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A Consumer Behavioral Approach
to Resale Price Maintenance

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A CONSUMER BEHAVIORAL APPROACH TO RESALE PRICE MAINTENANCE

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ABSTRACT

This Article reexamines the various pro-competitive justifications and theories of harm for resale price maintenance (“RPM”), one of the most controversial practices in antitrust law. It argues that the existing literature overlooks three important issues regarding RPM, namely, the kind of retail service invoked in a justification, the kind of retailer at issue, and the prevailing model of consumer behavior. All three issues have important implications for the plausibility and validity of the various justifications and theories of harm for RPM. It argues that most of the existing literature presumes the inter-brand primacy model of consumer behavior. Once this model is not applicable, much of the prevailing analysis breaks down and the legality of RPM needs to be reconsidered. In particular, this Article demonstrates that many of the accepted justifications for RPM are of doubtful validity or are only valid under limited circumstances. This lends support to a more hostile view of RPM.

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I. INTRODUCTION

THE legality of resale price maintenance (“RPM”) is probably one of the most written about and controversial areas of antitrust law and economics. Numerous articles have been published offering various theories of harm and pro-competitive justifications for resale price maintenance. In light of these anti-competitive and pro-competitive accounts of RPM, various approaches to RPM have been proposed. These approaches range from presumptively illegal¹ to full-fledged “rule of reason”² to *per se* legality.³ However, all these existing accounts of RPM suffer from a common infirmity: a lack of scrutiny and a detailed account of the market realities and consumer behavior observed in the retail sector. Retail services are generally assumed to be homogenous as far as justifications for RPM are concerned. There is a lack of exploration of the various kinds of retail services and how each kind fits in differently with the myriad justifications for RPM. There is also a lack of attention to the retailers, which are usually assumed to be fungible except for the different degrees of market power at their disposal. Retailers differ in one very important dimension—how many brands they carry. Whether a retailer is a single-brand or multi-brand one has serious implications for the analysis of RPM.

Lastly, most accounts of RPM are premised on a model of consumer behavior under which consumers choose a brand before they choose which retailer to patronize. In other words, brands are the primary consideration in the eyes of consumers. The notions of inter-brand and intra-brand competition, which are fundamental concepts in the analysis of RPM, are premised on this model of consumer behavior, which this Article calls the “inter-brand primacy model.” However, marketing scholars have long observed that there are indeed other models of consumer behavior under which brands are no longer the consumers’ primary consideration, where consumers do not follow the previously described thought process. Once the inter-brand primacy model ceases to apply, the conventional analysis of RPM breaks down and much of the prevailing wisdom about RPM is no longer

¹ Brief for William S. Comanor and Frederic M. Scherer as Amici Curiae Supporting Neither Party, *Leegin Creative Leather Prod., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007) (No. 06-480), 2007 U.S. S. Ct. Briefs LEXIS 69, at *2–3.

² See Pauline M. Ippolito, *RPM Myths that Muddy the Discussion*, 55 ANTITRUST BULL. 151 (2010).

³ See Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981).

valid. As it turns out, one of the main implications of incorporating these market realities and alternative models of consumer behavior is that many of the existing justifications for RPM are called into question.

At this juncture, it is important to clarify the scope of this Article. This Article focuses on offline, brick-and-mortar retailing and not on internet commerce. There are two main reasons for this. First, the discussion about the various kinds of retail service that follow has limited applicability to online retail. Compared to brick and mortar retailers, the range of retail services that can be provided by online retailers is by nature much more limited. Many of the general retail services that will be discussed below, such as general store environment, availability of parking space and fitting facilities, and opening hours obviously have no relevance to online retailers. Even the product-specific retail services that can be provided by online retailers are limited. There is obviously no in-person product demonstration. Therefore, many of the arguments based on the type of retail services will carry much less weight in the online retail context. Second, almost all the literature on the three consumer behavior models is based on brick-and-mortar retailing. Although the three consumer behavior models, namely inter-brand primacy model, inter-retailer primacy model, and impulse purchase model, also apply to online consumption behavior, given that almost all the research is done in the offline context, it is prudent not to apply the insights from the research to online retail.

