As a counterexample to John Maynard Keynes’s pronouncement about the influence on policy of ‘defunct economists’, contemporary antitrust law in the United States is shaped by the living. Nowhere is this truer than in the area of vertical restraints. Starting with debates over restrictions in patent licensing and continuing with the most recent debates leading up to the Supreme Court’s decision in *Leegin Creative Leather Prods. v. PSKS, Inc.*, the proper legal treatment of vertical restraints has been framed in terms of ongoing debates over the economics of contractual restrictions on business freedom and the structuring of competition.

This chapter examines the law and economics of vertical restraints with particular attention to the Supreme Court’s recent decision in *Leegin*. While the law of vertical restraints has moved towards a rule of reason, and hence greater contractual freedom under the antitrust laws, this shift requires us to rethink the meaning of competition and the role of law in shaping the rules of the marketplace. Concomitant with this shift towards contractual freedom is the centrality of intellectual property in shaping competition policy. This chapter identifies parallels between the legal analysis of vertical restraints and the theory of intellectual property, with the goal of devising a unified approach to the law and economics of distribution mechanisms. While the principal discussion is of US antitrust law, the chapter concludes with a comparison with the European Union’s approach to vertical restraints, an alternative legal regime that provides greater emphasis on the competitive norm of the free movement of goods.

**Vertical restraints as a possible misnomer**

A vertical restraint, or vertical agreement, is a limitation on pricing, output or other marketing decisions placed in a contract between two entities in different positions in the production and distribution chain of a product or service. By contrast, a horizontal restraint is a limitation placed in a contract between two entities in the same position in the chain. For example, an agreement among manufacturers of an identical product or service is a horizontal restraint. An agreement between a manufacturer
and a distributor, or a distributor and a customer, is a vertical restraint. Some commentators refer to vertical restraints as downstream or upstream restrictions, suggesting the metaphor of a product or service flowing through the stream of commerce from the manufacturer to the end user.\(^5\)

The categories of horizontal and vertical restraints are criticized as being empty in offering legal guidance on how to structure and manage business arrangements. Professors Baxter and Kessler argue that the adjectives ‘horizontal’ and ‘vertical’ inaccurately and confusingly describe business relationships.\(^6\) For example, they point out that horizontal restraints on price are per se illegal, but courts have, in cases, upheld such restrictions among manufacturers or suppliers. Furthermore, many cases involve agreements that are a combination of vertical and horizontal restrictions. For example, a retailer may require that manufacturers jointly agree to boycott another retailer, as occurred in the *Toys R Us* case.\(^7\) In such situations, the distinction between horizontal and vertical is unhelpful in disposing of the case, and courts typically look at a combination of market power and harm to competition.

The spirit of the Baxter–Kessler argument is sound, but nonetheless, the usage of the words ‘horizontal’ and ‘vertical’ persists. Their proposal to replace the horizontal and vertical categories with the concepts of substitutes and complements has not taken root. Furthermore, the fight over language ignores some of the functional implications of the categories. At the heart of the distinction between horizontal and vertical arrangements is the difference between production and distribution of a product or service. Antitrust scholars concerned over competition sometimes ignore the broader question of competition over what end and through what means.\(^8\) Most often, antitrust disputes focus on the micro, or even pico, details of the competitive process, such as how a product will be manufactured or how a service will be provided to the end user. Broader market competition over price, quantity and quality will often be in the background of the specific dispute, but the competition at issue in a particular antitrust case will often entail rivalries among players on how to structure a market and extract the relevant surplus from specific business transactions.

For example, one type of vertical restraint is a restriction on the minimum resale price at which a distributor can resell a product. This is the restraint at issue in the *Leegin* case, mentioned above and discussed in greater detail below. While minimum resale price restrictions are part of the broader competitive process by which goods are provided to consumers at the socially optimal levels of price, quantity and quality, these restrictions arise from contract negotiations between a manufacturer and retailers over how to divide the surplus earned from the marketplace. The rivalry over the surplus includes the determination of how to provide
other product dimensions, such as information on product quality and maintenance, to the end user.

To see this point in another way, the issue of vertical restraints would go away if the various links in the production and distribution chain integrated into one entity that manufactured, distributed and directly sold the product to the end user. In such a situation, we are in the classic model of competition where the rivalry is between the seller and end user over the price, quantity and quality of the product. In the vertically integrated scenario, the details are determined through internal management and authority. In the vertical restraint scenario, the details are sorted out through competition among the diverse entities that constitute the production and distribution chain. The challenge to antitrust law is to devise the rules that manage competition among these diverse entities.

