Supplier terms and pricing issues under US antitrust law

Introduction

The US Supreme Court overturned nearly a century of US case law regarding resale price maintenance agreements ("RPM") in its 2007 decision in *Leegin Creative Leather Products v. PSKS, Inc. (2007) ("Leegin")*. Consistent with the Court's general approach of making the evidence-based analysis of economic effects the focus of antitrust inquiry, economic analysis of RPM agreements was central to the Court's holding in *Leegin*. Recognizing the potential competitive benefits of RPM, *Leegin* abandoned the long-standing treatment of such agreements as *per se* illegal, thereby effectively eliminating any difference in treatment of price- and non-price- vertical restraints under the Sherman Act.

However, there is little evidence that *Leegin* has led to an expansion of RPM agreements in the marketplace to date. This is attributable in part to a continuing lack of certainty on how courts will analyse RPM agreements. The Court's decision in *Leegin* offers limited guidance on the application of the Rule of Reason to such agreements, and the dearth of subsequent case law in the lower federal courts leaves work to be done in clarifying the Court's guidance. This uncertainty is compounded by the lack of formal guidance from the US antitrust authorities and the fact that minimum RPM agreements remain *per se* illegal under state law in some US states. The US market has generally responded by retaining the pre-*Leegin* practice of unilateral minimum price policies such as manufacturers' suggested prices and minimum advertised price policies (co-called "Colgate policies").

Regarding online restrictions, US law does not distinguish between vertical restraints in the context of online sales from physical sales, so a standard analysis of the anticompetitive effects of the alleged restraints will apply, focusing on the market definition and market power of the supplier.

The Supreme Court has not clarified the standard that should be applied to discounting and rebates, and federal circuit courts currently diverge in their approaches. The dominant approach asks whether the supplier is providing product to resellers below cost.

What is the basic position under US antitrust law regarding resale price maintenance (RPM)?

Post-Leegin, the basic position under US law is that RPMs may have competitive benefits that outweigh anticompetitive harms.

In the wake of *Leegin*, courts must now apply a Rule of Reason analysis to all RPM agreements. Rule of Reason analysis begins with a definition of the relevant market and an evaluation of the parties' market power within the relevant market, but takes a number of additional factors into consideration, including specific information about the relevant business, its condition before and after the restraint was imposed, and the restraint's history, nature, and effect.

The *Leegin* Court suggested that additional factors, beyond the standard Rule of Reason analysis, may be relevant specifically to the analysis of RPM agreements.

- **Prevalence**: The greater the number of manufacturers employing RPM agreements within a specific market, the more likely that the practice may support a manufacturer or retailer cartel.
- **Source**: Where the impetus for a RPM agreement comes from retailers, the RPM may facilitate a retailer cartel or support a dominant, inefficient retailer.
- **Market power**: Vertical price restraints such as RPM may not be of "serious concern" if the manufacturer or retailer imposing the RPM agreement lacks market power, as it is less likely that that it can restrict competitors' access to distribution outlets.
- **Lower court guidance**: The Supreme Court in Leegin expressly called on lower courts to "establish the litigation structure" and "to provide more guidance to businesses" in respect of the analysis of RPM agreements.

Federal courts have generally not reached the *Leegin* factors, as cases involving RPM agreements have been decided on, for example, the threshold questions of whether the plaintiff has sufficiently articulated a relevant market and demonstrated harm to competition in that market.

What do recent cases and investigations tell us about the the US antitrust authorities', the US federal courts, and the US states' respective positions on RPM?

US antitrust authorities

While officials at both the FTC and DOJ have acknowledged the uncertainty following *Leegin*, neither agency has issued formal guidance on RPMs to date. In its Antitrust Guidelines for the Licensing of Intellectual Property, issued on January 13, 2017, the Agencies state that Rule of Reason analysis will be applied to price maintenance agreements in the IP licensing context, but provide no comment on the application of the *Leegin* factors.

The primary guidance on the enforcement approach the US antitrust authorities may take therefore comes from the FTC's decision in *Nine west Grp. Inc.* (2008). Nine West entered a consent decree in 2000 with the FTC, according to which Nine West was prohibited from entering into RPM agreements. After *Leegin*, Nine West applied to the FTC for a modification of the order. The FTC applied two of the Supreme Court's four *Leegin* factors and modified the order, removing the restriction. Specifically, the FTC found that Nine West lacked market power in the relevant market and that the impetus for the contemplated RPM agreements came from Nine West, a manufacturer, not from a dominant retailer, an arrangement the Supreme Court deemed less suspect under US antitrust law.