This Article attempts to refine the understanding of RPM by providing a detailed analysis of various market realities and the implications of alternative models of consumer behavior. Part II introduces certain basic issues regarding RPM, including the fundamental economic rationale for RPM and the various kinds of retail services and retailers. Part III describes in considerable detail the various models of consumer behavior, including the inter-brand primacy model, the inter-retailer primacy model, and the impulse purchase model, and their preliminary implications for RPM. Part IV examines the justifications for RPM in light of the insights generated in the previous two Parts, and suggests that most pro-competitive accounts of RPM are no longer valid or are only valid under limited circumstances. Part V looks at the prevailing theories of harm for RPM and assesses how they need to be adjusted in light of the insights set forth by Parts II and III. It also proposes a new theory of harm premised on price coordination short of outright collusion, which is only possible with multi-brand retailers. Part VI puts the various theoretical insights into practice and suggests how the courts should analyze RPM in light of the conclusions of this Article. Part VII concludes this Article.

II. SOME PRELIMINARY ISSUES

Before delving into the substantive arguments, it is important to explain a number of preliminary issues to lay the groundwork for the analysis. These issues include an overview of the economic rationale for RPM and vertical restraints in general, the distinction between single-brand and multi-brand retailers, and a classification of different kinds of retail service and their significance. These issues will form the building blocks for further analysis.

A. The Economic Rationale for RPM

Resale price maintenance refers to situations in which the manufacturer designates a price at which, or the minimum price above which its retailers are allowed to sell the product. Before evaluating the pros and cons of RPM, it is worth pondering why manufacturers and/or retailers would want to enter into an RPM agreement. The first prerequisite for RPM is that the upstream market or the downstream market—or both—are not perfectly competitive. If these markets were perfectly competitive, where products were homogenous, the manufacturers would only be able to charge their marginal cost of production for the wholesale price, and the retailers would only be able to impose a retail margin that covers their marginal cost of distribution.⁴ If a manufacturer attempted to raise the retail price of its product by way of RPM, it would lose all sales to competing products in the market. If a retailer attempted to do the same, it would lose sales of the product to all the competing retailers. The manufacturer would also have no incentive to increase the retail margin of a retailer. Doing so would require the manufacturer to lower its wholesale price below its own marginal cost of production, given that the retail price cannot be raised without disastrous consequences. The manufacturer would also stand to gain nothing from increasing the retail margin of the retailers, as the products are homogenous. There is no place in such a market for retail services of various kinds that are often used to justify RPM. Consumers will only purchase the products at their marginal costs of production and distribution, nothing more.

⁴ Kenneth G. Elzinga & David E. Mills, *The Economics of Resale Price Maintenance*, in 3 ISSUES COMPETITION L. & POLY 1842 (ABA Section of Antitrust Law ed., 2008) [hereinafter Elzinga & Mills I]; G. Frank Mathewson & Ralph A. Winter, *The Law and Economics of Resale Price Maintenance*, 13 REV. INDUS. ORG. 57, 64 (1998) [hereinafter Mathewson & Winter I].

Mathewson and Winter have concluded that “[i]n an environment of perfect, frictionless competition, there are no incentives for complicated contracts.”⁵

RPM may play a role in markets with differentiated products.⁶ In such a market, products differ along a number of dimensions, including price, product quality, brand reputation, and retail services. Therefore, manufacturers no longer compete only on price. Manufacturers can enhance their product quality, brand reputation, and retail services to increase demand for their products. Retail services may include “presale display, product-specific information, store hours, adequate inventory, postsale service, the reputation of the retailer as a certifier of product quality, and other shopping amenities.”⁷ Better retail services may raise consumer demand for a product, as may lower prices, better quality, or stronger brand recognition.⁸ The provision of retail services comes at a cost, and this cost may be passed onto consumers in the form of higher prices. While one may be tempted to assume that higher prices will necessarily suppress demand for the product, if consumer demand responds more sensitively to an increase in retail services than to an increase in price, it is possible that retail services may result in higher unit sales of the product despite the concomitant price increase.⁹ In other words, product output will rise if the service elasticity of demand is greater than the price elasticity of demand. Manufacturers would thus have the incentive to increase retail services. And herein lies the role for RPM. It turns out that, for a variety of reasons that will be further explored below, there could be a market failure in the provision of retail services.¹⁰ If the various parties in a supply chain are left to simple market transactions, there will be an under-supply of retail services. According to RPM’s defenders, the main pro-competitive purpose of RPM is the procurement of retail services of various kinds. Opponents of RPM question whether RPM is the best way to obtain these services.