Characterizing the problem of vertical restraints in terms of rivalry among different entities in the production and distribution chain helps identify a common problem between the law of vertical restraints and the law of intellectual property. Intellectual property law, like vertical restraints, regulates the distribution of a product or service. Typically, the subject of intellectual property (scientific discoveries, entertainment works, information content) can be produced at positive marginal cost but distributed at zero marginal cost. The exclusivity of intellectual property rights allows the producer of the work, protected by intellectual property law, to control various aspects of the work’s distribution through licensing. In turn, the scope of the rights owner’s exclusivity is limited by doctrines such as fair use and the first sale doctrine. In other words, intellectual property law, like vertical restraints, mimics the vertical integration of the production and distribution of a work. For intellectual property, this mimicking occurs through the creation of a legal right of exclusivity which counters the technological ease of distribution. For vertical restraints, the mimicking occurs through a contractual restriction. Therefore, it should not be surprising that many vertical restraint cases involve, either in the background or foreground, intellectual property issues.

The parallel between vertical restraints and intellectual property has implications for antitrust policy. For example, minimum resale price maintenance has been justified as a reasonable business practice allowing the manufacturer to police investments in quality and curb free-riding by retailers. But trademark law serves the same function by requiring the manufacturer to police the retailers’ investment in maintaining the quality signals contained in the trademarked brand. Since minimum resale price maintenance runs the risk of serving as a mechanism for fixing the price of the product at the retail level (i.e., disguised horizontal price fixing, with all the controversies surrounding that terminology), the argument can be
made that minimum resale price maintenance is a suspect means of policing the brand when trademarks are available. Consistent with this argument, the European Union treats vertical restraints on non-branded goods and services as less harmful than vertical restraints on branded goods and services under the Guidelines for Regulation 2790/99.10

The law of vertical restraints can be refashioned with these two insights: (1) vertical restraints arise from the competition among producers and distributors, and (2) intellectual property law also regulates the production and distribution of a product or service. The legal and economic analysis of particular types of vertical restraints can be understood in light of these two propositions.

Vertical restraints in the US: the perspective from Leegin
Since the 2007 decision by the United States Supreme Court in Leegin, all vertical restraints are subject to the rule of reason rather than a per se rule. Prior to this 2007 decision, vertical territorial restrictions and maximum resale price maintenance were judged by the rule of the reason, while minimum resale price maintenance was per se illegal.11 The historic ruling in Leegin removed the special treatment for minimum resale price maintenance. Given the importance of this ruling, I will focus my attention on the Leegin decision and analyze prior case law in light of this new precedent.

The facts of Leegin are quite elegant in highlighting the debate over minimum resale price maintenance. Leegin sold belts under the brand name ‘Brighton’ which were distributed by small retailers like Kay’s Kloset, located outside of Dallas, Texas. Leegin controlled the distribution of its belts through the ‘Brighton Retail Pricing and Promotion Policy’ which suggested prices for the designer belts. The manufacturer also created a special program to target star retailers. Kay’s Kloset, because of the volume of belts it sold, was one of the stars until Leegin became disappointed with the size and atmosphere of the store. Strife between the manufacturer and retailer emerged when Kay’s Kloset discounted the price of the belts in order to compete with other retailers. As a result, Leegin informed Kay’s Kloset that it would no longer be a distributor of the Brighton line of belts. Kay’s Kloset sued Leegin for violation of the antitrust laws, claiming that Leegin’s actions violated the per se rule against minimum resale price maintenance established by the United States Supreme Court in Dr. Miles Medical Co. v. John D. Park & Sons, Co. in 1911.12 The retailer won a $1.2 million judgment against Leegin, and Leegin appealed the ruling all the way to the Supreme Court. Leegin’s argument on appeal was for Dr. Miles to be overturned in light of the rule of reason treatment the Court had applied to other vertical restraints. The
Court, in a five to four decision, ruled in favor of Leegin, holding that the per se rule in *Dr. Miles* was ‘a flawed antitrust doctrine that serves the interests of lawyers . . . more than the interests of consumers’.13 As a result, all vertical restraints are governed by the rule of reason.

The holding of *Leegin* had been predicted for a long time.14 Shortly after *Dr. Miles* was decided, the Court had begun placing qualifications on the per se rule. In *United States v. Colgate*, a 1919 case, the Court held that suggested prices by a manufacturer did not constitute an agreement for purposes of Section 1 of the Sherman Act.15 In a series of subsequent cases, the Court held that the per se rule did not apply if the manufacturer retained title, as would be the case in a consignment arrangement or under an intellectual property license. In 1967, the Court held, in *United States v. Arnold, Schwinn, & Co.*, that a vertical territorial restriction was per se illegal.16 A year later, the Court held that maximum resale price maintenance was per se illegal in *Albrecht v. Herald Tribune*.17 Then, in the 1970s, the retraction began in earnest with the Court overruling *Schwinn* in its 1977 *GTE Sylvania* decision, holding that vertical territorial restrictions had some pro-competitive benefits and therefore should be judged by the rule of reason.18 Twenty years later, the per se rule of *Albrecht* went by the wayside in *State Oil v. Khan*, which held that the rule of reason applied to maximum resale price maintenance.19 Against this background of changing laws, economists were questioning the per se treatment of minimum resale price maintenance, arguing that many of the pro-competitive benefits of territorial restriction applied a fortiori to minimum resale price maintenance. Practitioners and scholars knew that the shoe would eventually drop, and consistent with the decennial shift in the tide, minimum resale price maintenance went the way of maximum ten years after the *Khan* decision.

