Legal Standards for Vertical Restraints

FISCALIA NACIONAL ECONOMICA

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Justice Breyer,

Leegin Creative Products, Inc. v. PSKS, Inc., 551 U.S. 877, 914-15 (2007)

> [E]conomics can, and should, inform antitrust law. But antitrust law cannot, and should not, precisely replicate economists' (sometimes conflicting) views. That is because law, unlike economics, is an administrative system the effects of which depend upon the contents of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients.

See also Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 234 (1st Cir. 1983)

Vertical restraints: what are they?

An agreement or concerted practice entered into between two or more undertakings each of which operates, for the purposes of the agreement or the concerted practice, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services.

Payment Schemes

- Franchise fees
- Progressive or fidelity rebates
- Royalties

Provisions Specifying the Parties' Rights

- Resale price maintenance
- Quantity fixing
- Exclusive dealing
- Tie-ins
- Territorial or customer restriction

Economic role of vertical restraints

Potential pro-competitive benefits

- Enhanced vertical coordination between upstream and downstream decisions and efforts
- Eliminating free-rider problems can foster non-price competition
- Some exclusivity rights can mitigate hold-up problems and encourage relationship-specific investments

Short-term anti-competitive risks

- Facilitating practices and sham cartels
- Competition dampening
- Common agency
- Interlocking relationships
- Territorial or customer restriction

Long-term perspective

- Can foster potential competitors' incentives to enter a market (pro-competitive)
- Can also be used by incumbent to raise entry barriers (market foreclosure).

Evolving treatment of vertical restraints in the U.S.

Dr. Miles Medical Co. v. John D. Park & Sons Co., 200 U.S. 373 (1911), minimum resale price agreements held to be *per se* unlawful

U.S. v. Arnold, Schwinn & Co., 338 U.S. 365 (1967), vertical non-price restraints held to be *per se* unlawful

Albrecht v. Herald Co., 390 U.S. 145 (1968), maximum resale price maintenance held to be *per se* unlawful, following *Dr. Miles*

Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977), reversed *Schwinn* and held that non-price vertical restraints would be analyzed under the "rule of reason"

State Oil v. Khan, Inc., 522 U.S. 3 (1997), overrules Albrecht, and holds that maximum resale price maintenance subject to "rule of reason"

Leegin Creative Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007), 5-4 decision overrules *Dr. Miles* and holds that minimum resale price agreements, like other vertical restraints, to be analyzed under the "rule of reason"

Leegin: Justice Breyer's dissent

Rule of reason, as applied in the U.S. in the vertical non-price context, has resulted in a de facto rule of per se legality

Anti-competitive risks of RPM

- Facilitating manufacturer or retailer cartels
- Abuse by dominant manufacturer to forestall entry
- Abuse by dominant retailer to forestall innovation

Administrability concerns

- While economic theory "can, and should, inform [competition] law," the law "cannot, and should not, precisely replicate economist's (sometimes conflicting) views."

- "[L]aw, unlike economics, is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients."

Decision Theory and Legal Standards

C. Frederick Beckner III & Steven C. Salop, “Decision Theory and Antitrust Rules,” 67 ANTITRUST L.J. 41 (1999)

Sets out a process for making factual determinations and decisions when information is costly and therefore imperfect.

The appropriate standard turns on “the configuration of informational presumptions, costs and benefits for a particular case or class of cases,” wherein:

- Presumptions entail “the initial general and case-specific information known to the decision maker.”
- Costs include gathering and evaluating additional information about the conduct; and
- Benefits consist of “the reduced likelihood of factual and judicial error, which depends on the degree of uncertainty faced in the absence of the information and the importance of the issue to the proper outcome of the case.”

Decision theory and the *Leegin* dissent

1. Initial presumption: RPM *per se* unlawful

2. What are the potential benefits of gathering additional information about the practice?

   - Depends on how frequently pro-competitive uses are encountered in practice: “uncertain ‘sometimes.’”

3. What are the costs of gathering additional information?

   - In the U.S. system, significant.

4. How often will engaging in this information gathering decrease errors?

   - “How easily can courts identify instances in which the benefits are likely to outweigh potential harms? My own answer is, not very easily.”

Structured Rule of Reason

Mass. Bd. of Optometry, 110 F.T.C. 549, 604 (1990):

> First, we ask whether the restraint is "inherently suspect." In other words, is the practice the kind that appears likely, absent an efficiency justification, to "restrict competition and decrease output."… If the restraint is not inherently suspect, then the traditional rule of reason… must be applied. But if it is inherently suspect, we must pose a second question: Is there a plausible efficiency justification for the practice… [which] cannot be rejected without extensive factual inquiry[?] If it is not plausible, then the restraint can be quickly condemned. But if the efficiency justification is plausible, further inquiry—a third inquiry—is needed to determine whether the justification is really valid.

PolyGram Holding, Inc. v. Fed. Trade Comm'n, 416 F.3d 29 (D.C. Cir. 2005):

> If, based upon economic learning and the experience of the market, it is obvious that a restraint of trade likely impairs competition, then the restraint is presumed unlawful and… the defendant must either identify some reason the restrain is unlikely to harm consumers or identify some competitive benefit that plausibly offsets the apparent or anticipated harm.

Structured Rule of Reason for RPM in the U.S.?

Leegin majority appears to signal that the competitive analysis need not always require an exhaustive inquiry:

> As courts gain experience considering the effects of these restraints by applying the rule of reason over the course of decisions, they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businessmen. Courts can, for example, devise rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote precompetitive ones.

May 6, 2008 Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000, *In the Matter of Nine West Group Inc.*

> Not every use of RPM "inherently suspect," but rather those instances where the defendants could not establish the absence of *Leegin* factors.

Rey's conclusions on vertical restraints

Not only can vertical restraints yield efficiency benefits, as well as serve anticompetitive purposes, *the same restraints can have similar effects in some market environments, and different ones in other markets*.

The more market power, the greater the concern about anticompetitive effects.

With respect to Chile, Rey notes:

> This is particularly relevant for the Chilean economy, which is both small and concentrated; some of the key retail industries have just a few participants, and in most markets interbrand competition is oligopolistic in nature. In this context, market power is likely to be important, which can encourage unilateral conduct aiming at exploiting it more fully, as well as strategic behavior aiming at softening competition between incumbent rival vertical structures or foreclosing the market to new competitors. In this context, vertical restraints such as RPM and exclusive dealing must be analyzed carefully, as the possibility of anticompetitive effects is more likely.

Some takeaways?

1. The economics literature has provided policy makers with valuable insights into the competitive benefits (and risks) of many vertical restraints

   But in some instances, the theoretical literature is far more developed than our empirical knowledge.

1. The literature can help us design legal standards that tend maximize social welfare by permitting efficient uses of certain vertical restraints—but those standards cannot fully replicate the economics literature.

1. Decision theory can provide a tool for evaluating legal standards that might be applied to particular categories of conduct.

2. Because certain restraints can have similar effects in some market environments, and different ones in other markets, an optimal legal standard in one economy might not be appropriate in others.

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