The source of market failure in the provision of retail services is the existence of externalities in a vertical structure between a manufacturer and its retailers (unless the manufacturer only has an exclusive retailer). Economists have identified four kinds of externalities within a vertical structure: vertical pecuniary, vertical promotional/quality, horizontal pecuniary, and horizontal

⁵ Mathewson & Winter I, *supra* note 4, at 64.

⁶ See Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86, 87 (1960).

⁷ Elzinga & Mills I, *supra* note 4, at 1842.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

promotional. Vertical pecuniary externality is the origin of the well-known problem of double marginalization.¹¹ The idea is that parties in a vertical relationship make decisions that will have an impact on each other's profitability. Within such a relationship, there are decisions that affect the joint profit of all the parties involved, and decisions that affect how the profit is split. If the former decisions are delegated to the retailers, there will be externalities and the vertical relationship will fail to maximize its overall profit.¹² To put in more concrete terms, a manufacturer will set its wholesale price to maximize its profit. A retailer will set its retail price to maximize its profit in light of the wholesale price, paying less attention to the fact that the retail price it sets affects the unit sales of the product. The retailer will take into account how the retail price affects its own profitability, but not the manufacturer's profitability, even though the retail price affects both. If both the manufacturer and the retailer possess market power, they will both set prices that will yield themselves a supra-competitive profit. When both parties set their profit margin without regard for each other, they will set a price that is too high for the overall output level and both will suffer.¹³

Beyond pricing, a retailer can also create externalities for the manufacturer through its decision to undertake in-store promotions. When a retailer undertakes in-store promotion of a particular brand, the benefit inures to both the manufacturer of the product and the retailer itself. Every unit of the product will bring in profit for both the manufacturer and the retailer. However, when determining the amount of in-store promotion to undertake, the retailer will only focus on its own profitability and ignore the impact of the promotion on the manufacturer's profitability. And because in-store promotion provided by a retailer largely draws consumers from one brand to another within the same store—called the inter-brand substitution effect—and does not significantly benefit the retailer at issue by drawing customers from other retailers—called the inter-retailer substitution effect—in-store promotion benefits the manufacturers more than the retailers.¹⁴ This will lead to an under-provision of promotion by retailers.¹⁵ Richard Romano further argues that vertical non-pecuniary externality goes in both directions. Not

11 See G. Frank Mathewson & Ralph A. Winter, *An Economic Theory of Vertical Restraints*, 15 RAND J. ECON. 27, 32–33 (1984) [hereinafter Mathewson & Winter II].

12 Patrick Rey & Thibaud Vergé, *Economics of Vertical Restraints*, in HANDBOOK OF ANTITRUST ECONOMICS 353, 360 (Paolo Buccirossi ed., 2008) [hereinafter Rey & Vergé I].

13 Mathewson & Winter II, *supra* note 11, at 32–33.

14 Benjamin Klein, *Competitive Resale Price Maintenance in the Absence of Free Riding*, 76 ANTITRUST L.J. 431, 444 (2009).

15 Richard E. Romano, *Double Moral Hazard and Resale Price Maintenance*, 25 RAND J. ECON. 455, 460 (1994).

only does a retailer impose externalities on a manufacturer through its promotion decisions, a manufacturer also imposes externalities on its retailer through its product quality decisions.¹⁶ Because a manufacturer does not capture the full benefit of its product quality decision—part of the profit generated by the product is inevitably shared with the retailer in the form of retail margin—the manufacturer’s product quality decision is distorted and it “will choose a lower than jointly optimal quality.”¹⁷ Romano characterizes this as the problem of double moral hazard in a vertical relationship.¹⁸

Horizontal externalities refer to the relationship among the retailers. The idea is that the action of one retailer not only affects the manufacturer’s interests, it also affects those of other retailers. Horizontal pecuniary externality refers to the fact that when a retailer raises the price of a manufacturer’s product, it increases demand for the product in competing retail outlets through positive cross elasticity of demand.¹⁹ This externality arises because of intra-brand, inter-retailer competition. When a retailer raises the price of its product, it will only focus on the impact of its decision on its own profitability and ignore the increase in demand for competing retailers. From the perspective of the vertical structure, there is a suppressed incentive to raise prices. Horizontal promotional externality refers to the fact that the promotional activities undertaken by a retailer for a brand not only benefit the manufacturer, but they may spill over and benefit other retailers of the same brand.²⁰ Promotional activities have spillover effects. This means that individual retailers undertake an insufficient amount of promotional activities to the detriment of the vertical structure.