In many ways the per se rule had been chipped away. First, the limitations placed by *Colgate*, and the consignment and licensing cases removed major areas of business practice from the scrutiny of the per se prohibition. New evidentiary burdens placed on plaintiffs also effectively weakened the per se rule. In *Monsanto Co. v. Spray-Rite Service Corp.*, decided in 1984, the Court required an antitrust plaintiff raising a claim of price fixing conspiracy among manufacturer and distributors to rule out the possibility that the defendants were acting independently.20 Four years later, the Court ruled, in *Business Electronics v. Sharp*, that an antitrust plaintiff claiming an agreement to set resale prices based on a pattern of dealer termination, must show that the manufacturer and retailer had agreed to set a specific price.21 These two hurdles made it quite difficult for a plaintiff to prosecute an antitrust claim based on resale price maintenance. Under *Leegin*, the plaintiff must, in addition, show that the anti-competitive
effects of setting minimum resale prices outweigh any pro-competitive benefits.

The Court’s rejection of a per se rule in favor of the rule of reason was predicated on identifying several pro-competitive benefits from minimum resale price maintenance. At the outset, Justice Kennedy’s opinion states that the rule in *Dr. Miles* was based on formalistic legal thinking as opposed to a consideration of business realities. The 1911 Court adopted a per se rule because the restriction on minimum prices was viewed as a restraint on alienation that was disfavored at common law. The 2007 Court states that equating the restriction on minimum resale prices with restraints on alienation ignored the reality that such restraints were less suspect when applied to chattels than when applied to land. Furthermore, such reliance on historic, antiquated doctrine did not take into consideration the realities of the manufacturer–dealer relationship.

Citing the economics literature extensively, the Court identifies three pro-competitive benefits to minimum resale price maintenance. First, allowing manufacturers to restrict retailers’ ability to discount is an effective tool to prevent free-riding in the provision of services that might be beneficial to consumers. Second, minimum resale price maintenance is an important business tool to discipline retailers who did not meet manufacturer expectations by providing the retailers a guaranteed margin, loss of which could be threatened through termination. Finally, minimum resale price maintenance, by reducing intrabrand competition through price cutting, promotes interbrand competition that in turn encourages entry and innovation by manufacturers. Put together, the Court identifies the benefit of resale price maintenance in cementing the manufacturer–retailer relationship through curing retailer opportunism that inhibited competition at the manufacturing level.

The Court does identify two anti-competitive uses of minimum resale price maintenance as well. The first is the use of minimum resale price maintenance as a means of policing horizontal price fixing either by manufacturers or by retailers. The second is the abuse of minimum resale price maintenance by a dominant manufacturer or a dominant retailer to prevent innovation and the adoption of new distribution methods and business practices. While acknowledging these harmful uses, the Court does not see them as justifying per se condemnation. Furthermore, each of these harms could be addressed through the per se rule against horizontal price fixing or through a claim for monopolization. Since a practice may have a mix of pro-competitive and anti-competitive effects, the rule of reason is the appropriate legal standard.

In *Leegin*, the four dissenting judges express skepticism about the majority’s rejection of the per se rule in an opinion authored by Justice
Breyer. Minimum resale price maintenance, the dissent points out, has led to higher prices for consumers. Congress had permitted states to legalize minimum resale price maintenance from 1937 to 1975, and 36 states did so. Retail prices in the 36 states where the practice was legal were estimated to be about 19 to 27 per cent higher than in states where it was not allowed. Minimum resale price maintenance is inconsistent with the goals and ideal of price competition. Furthermore, even if the practice does have pro-competitive benefits in promoting the entry of new manufacturers and in limiting free-riding, the dissenters do not see substantive evidence of these benefits. Instead, the dissenters point to the expansion in retailing that occurred under the per se rule against minimum resale price maintenance, as small retailers were able to compete aggressively on the basis of price and realize advantages from economies of scale. Finally, the dissent sees the change in the law as raising administrative costs and disrupting the structure of the economy:

What about malls built on the assumption that a discount distributor will remain an anchor tenant? What about home buyers who have taken a home's distance from such mall into account? What about Americans, producers, distributors, and customers, who have understandably assumed, at least for the last thirty years, that price competition is a legally guaranteed way of life? The majority denies none of this. It simply says that these 'reliance interests [. . .] cannot justify an inefficient rule'.