US federal courts

There is a dearth of federal court decisions applying the *Leegin* factors to the merits analysis of an RPM agreement since the Supreme Court's decision in 2007. Where RPM agreements have been the subject of federal litigation, courts have generally disposed of the case without applying the *Leegin* factors.

One exception is the decision by the Third Circuit Court of Appeals in *Toledo Mack Sales & Serv. v. Mack Trucks Inc.*, 530 F.3d 204, 225 (3d Cir. 2008) ("Toledo Mack"). The case involved allegations by a dealer of trucks that, in relevant part, alleged that the manufacturer had engaged in illegal vertical restraints of trade with other dealers. Having found that the plaintiff sufficiently alleged the existence of a vertical agreement between manufacturers and the dealers, the Third Circuit turned to the *Leegin* factors to conduct its Rule of Reason analysis. The court found that two of the factors suggested the evidence was sufficient for a finding of an illegal agreement, i.e., the impetus for the RPM came from the dealers themselves, supporting an inference of a retailer cartel, and the market power of the manufacturer in the relevant product markets supported an inference of manufacturer dominance.

US state courts

Despite the US Supreme Court's decision in *Leegin*, RPM agreements remain *per se* illegal in some US states. While some US states have rejected *Leegin* outright, others have yet to review the legality of RPM agreements under state law in light of the Supreme Court's decision. As US states have concurrent antitrust enforcement authority with the federal government, the divergence in respect of RPM agreements between state and federal authorities remains a considerable source of continuing uncertainty for clients. For example:

- **California**: Post-*Leegin*, courts have continued to interpret minimum RPM agreements as *per se* illegal under California's Cartwright Act, e.g., See, e.g., *Darush v. Revision LP* (C.D. Cal. Apr. 10, 2013) ("[S]imply because the Supreme Court has changed course regarding the Sherman Act

[i.e, the *Leegin* decision] does not mean the California Supreme Court will regarding the Cartwright Act. Until the California Supreme Court has given a persuasive indication that it will, the Court cannot simply disregard its decision."). The California attorney general has indicated California's intent to continue to prosecute minimum RPM agreements.

- **Maryland**: Maryland legislators responded to the Supreme Court's *Leegin* decision by amending state antitrust statute to render minimum RPM agreements *per se* illegal under state law. *See* Md. Code Ann., Comm. Law § 11-204(a)(1); (b). The statute provides for civil damages, injunctive relief, and criminal fines and imprisonment for wilful violations of the statute.
- **New York**: Under New York law, minimum RPM agreements remain unenforceable, despite *Leegin*. However, such agreements are not *per se* illegal, and New York courts have rejected the New York's attorney general's enforcement actions against RPM agreements, e.g, *New York v. Tempur-Pedic Int'l, Inc.* (1st Dep't 2012) (holding that even if there had been an RPM agreement, New York law made such agreements "unenforceable," not "illegal").

How are online sales restrictions treated?

Generally, US manufacturers and suppliers are free to include a wide range of restrictions on the distribution of their products and online sales are treated no differently. Manufacturers and suppliers may justify online sales restrictions in the context of efforts to minimize free-riding issues, protect the equity of its brand, or to otherwise improve inter-brand competition. Similar concerns may justify a practice permitting internet sales by selected distributors. The US antitrust analysis will generally turn on whether the relevant entities wield market power within the relevant markets, or whether collusion between competitors is present.

Are Platform restrictions permitted?

Yes, subject to the Rule of Reason analysis applied in all price- and non-price-related restraints. Where a manufacturer or supplier is acting on its own, the FTC has stated that such restrictions will generally be legal. A manufacturer or supplier may therefore reserve online distribution channels for itself or for select distributors. Assessing the market power of the relevant entities is key to determining the legality of alleged vertical restraints. However, US law and enforcement practice, unlike the EU vertical guidelines, do not deem the distinction between online and physical distribution channels dispositive for purposes of antitrust analysis. The US antitrust authorities have observed that harmful anticompetitive effects may arise from a practice regardless of the degree of online sales, and the economic literature on the subject does not justify a rigid distinction in treatment between virtual and physical distribution platforms.

US law also differs from the EU approach in respect of passive sales, as US law does not distinguish between active and passive selling in the context of vertical restraints.

What about online pricing restrictions?