The main economic justification for RPM, and vertical restraints in general, is that they can be used “to coordinate and restore the efficiency of the vertical structure.”²¹ Vertical pecuniary externality and horizontal pecuniary externality work in opposite directions. The former results in an excessively high price from the overall perspective of the vertical structure, while the latter reduces the incentive of retailers to raise prices.²² The dominant effect between these two is uncertain and varies in individual cases. If the former dominates, vertical maximum resale price may be introduced to reduce the impact of double marginalization. If the latter controls, then RPM

¹⁶ *Id.* at 460–61.

¹⁷ *Id.*

¹⁸ *Id.* at 455.

¹⁹ Mathewson & Winter II, *supra* note 11, at 32–33.

²⁰ *Id.*

²¹ Rey & Vergé I, *supra* note 12, at 360.

²² Mathewson & Winter II, *supra* note 11, at 32.

may be used to raise prices. With vertical promotional externality, the solution may consist of RPM.²³ The question is whether it is of the maximum or the minimum kind. That depends on the circumstances and the competitive parameters in the market.²⁴ If product quality and promotion are “strategic complements,” then minimum RPM is beneficial.²⁵ The manufacturer can attempt to induce greater promotional effort by retailers by raising retail prices, which in turn lifts the marginal returns to product quality.²⁶ When that happens, the manufacturer will have a greater incentive to invest in product quality.²⁷ The double moral hazard at both levels of the supply chain is corrected simultaneously.

Using RPM to address horizontal promotional externality is a very familiar argument. It encompasses the standard argument of free riding, and the justification of quality certification, inventory maintenance, and other arguments premised on the procurement of retail services. Much of this Article will focus on using RPM to address horizontal promotional externality as a pro-competitive justification for RPM. At this juncture, it is worth noting that even though textbook economics teaches us that externalities distort the functioning of a market and need to be corrected, some economists have argued that it is not always in the consumers’ interest to do so.²⁸ Therefore, articulating the existence of externalities does not fully address the merits of RPM. One important question to ask is whether there are alternative ways to tackle these externalities.

Solely focusing on the use of RPM to address externalities in a vertical structure also ignores instances in which RPM can be used for anti-competitive purposes. While RPM can be used to improve economic efficiency, it can also be used to facilitate cartels at the manufacturer or the retailer level, to foreclose rivals at either the manufacturer or the retailer level, or to soften competition at the manufacturer level in the absence of a cartel. Economists have posited that RPM may allow manufacturers to raise prices short of collusion or other kinds of coordination, by allowing them to pool their profit through multi-brand retailers. Therefore, while economic theories provide rationale for the legitimate use of RPM, one should not overlook its anticompetitive potential.

²³ Romano, *supra* note 15, at 464.

²⁴ *Id.* at 464.

²⁵ *Id.* at 471–72.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *See, e.g.,* Rey & Vergé I, *supra* note 12, at 360.

B. Single-Brand vs. Multi-Brand Retailers

Retailers differ along many dimensions. They may differ by the amount of services they provide, their price range, or by their range of products. Some retailers may carry a specialized range of products,²⁹ while some distinguish themselves by being as comprehensive as possible in their product selection.³⁰ Some of them may only carry one brand. There are, therefore, single-brand retailers and multi-brand retailers, the latter of which are the norm. Examples of single-brand retailers include gas stations, car dealers, and retailers for luxury goods such as fashion, accessories, watches, etc. As it turns out, whether a retailer is single-brand or multi-brand has implications for the use of RPM, and especially for the justifications for RPM. Specifically, to the extent that RPM is being justified by the need to generate retail services that are shared across all brands sold at a multi-brand retailer, one needs to be concerned about the spillover effect. Services generated by the retail margin of one brand will yield benefits to other brands, which can be called the inter-brand spillover effect.