In contrast with the majority, the dissent does not see a problem with treating minimum resale price maintenance differently from vertical restraints. According to the dissent, the empirical evidence of anti-competitive effects and the lack of evidence of pro-competitive benefits militate against adopting the rule of reason for minimum resale price maintenance.

The contrasting majority and dissenting opinions highlight three issues central to understanding the treatment of vertical restraints in the US: (1) the difference between the rule of reason and a per se rule; (2) the use of economic theory in competition law; and (3) the meaning of competition. I address each of these issues in turn.

Rule of reason versus per se rules
The majority and dissent take diametrically opposing views on the place of the rule of reason in the analysis of agreements under the Sherman Act. Justice Kennedy’s opinion states that the rule of reason is the presumed standard for challenges to anti-competitive agreements, and the per se rule is applied ‘only after courts have had considerable experience with the type of restraint at issue . . . and only if courts can predict with confidence that it would be invalidated in all or almost all instances under the rule of
reason’. By contrast, the dissent would apply a per se rule when ‘the likely anticompetitive consequences of a particular practice are so serious and the potential justifications so few (or, e.g., so difficult to prove) that courts have departed from a pure “rule of reason” approach’. Justice Breyer’s approach would not presume a rule of reason but would recognize that courts ‘often apply’ this approach.

Given such contrasting views on the appropriateness of the rule of reason, it is not surprising that there was such a split in the Court on the treatment of minimum resale price maintenance. By way of comparison, the 1997 case of *State Oil v Khan*, which ruled that maximum resale price maintenance was subject to the rule of reason, was a unanimous decision with the seven justices common to both panels agreeing on the outcome. (Justices Roberts and Alito have replaced Justices O’Connor and Rehnquist since the *Khan* decision, and we can only speculate on how these two justices would have ruled in *Leegin*. Likely, the outcome would not have been that different given the two departing justices’ pro-business tendencies, but Justice O’Connor had shown a proclivity towards competition in her intellectual property jurisprudence and, therefore, may have been the swing vote that saved *Dr. Miles*.) The four dissenting justices in *Leegin*, given their votes in *Khan*, cannot be viewed as antitrust zealots. Instead, the different voting patterns can be explained by the merits of the business practice. Maximum resale price maintenance does not have ‘few business justifications’, to borrow the language of the *Leegin* dissent since it serves to combat monopolistic pricing by single retailers in remote geographic areas (such as the retailer in *Khan*). Even if the justification of combating monopolistic practices by retailers is questionable, maximum resale price maintenance has been used to curb price discrimination and to limit opportunistic behavior by a retailer. Furthermore, maximum resale price maintenance, unlike minimum, still allows for price competition among retailers and the benefits of reduced prices to consumers. Consequently, for the dissent, maximum resale price maintenance is a potentially more reasonable business practice than minimum resale price maintenance.

Given the different burdens of persuasion the majority and dissent pose for per se rules, economic theory and norms of competition are critical in determining how a particular business practice will be treated under the antitrust laws. For the majority, the anti-competitive harms must be clear and must dominate any pro-competitive justifications in order for per se treatment to prevail. For the dissent, the pro-competitive justifications have to trump anti-competitive effects. Consequently, economic evidence as to pro-competitive effects is enough to sway the majority towards rule of reason treatment. The dissent, however, does not find the economic
Evidence strong enough. Two points can be gleaned from the analyses in *Leegin*: (1) economic evidence has to be garnered in an appropriate way to justify a per se rule, and (2) underlying norms of competition inform how the court views the benefits and harms of business practices. I turn to each of these two points next.

**Economic theory**

Economic theory plays a critical role in the majority’s analysis. The citation of, and reliance on, the economics literature is perhaps the most extensive of any antitrust case. Particularly relevant to the Court’s decision are articles by Mathewson & Winter (1998);26 Klein & Murphy (1988);27 and Deneckere, Marvel & Peck (1996).28 So influential were the citations of economics literature that they deserved specific comment by Justice Breyer:

> Economic discussion, such as the studies the Court relies upon, can help provide answers to these questions, and in doing so, economics can, and should, inform antitrust law. But antitrust law cannot, and should not, precisely replicate economists’ (sometimes conflicting) views. This is because law, 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.29

It should be pointed out that among the current nine justices, Justice Breyer is the closest to adopting the methodology of economics in his past writing and his current jurisprudence. Justice Kennedy, by contrast, is more closely identified with catholic and natural law approaches to decision-making. The irony of Justice Kennedy writing a largely economics based decision, and Justice Breyer taking a more critical stance, is perhaps a result of distance. Justice Kennedy is more willing to defer to economic expertise than Justice Breyer, who can assess the economic methodology more critically. Whatever the source of the differences, the majority and the dissent take positions that reflect differing understandings of the economics of minimum resale price maintenance.

