effort to sell a particular line of products. For example, a department store might have numerous sales persons on the floor, but only a few may have the knowledge necessary to market effectively a particular type of product, e.g., a high-definition television or innovative kitchen appliance.

A final possibility raises another cautionary note. It may be that the “opportunity cost” comes about because of limited capacity of the end users to absorb sales from the individual retailer. If that is the case, then to some degree the retailer presumably possesses some market power. It is not in a textbook competitive market, in which it is a price taker because buyers of its services—either final customers or upstream manufacturers—have numerous alternatives. If the retailer possess market power, however, it is harder to make the argument that RPM, exclusive dealing, or anything else that ties up the retailer appreciably makes matters worse. Just as we found with upstream dominance, if the retailer already possess market power, it is harder to argue that “but for” the restraint, the market would achieve a more efficient outcome.

In summary, then, for RPM to have an exclusionary effect, we would need the following:

- A single upstream firm imposing it over a dominant share of a retail market.
- Discount outlets unlikely to be acceptable substitutes in that retail market, at least with regard to selling the upstream firms' rivals' products.
- Covered retailers must have limited capacity to carry the type of product sold by the upstream firm.

V. Concluding observations

Until the Supreme Court's 2007 ruling in *Leegin*, resale price maintenance had been *per se* illegal in the United States for nearly a century. It remains illegal in Canada under the *Competition Act*. Yet numerous economic studies have illuminated the efficiency benefits of RPM. Those suggest that, at worst, RPM deserves equivalent treatment with non-price restraints, which since the late 1970s have been analyzed under a cost-benefit like "rule of reason" test in U.S. courts. After Supreme Court rulings in the 1980s expanded the conditions an agreement between a manufacturer and its retailers must meet to warrant *per se* illegality, the *Leegin* decision gave RPM "rule of reason" status.

That RPM was not declared legal implies that it could be anticompetitive. The primary justifications for regarding RPM as potentially anticompetitive are that it either replicates the effect of an intrabrand downstream retailer cartel or facilitates an upstream manufacturer cartel. The plausibility of either can be questioned on theoretical and empirical grounds, but the Supreme Court, in *Leegin*, introduced a seemingly novel consideration—that RPM could be exclusionary.

After reviewing the Court's limited authority for that claim, we reviewed a theory of exclusion based on monopolizing access to an erstwhile competitive complement market. That theory leads to two basic questions—coverage of a properly defined complement market (e.g., retailing) and effect of RPM on the implicit price of access to that market. We cannot rule out that RPM could be anticompetitive, but find it unlikely, as it requires that a single firm cover the relevant retailing market under RPM and that covered retail-

ers have limited capacity, so inducements to sell more of one firm's products reduce the incentive to sell those of rivals.

Such a conception differs from the argument posed by Marvel and recently expanded upon by Paldor. They find an exclusionary effect from RPM as a giving a reward to downstream firms—higher retail margins—that the upstream firm can threaten to take away if displeased by the retailer's conduct. This builds on Klein and Murphy's insight that RPM in general can sustain vertical contracts of any sort. This could provide an additional breach penalty for explicit exclusive dealing, and arguably could support implicit exclusive dealing. Exclusive dealing perhaps does not require exclusive contracts. The U.S. Antitrust Division so contended in its monopolization case against Dentsply, a manufacturer of artificial teeth for dentures accused of preventing competitors from getting access to national distributors to dental labs.⁴⁶

The tests for whether the "consideration for exclusion" theory holds would seem to be the same as those outlined here. However, as the discussion above shows, absent capacity constraints that create an opportunity cost, RPM in and of itself has no effect on marginal incentives to carry entrants. If one believes that the effects of RPM is ancillary to explicit or implicit exclusive dealing, then the harm is the exclusive dealing itself, not the RPM, and the case should be brought as such.

⁴⁶ U.S. v. Dentsply, 277 F. Supp. 2d 387 (D.C. Del. 2003), *rev'd and remanded*, 399 F.3d 181 (3rd Circ. 2005).