Despite the prevalence of multi-brand retailers, a considerable number of economic studies of RPM presume single-brand retailers. Hyun Jae Doh notes the deficiency of the previous studies of RPM which are premised on single-brand or undifferentiated retailers, or both,³¹ and cautions that “[t]o examine the incentive to impose RPM and its effects in . . . an environment [that more closely corresponds with the reality of the retail market], . . . we need to depart from . . . [the] single product retailer model.”³² In Hao Wang’s study of RPM in an oligopolistic manufacturer market with uncertain demand, he adopts “the convention that every retailer carries only one manufacturer’s product and charges a single price.”³³ This is despite the fact that his study is premised on a multi-brand market and provides for multiple manufacturers. Other studies do not explicitly adopt the premise of single-brand retailers.³⁴ Nonetheless, by stipulating one manufacturer in the market,

²⁹ SAJAL GUPTA & GURPREET RANDHAWA, *RETAIL MANAGEMENT* 270 (2008).

³⁰ *Id.*

³¹ Hyun Jae Doh, *Multi-Product Retail Competition and Minimum Resale Price Maintenance*, 26 *KOREAN ECON. REV.* 361, 362, 390–91 (2010).

³² *Id.* at 368.

³³ Hao Wang, *Resale Price Maintenance in an Oligopoly with Uncertain Demand*, 22 *INT’L J. INDUS. ORG.* 389, 392 (2004).

³⁴ See Yongmin Chen, *Oligopoly Price Discrimination and Resale Price Maintenance*, 30 *RAND J. ECON.* 441, 444 (1999); Raymond Deneckere et al., *Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition*, 87 *AM. ECON. REV.* 619, 622 (1997) [hereinafter Deneckere I]; Raymond Deneckere et al., *Demand Uncertainty, Inventories, and*

these studies assume away multi-brand retailers and all the complications that they bring to the analysis of RPM. Where the multi-brand character of the retailers is relevant to the ensuing analysis, it will be incorporated to shed light on how the harm of and justifications for RPM are changed.

C. A Taxonomy of Retail Services

A variety of retail services have been invoked in the context of addressing horizontal promotional externality. These services fall within two general categories: general retail services and product-specific retail services. General retail services refer to general in-store amenities, which include store location, parking facilities, opening hours, general store environment and ambience, number of shop assistants, number of cashiers, number of fitting rooms, general training of shop assistants, return and refund policies, credit terms, and repair facilities.³⁵ For example, Mohan and co-authors observe that “[r]etail layouts are important since they help present product assortments in an effective and positive way. . . . A good layout may also make the shopping more enjoyable, by reducing the perceived stress in shopping and by evoking positive effect.”³⁶ They further comment that “[s]tore personnel contribute to entertaining store experiences.”³⁷ In the context of supermarkets, Lal and Rao assert that “supermarkets typically compete on various non-price factors such as fast check-out, adequate parking space, courteous in-store help, enhanced assortment” and other factors.³⁸ Importantly, they note that these general in-store amenities tend to affect the consumer’s choice of retailer instead of her choice of product once inside a store.³⁹ They describe how different kinds of supermarkets, ones pursuing the “Every Day Low Price” strategy and ones adopting a promotional pricing strategy, otherwise known as “Hi-Lo,” compete with each other for customers through their general

Resale Price Maintenance, 111 Q.J. ECON. 885, 890 (1996) [hereinafter Deneckere II]; Daniel P. O’Brien & Greg Shaffer, *Vertical Control with Bilateral Contracts*, 23 RAND J. ECON. 299, 300 (1992); Patrick Rey & Jean Tirole, *The Logic of Vertical Restraints*, 76 AM. ECON. REV. 921, 922 (1986); Romano, *supra* note 15, at 457.

³⁵ Elzinga & Mills I, *supra* note 4, at 1843. *See also* THOMAS R. OVERSTREET, JR., BUREAU OF ECON, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE 57 (1983).

³⁶ Geetha Mohan et al., *Impact of Store Environment on Impulse Buying Behavior*, 47 EUR. J. MARKETING 1711, 1714 (2013).

³⁷ *Id.*

³⁸ Rajiv Lal & Ram Rao, *Supermarket Competition: The Case of Every Day Low Pricing*, 16 MARKETING SCI. 60, 70 (1997).