For the majority, the economics literature serves as a source of identifiable benefits from minimum resale price maintenance. Specifically, the court cites extensively from the transaction costs economics literature identifying minimum resale price maintenance as solving an information problem arising between a manufacturer and its retailers. The problem can be stated as follows. If the manufacturer and retailers were one vertically integrated entity, this combined entity could make joint decisions about pricing the product and providing services that maximize the entity’s profit. When a manufacturer and retailers are separate entities,
however, decisions on pricing and provision of services must be made separately. Individual retailers are competing against each other, and one way in which such competition could occur is by retailers undercutting each other with respect to price. Such price competition can reduce profit margins and result in the underprovision of services and the exit of retailers. Manufacturers can curb such competition through vertical restraints in contracts. For example, the manufacturer could limit the territories serviced by a specific retailer and therefore curb the retailers’ ability to compete for a customer base. This pro-competitive benefit of territorial restrictions explains the rule of reason treatment of territorial restrictions. In addition, a manufacturer could restrict the retailers’ ability to engage in price competition by placing a floor on the resale price. If the floor is set correctly, the minimum price can ensure a profit margin to the retailer that would allow it to provide adequate services and prevent destructive exit. Furthermore, minimum resale price maintenance can create incentives for retailers to provide services to consumers by preventing a price cutting retailer from free-riding on services provided by a competitor retailer. With these economic benefits identified, the majority concludes that per se treatment against minimum resale price maintenance is unwarranted.

The dissent’s response is to emphasize that there is no economic consensus about the benefits from resale price maintenance. The criticism is based on lack of empirical data. Free-riding, the underprovision of services, and destructive exit can occur in theory, but will it occur in practice? ‘We do, after all, live in an economy’, the dissent reminds us, ‘where firms, despite Dr. Miles’ per se rule, still sell complex technical equipment (as well as expensive perfume and alligator billfolds) to consumers.’30 How often does free-riding actually occur, the dissent asks, and after considering the extensive record and the economics literature, the dissent answers that free-riding happens ‘sometimes’.31 More importantly, the dissent is concerned about a court’s ability to distinguish between the pro-competitive and anti-competitive effects of minimum resale price maintenance. The per se rule of Dr. Miles provides a bright line rule for the purposes of enforcement and predictability, and the lack of any substantive economic evidence in favor of the anti-competitive harms of the per se rule warrants against moving to the rule of reason.

On the surface, the difference between the majority and dissent is largely a question of empirical evidence. But there is a substantive difference in how the two sides view the competitive process. The majority’s reliance on the transaction costs economics literature results in an emphasis on the information problems that arise in the contract between the manufacturer and retailers. The information problem can be solved in part by centralized decision making through vertical integration of a manufacturer and
Vertical restraints serve as a contractual substitute for vertical integration. The problem is how the law should allocate the right to set price. The majority assigns all the rights to the manufacturer to then reassign through the contract with the retailer. In effect, after the *Leegin* decision, the manufacturer has the right to set all the terms of the vertical restraints, whether based on price or territory. This right can be abrogated only when it is used in an anti-competitive fashion that outweighs the pro-competitive benefits, such as in the case of horizontal price fixing among manufacturers or among retailers.

The natural question is whether the manufacturer should have the right to set the terms of the vertical restraint, specifically the right to set minimum prices. The Coase Theorem would guide us in answering the question by consideration of transaction costs. Since the majority views the information problem as one of preventing free-riding in the provision of services, the concern is that a manufacturer is in a better position to determine what types of services should be provided (and how) as part of the product distribution to consumers. Giving a manufacturer the right to set the terms of a vertical restraint is consistent with giving it control over how a product is made and sold. Therefore, the most efficient allocation, according to the majority’s thinking, is to grant the right to set price to the manufacturer which can set the terms of the agreement with retailers in a way that resolves the information problem.

The dissent, however, has a different view of the economics, starting with its description of the free-riding problem. As the dissent points out:

‘Free riding’ often takes place in the economy without any legal effort to stop it . . . We all benefit freely from ideas, such as that of creating the first supermarket. Dealers often take a ‘free ride’ on investments that others have made in building a product’s name and reputation. The question is how often the ‘free riding’ problem is serious enough significantly to deter dealer investment.

The dissent adopts an approach that is much less proprietary in its implications than the majority’s approach. The dissent would unequivocally allocate the right to set a minimum price to the retailers, largely because of the benefits of open price competition. The encomium to free-riding is one to market freedom more broadly, but market freedom tempered by price competition. In contrast with the majority’s decision that sees the information problems leading to free-riding as insurmountable unless the per se rule is removed, and thereby that reallocates the right to set minimum price to the manufacturer, the dissent’s decision presents a world with low transaction costs in which competition between manufacturer and retailers and among retailers will prevail in the lowest price for consumers.

Both the majority and the dissent speak in terms of efficiency, but while
the majority sees the prohibition against minimum resale price maintenance as clearly inefficient, the dissent is less certain, finding benefits in price competition. Different interpretations of economics theory and the weight given to empirical data explain much of the opposing conclusions. Also important are contrasting conceptions of competition, the subject of the next section.