Yes, US law and EU again differs on the restrictions a supplier may impose on a distributor in respect of pricing for products sold through different distribution channels, e.g., online as opposed to physical stores. The US Supreme Court's decision in *Leegin* eliminated the previous distinction under US antitrust law between price- and non-price vertical restraints. Dual pricing policies would therefore be analysed under a Rule of Reason framework, as discussed above. US law and enforcement authorities make no distinction between direct and indirect dual pricing measures. Each policy or agreement will be analysed on a case-by-case basis to evaluate the anticompetitive effects of the practice (if any), and weigh them against the need to achieve any applicable pro-competitive benefits.

What is the approach to discounts and rebates under US antitrust law?

Bundling discounts are offered by manufacturers or suppliers for the purchase of a quantity of products at a rate less than the combined per-unit cost. The Supreme Court has not provided a clear standard with which to assess bundling discounts, and federal circuit courts are currently split in their approaches. The dominant approach looks to the objective question of whether the discounted product is being supplied below cost.

The Ninth Circuit Court of Appeals articulated the dominant approach, the so-called discount allocation standard, in *Cascade Health f/k/a McKenzie Willamette v. PeaceHealth* (9th Cir. 2008) ("PeaceHealth"). The plaintiff, a hospital competing with PeaceHealth in a small market in Oregon with no other hospitals, alleged that PeaceHealth forced it out of the market by offering discounts to insurance companies that purchased the full range of PeaceHealth's hospital services. The plaintiff claimed that it could not match PeaceHealth's price because it did not offer the same range of services. The Ninth Circuit vacated the lower court judgment on the basis that bundling discounts are lawful absent proof that the discounted price is below the manufacturer or supplier's average variable cost of production. However, the Ninth Circuit recently declined to extend *PeaceHealth* in *Aerotec International, Inc. v. Honeywell International, Inc.* (9th Cir. 2016). The Ninth Circuit held that both the plaintiff and the defendant, competitors in the market for the repair and maintenance of components of commercial aircraft, were able to bundle components with repair services.

The Third Circuit Court of Appeals, by contrast, adopted an approach that looks to the exclusionary effects of practice in question, rather than treating the issue of below-cost pricing as dispositive of the antitrust inquiry. *LePage's Inc. v. 3M* (3d Cir. 2003) (*en banc*), *cert. denied*, 542 U.S. 953 (2004). The exclusionary effects test adopted in *LePage's* remains the law in the Third Circuit, but has not proven as influential in other circuits in the United States.

Antitrust liability for loyalty discounts will generally turn on the market power of the relevant supplier. Where the supplier possesses "substantial" market share, where substantial harm to competition can be shown, and where the supplier deployed the loyalty discounts as part of a broader strategy of deterring buyers from competitors or coercing buyers into remaining with the supplier, US courts have found antitrust violations, e.g., *ZF Meritor, supra, Masimo Corp. v. Tyco Healthcare Group L.P.,* 2009 WL 3451725 (9th Cir. Oct. 28, 2009) (supplier imposed requirement that buyers purchase 90-95% of their requirements from supplier to be eligible for loyalty discounts). Where some of these elements are absent or where the supplier lacks market power, loyalty discounts are unlikely to pose antitrust compliance risks.

Have there been any recent developments in this area of antitrust law?

While there has been insufficient development in the lower courts to date to determine how the relevant factors identified by the Supreme Court in *Leegin* will be applied in different factual circumstances, courts have nevertheless dismissed challenges to RPM agreements for failure to sufficiently allege a relevant market or anticompetitive harm. This development in itself demonstrates the harmonization of the treatment of price- and non-price vertical restraints under the Rule of Reason in the wake of *Leegin*.

The practical effect of *Leegin* on the marketplace has been less clear, with many manufacturers and suppliers preferring to retain pre-*Leegin*, unilateral *Colgate* policies or minimum advertised pricing policies to avoid entering RPM agreements with resellers. On the other hand, *Leegin's* abandonment of *per se* treatment and "automatic" liability for RPM agreements should permit suppliers greater flexibility in their dealings with resellers.

The patchwork of state law remains an area of uncertainty. Some US states have explicitly rejected *Leegin* and actively pursued enforcement under state antitrust statutes, while others have avoided revising state law in the wake of the Court's decision. Although state attorneys general have met with limited success in some instances (e.g., New York), the possibility of class action suits remains a risk factor.

Unlike EU law, US antitrust law has not developed specific proscriptions related to vertical restraints in an online context, as the venue of the restraint is not deemed to be of significance for the competition analysis.

Without a decision from the Supreme Court on practices related to discounting and rebates, the current state of US law on these points remains somewhat uncertain, although the Ninth Circuit's approach, rooted in an objective economic analysis, is consistent with the general trend in the development of US antitrust law and has been followed in other circuits.

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