³⁹ *Id.*

retail services.⁴⁰ At least in the context of supermarkets, it seems that it is the price and quality of individual products, and not general retail services, that affect a consumer's product choice.⁴¹ In other words, general retail services tend to generate inter-retailer substitution effect,⁴² which means that retailers are unlikely to have insufficient incentives to provide them.⁴³

The other type of retail service is product-specific services.⁴⁴ These include the kind of retail services that are often used to justify RPM, such as product demonstration and promotion,⁴⁵ product display,⁴⁶ care of product (e.g., proper temperature control or product rotation),⁴⁷ inventory,⁴⁸ and post-sales service such as product repair. Product demonstration is probably the quintessential retail service within the paradigm of the free riding defense. The archetypal scenario of free riding is when a consumer goes to a full-service retailer to obtain an elaborate product demonstration, just to go to a low-cost retailer later to buy the product at a cheaper price. Product display refers to the competition among manufacturers for the best shelf space and the most prominent display for their products within a store. Product promotion encompasses other kinds of in-store promotional efforts undertaken by a retailer for a manufacturer's product. Care of product applies to products that require special handling. Klein and Murphy use the case of Coors beer as an example of a product that requires special handling in the distribution and the retail process.⁴⁹ Coors eschews pasteurization to produce a higher quality beer that, unfortunately, deteriorates more rapidly in room temperature.⁵⁰ Coors therefore requires from retailers constant refrigeration, strict product rotation, and stocking of limited inventory to maintain the freshness of its product.⁵¹ Maintenance of sufficient inventory is

⁴⁰ *Id.* at 72–73.

⁴¹ *Id.* at 70, 72–73.

⁴² Klein, *supra* note 14, at 444.

⁴³ *Id.* at 447.

⁴⁴ Klein calls this “brand-specific” or “manufacturer-specific” promotional services. *Id.* at 443.

⁴⁵ Dennis W. Carlton & Judith A. Chevalier, *Free Riding and Sales Strategies for the Internet*, 49 J. INDUS. ECON. 441, 442 (2001).

⁴⁶ Greg Shaffer, *Slotting Allowances and Resale Price Maintenance: A Comparison of Facilitating Practices*, 22 RAND J. ECON. 120, 121 (1991).

⁴⁷ Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265, 281 (1988).

⁴⁸ Deneckere I, *supra* note 34, at 619–22; Deneckere II, *supra* note 34, at 886–89; Wang, *supra* note 33, at 390–91.

⁴⁹ Klein & Murphy, *supra* note 47, at 281.

⁵⁰ *Id.*

⁵¹ *Id.*

another kind of product-specific retail service that can be provided by a retailer.⁵² Consumers obviously prefer their desired product to be in stock at the time of purchase. Therefore, a manufacturer would want its retailers to maintain sufficient stock of its product.

It is worth noting that product-specific services all require investment in a particular product. Product-specific retail services generally affect product choice. The benefits of these product-specific retail services do not spill over to other products. There is, therefore, no inter-brand spillover effect. This is certainly true of product display and promotion, care of product, and maintenance of inventory. It is possible for training on the demonstration of a particular product to spill over to other similar products. A shop assistant who is trained to demonstrate a particular brand of complex stereo equipment will acquire a general understanding of complex stereo equipment, which will benefit her explanation and presentation of other stereo products. In contrast, the general retail services described above benefit all the products within a store. In fact, for most of these in-store amenities, such as shop location, opening hours, parking facilities, and cashiers, the retailer cannot selectively withhold the amenity from a particular product without expending significant effort and risking offending certain customers. There is, therefore, inter-brand spillover effect. Every time there is spillover effect or externalities, there is the possibility of free riding, which complicates the provision of general retail services funded by retail margins of individual products. This issue would obviously not arise in the case of a single-brand retailer. In the context of multi-brand retailers, however, such inter-brand free riding (as opposed to the intra-brand free riding at issue in the classic free riding defense) is a distinct possibility that needs to be addressed.

Apart from the inter-brand spillover effect of general retail services and the lack thereof of product-specific retail services, general and product-specific services also differ in their impact on the retailer. As suggested earlier, general retail services produce mostly inter-retailer substitution effect by attracting customers from other stores, while product-specific retail services generate intra-retailer inter-brand substitution effect by affecting a customer's choice of product once she is inside a store.⁵³ Therefore, one would imagine that a retailer has more incentive to provide general retail services as opposed to product-specific retail services.⁵⁴ A retailer stands to gain more by providing the former instead of the latter. This means that

⁵² Deneckere I, *supra* note 34, at 619. See also Deneckere II, *supra* note 34.

⁵³ Klein, *supra* note 1414, at 444.