Competitive norms
Professor Alan Meese writes convincingly about how courts have conceptualized competition in their antitrust analysis.33 His central point is that courts tend to misunderstand non-conventional contracting and to overemphasize price competition. The *Leegin* opinion may be the remedy to the conceptual failures Professor Meese has diagnosed. The cure, arguably, is worse than the disease. The Court effectively recognizes non-standard contracting and the varied ways in which competition can occur. But the result is one that creates strong proprietary rights that ignore the benefits of traditional price competition.

The majority acknowledges that minimum resale price maintenance has the potential to benefit consumers by providing ‘more options so that they can choose among low-price, low-service brands; high price-high service brands; and brands that fall in between’.34 The majority envisions a realm of contractual freedom in which the manufacturer can use minimum resale price maintenance to promote the provision of service by retailers or, alternatively, the manufacturer can allow retailers to compete over price. The problem, of course, is that the manufacturer cannot simultaneously use both strategies for an identical product unless it effectively polices the marketplace to prevent the discounted goods from entering the market where retailers are restricted. More realistically, manufacturers of a given product will gravitate towards one regime or another, and therefore, the effect of allowing minimum resale price maintenance will vary by industry. High end, high prestige products may be marketed with little or no price competition while lower end products may be distributed through discount channels. Whatever the result, the majority sees the marketplace as one in which multiple contractual forms can flourish, providing the appropriate mix of price and quality to consumers.

The dissent adopts a more conventional view of the marketplace governed largely by price competition. Market forces, however, do not work against the provision of service and quality. In fact, they work in their favor by permitting suppliers to attract consumers through the provision of technical information and consumer services. Furthermore, territorial restrictions and other contractual terms can aid in allowing manufacturers to police the provision of service and quality by retailers. The dissent,
Vertical restraints, competition and the rule of reason

However, does not accept the argument that minimum resale price maintenance is the most efficient or effective way to compete on the margins of quality and service. Instead, price is still the major dimension on which manufacturers and retailers do, and should, compete to ensure that consumers are provided quality goods at the minimum price. Allowing some forms of vertical restraints, such as based on territories or restrictions on maximum resale prices, would be sufficient to prevent free-riding and to realize the benefits of variety in service and price as portrayed by the majority.

An argument in the majority’s favor is that competitive pressures force manufacturers to work inefficiently around the per se prohibition on minimum resale price maintenance. The majority documents the steps taken by manufacturers to adopt policies of announced prices and dealer termination that could more effectively be implemented through direct use of minimum resale price maintenance. This argument rests on the efficiency of minimum resale price maintenance compared to other contractual mechanisms, a comparison that demonstrates the lack of empirical evidence at the heart of Justice Breyer’s opinion. The fundamental question here is evaluating the role of courts in the competitive process. For the majority, the simplest answer is to minimize the role of the courts altogether by allowing contractual freedom. The irony is that the rule of reason, while making it more burdensome for a plaintiff to bring an antitrust complaint, requires a court to scrutinize a business practice more closely to gauge its pro-competitive and anti-competitive consequences. The rule of reason therefore requires more judicial scrutiny than a per se rule. Therefore, the majority’s deference to contractual freedom by adopting the rule of reason invites greater scrutiny of business practices and the competitive process.

Another argument in favor of the majority’s abrogation of the per se rule is that, since the decision in *Dr. Miles*, retailers have grown significantly in size and market position within the United States. Consequently, any attempt by manufacturers to limit price competition may be countered by retailers. For example, many grocery stores have store brands for staples, such as cereal and soup, which compete with the manufacturers’ brands. Grocery stores can lower the price of the store brand items to put competitive pressure on the manufacturers’ brands. Of course, smaller retailers, such as Kay’s Kloset, the plaintiff in *Leegin*, will have a harder time competing with the manufacturers.

Recognizing non-price forms of competition through non-conventional contracting requires deeper empirical information and scrutiny of markets than the traditional use of price competition as the benchmark for assessing antitrust policy. But this observation is not a mandate that courts
should uphold any policy which potentially leads to lower prices. Lower prices within a market system can come at costs of lower quality, fewer services and less innovation. However, courts and policymakers can consider some of the implications of legal rules for the structure of a particular market and resulting incentives. Using this broad template as a guideline, we can reach some conclusions about the differing conceptions of competition between the majority and the dissent.

The majority adopts a pro-manufacturer view of competition, one that countenances limitations on intra-brand competition among retail- ers in order to promote inter-brand competition among manufacturers. Its view of competition is analogous to the strongly proprietary view of intellectual property, also justified in terms of free-riding prevention and the promotion of new entry and new products. Just as strong intellectual property rights place the rights to define manufacturing and distribution scope within the market to the rights holder, so the majority’s grant of rights to a manufacturer to set the terms of vertical restraints allows it to define the territorial scope of distribution channels for its output. In intellectual property, the strong rights are tempered in narrow ways through doctrines such as fair use and first sale, which protect the interests of users of works protected by intellectual property. In manufacturing, the rights are tempered by the standard of reasonableness to balance the pro-competitive and anti-competitive consequences of a manufacturer’s contractual choices.

The dissent’s defense of the per se rule against minimum resale price maintenance can be understood against this conception of the competitive process that supports the rights of manufacturers. Certainly, the dissent is not against contractual freedom, and it does not oppose the use of vertical restraints. Instead, it is concerned that the majority’s decision gives manufacturers too strong a set of rights that may invite restrictions on price competition at the retail level that will hurt consumers. To borrow an analogy from intellectual property, the dissent is proposing restrictions on the rights of the manufacturer to protect the rights of the retailers much like advocates of fair use or first sale rights seek to create a balance between the intellectual property owner and users. The goal, as in the case of intellectual property, is to ensure access to, and limit control over the channels of distribution.

Which set of rights within the competitive process is most appropriate is ultimately an empirical question whose answer depends on how the legal rules play out over time in actual business practice. The empirical evidence, however, is mixed with some support that resale price maintenance, at least when administered by the state, has been an effective means of enforcing a cartel. Furthermore, despite the theoretical justification for minimum
resale price maintenance as a means for providing point of sale service, restrictions on minimum resale prices have been used in markets, such as cookware, where point of sale service is of minimum concern. In light of the conflicting empirical evidence, Justice Breyer frames the question of how to treat minimum resale price maintenance in terms of the burden of overturning an established legal precedent; meanwhile Justice Kennedy frames it in terms of identifying some cognizable pro-competitive benefit that militates against a per se prohibition. At the heart of the disagreement, however, are differing views of contract and competition. A similar contrast can be seen when we compare the new US approach to vertical restraints with the European treatment.

A comparison of the US with the EU: contrasting norms of competition

Article 81, formerly Article 85, of the Treaty of Rome governs vertical restraints under European competition law. Specifically prohibited under Article 81(1) are agreements that ‘directly or indirectly fix purchase or selling prices or any other trading conditions’ and that ‘limit or control production, market, technical development, or investment’. Exceptions are envisioned under Article 81(3) under some limited circumstances for agreements ‘which contribute . . . to improving the production or distribution of goods or to promoting technical or economic progress’. Pursuant to Article 81(3), the European Council has adopted several regulations that expressly create such exceptions. Regulation 17, promulgated in 1962, allows the Commission to create block exemptions from Article 81(1). Exemptions have been created for licensing of patents and know-how as well as for technology transfer. An exemption was promulgated in 1983 for exclusive distribution agreements under some clearly defined circumstances based on market share and the size of the business entities. These were in effect until 1999 when they were superseded in 2000 by Regulation 2790/99, which deals specifically with vertical agreements.

Regulation 2790/99 provides a categorically defined set of exemptions for vertical agreements based on the size of the companies and market affected by the specific agreement. The recitals acknowledge the competitive benefits of vertical agreements, particularly their ability to ‘improve economic efficiency within a chain of production or distribution by facilitating better coordination between the participating undertakings’. One critical efficiency highlighted is ‘a reduction in the transaction and distribution costs of the parties and to an optimisation of their sales and investment levels’. European competition law, like US antitrust law, recognizes the benefits of vertical restraints, particularly those that arise from removing incentives to free-ride on investments in services. But, unlike the US’s adoption of an open ended balancing approach under the rule of
reason, the European Union creates categorical rules for the application of the exemption. Automatically exempt are any agreements in which the supplier does not have more than 30 per cent of the market (or in the case of an exclusive supply contract, the buyer has no more than 30 per cent of the market) and if the agreement does not cover what the regulations call ‘hard core’ restraints, which includes fixing minimum resale prices.

The regulation also provides a general methodology for determining when a vertical agreement should be exempted. In addition to considerations of market share and business size, the following factors work in favor of an agreement: (1) the tendency of the restraint to promote inter-brand competition; (2) the use of vertical restraints on non-branded products or services is less suspect than their use on branded products or services; (3) the use of vertical restraints to control a dominant position at the retail level, such as through the imposition of a maximum resale price; (4) the use of the vertical restraint to transfer and protect know-how within a business relationship; (5) the use of a vertical restraint to protect relationship-specific investments; and (6) a vertical restraint is less suspect when it is used by an entrant providing a new product or servicing a new geographic market.

What is striking about the European approach is the contrast with the analysis in *Leegin*. While the European approach recognizes many of the pro-competitive benefits recognized by the majority in *Leegin*, Regulation 2790/99 relies more on clear rules and guidelines as opposed to a balancing test that places great weight on the pro-competitive justifications of the business practice. Justice Breyer’s dissent, although he does not cite any European authorities, is very close to the European approach even if his opinion advocates maintaining a per se rule. At one point in the dissent, however, Justice Breyer states that he would propose a per se rule with a narrow exception for the entry of a new product in the marketplace, much like what we see in the European regulations.

Another contrast is the differing norms of competition in the US and the European Union that inform competition policy. The US approach focuses squarely on contractual relationships specifically and contractual freedom generally. As discussed above, the *Leegin* majority assigns rights under the contract to the manufacturer, which is given broad discretion in shaping the terms of a contract and the scheme of distribution. The emphasis in the European Union is on the consistent and free flow of goods among member states. As the European Court of Justice stated in its first opinion reviewing a vertical restraint under Article 81(1), ‘[T]here is no need to take account of the concrete effects of an agreement once it appears that it has as its object the prevention, restriction, or distortion of competition’. The presumption is reversed under European Union law; anti-competitive effects of a vertical restraint make the restraint illegal.
absent an exemption. The *Leegin* majority, however, held that vertical restraint is not per se illegal, and arguably presumptively legal, once pro-competitive justifications have been shown.

Competition as defined by the free movement of goods is not surprisingly a core value in European competition law. The Treaty of Rome is essentially a free trade agreement and consequently open markets and access are fundamental norms in the structuring of markets through competition law. Justice Breyer’s dissent echoes these norms with its vision of competition as well, albeit the dissenters’ vision is framed in terms of price competition. The *Leegin* majority illustrates the more proprietary model of competition that is prevalent in US antitrust law and intellectual property doctrines. Competition is based on strong property rights and freedom to contract, with the terms largely determined by the party which is deemed to be the most efficient in managing the property rights. In the European Union, and in Justice Breyer’s vision, competition is defined in terms of entry of new products and firms.

Given the two conflicting visions of competition on each side of the Atlantic, it is difficult to imagine some convergence in the law. The key test will be to see if the *Leegin* decision places some pressure on the European Union to create a block exemption for minimum resale price maintenance. Member states are allowed to permit some degree of minimum resale price maintenance on the sale of books in order to help publishers in promoting national culture. There is also a broader debate about the benefits of minimum resale price maintenance in promoting retailing. The *Leegin* decision will only fuel this debate. Whatever the result, the European solution most likely will be one that takes into account a very different model of competition and the values of market entry and price competition than evinced by the *Leegin* majority.

**After the rule of reason**

As Professors Kaplow and Shapiro caution, ‘[I]f the rule of reason is legally defined in terms of competition itself – that which promotes competition is legal, that which suppresses competition is illegal, end of story – then economics cannot directly address the legal test’. The majority’s decision in *Leegin* ignores this advice. Justice Kennedy’s opinion absorbs the findings of transaction costs economics and transforms them into competition policy. But transaction costs economics, with all its richness and importance, does not provide a general theory of competition. As a result, the *Leegin* opinion substitutes a proprietary model of contractual freedom for a true consideration of competition norms. Justice Breyer perhaps has the better of the debate, especially when compared with the approach of European competition law.
Now that we have moved into a regime of rule of reason for all vertical restraints in the United States, the natural question is what next? Prior to the Dr. Miles decision in 1911, there was no common law decision that struck down a vertical restriction. After Leegin, an illegal vertical restraint may once again become a rarity. The rule of reason mandates a consideration of both the pro-competitive and anti-competitive effects of a given agreement to determine its legality. Perhaps, as more agreements are subject to the rule of reason, courts will be able to identify specific guidelines and bright line rules for categorizing certain practices as illegal under the antitrust laws. Ideally, a categorical approach as we see in the European Union, but with different categories, will emerge. More realistically, the Leegin majority has created a rule of per se legality, with the pro-competitive justification of preventing free-riding serving to absolve all vertical restraints, except for those that would be actionable as horizontal restraints under Section 2. In fact, a recent speech by Commissioner Rosch of the Federal Trade Commission suggests that most vertical restraints are being challenged as monopolization cases. The result may be less competition in the form of new entry and price discounting.

To end optimistically, I hope Congress, the Department of Justice and the Federal Trade Commission consider the issue of vertical restraints in the near future and consider an approach like that of the European Union. A categorical approach has the benefits, like that of a per se rule, of providing clarity and guidance to business planning while also promoting competitive entry that places a downward pressure on price. Such an approach would truly provide a rule for a competitive marketplace founded on reason rather than freedom of manufacturers to set the terms of a contract.

Notes
1. Professor of Law and Associate Director, INSITE, The University of Wisconsin Law School.
23. *Id.*
24. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
34. *Leegin, supra* note 3.
39. *Id.*
41. *Id.*
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Cases
Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 US 373 (1911).
Toys ‘R’ Us, Inc. v. Federal Trade Commission, 221 F.3d 928 (7th Cir. 2000).