⁵⁴ *Id.* at 447.

retailers may have insufficient incentives to provide product-specific retail services, which explains vertical promotional externality.⁵⁵ Thus, by virtue of the inter-brand spillover effect, there are insufficient incentives for manufacturers to fund general retail services. And by virtue of the inter-brand substitution effect, retailers are unlikely to be adequately motivated to provide product-specific retail services.⁵⁶ There will be under-provision of both types of service to the extent that retailers rely on manufacturers to fund general retail services and manufacturers rely on retailers to finance product-specific retail services.

III. DIFFERENT MODELS OF CONSUMER BEHAVIOR

One of the unspoken assumptions underpinning most of the traditional legal and economic analyses of RPM is the inter-brand primacy model of consumer behavior. This model makes certain assumptions about the sequence of consumers' decisions, the respective roles of brands and retailers in the market, and the relative importance of intra-brand and inter-brand competition. While these assumptions are usually left unarticulated, they have important implications for how the theories of harm and pro-competitive justifications for RPM should be formulated and applied. It is therefore worth spelling out these assumptions explicitly. This is important not only because it will improve our understanding of the potential harm of and justifications for RPM, but also because the inter-brand primacy model is not the only pertinent model of consumer behavior. Two other models of consumer behavior are the inter-retailer primacy model and the impulse purchase model. Under these alternative models, there are differing roles for the brands and the retailers, and the relative weight of intra-brand and inter-brand competition shifts. In fact, one may argue that it is no longer correct to conceptualize competition along these two dimensions. There is a need to re-conceptualize the competitive process, which may affect the validity of the various theories of harm of and pro-competitive justifications for RPM.

Steiner sums up the distinction between the inter-brand primacy model and the inter-retailer primacy model most succinctly: the relevant question is whether consumers will “switch brands within store” or “switch stores within brand.”⁵⁷ According to Comanor,

⁵⁵ *Id.* at 448.

⁵⁶ *Id.* at 448.

⁵⁷ Robert L. Steiner, *The Nature of Vertical Restraints*, 30 ANTITRUST BULL. 143, 157–58 (1985).

[t]his distinction has strong implications for the design and implementation of antitrust policy toward manufacturer-distributor relationships. A failure of antitrust policy toward these relationships in the past followed in part from an effort to create a ‘one size fits all’ policy.⁵⁸

It is precisely this “one size fits all” policy that this Article seeks to address.

A. The Inter-Brand Primacy Model

Under the inter-brand primacy model, consumers are assumed first to choose the brand of product to purchase in a differentiated product market, and then to shop among the different retailers carrying the product for the best deal. Marketing scholars have called these consumers planners, who make planned purchases having determined both the product category and the brand of purchase.⁵⁹ Kollat and Willett propose a typology of five levels of consumption intentions formulation: (1) both product and brand chosen, (2) only product chosen, (3) only product category chosen, (4) need recognized, and (5) need not recognized.⁶⁰ Planners fall within the first level.⁶¹ Cobb and Hoyer also describe planners as having the strongest brand preference among all types of shoppers.⁶²

The first step in the decision-making process of these consumers is characterized by inter-brand competition while the second step entails intra-brand competition. Consumers are assumed to focus on different factors at the two stages. At the inter-brand stage, consumers will focus on a variety of product attributes, such as price, product quality, brand reputation, availability of sales and after-sales services, etc. Some of these attributes are within the manufacturer’s direct control, such as product quality and brand reputation. Some of them are not, such as final product price (in the absence of RPM) and the provision of certain retail services such as product demonstration and

⁵⁸ William S. Comanor, *Leegin and Its Progeny: Implications for Internet Commerce*, 58 ANTITRUST BULL. 107, 108 (2013).

⁵⁹ Cathy J. Cobb & Wayne D. Hoyer, *Planned Versus Impulse Purchase Behavior*, 62 J. RETAILING 384, 394 (1986).

⁶⁰ David T. Kollat & Ronald P. Willett, *Customer Impulse Purchasing Behavior*, 4 J. MARKETING RES. 21, 21 (1967).

⁶¹ *Id.*

⁶² Cobb & Hoyer, *supra* note 59, at 396.

in-store promotion. At the intra-brand stage, consumers have already picked a product and are now merely looking for the best place to purchase it. Consumers' primary consideration at this stage is price. Having settled on one product among the many different brands, consumers would now like to purchase the product at the lowest price possible.⁶³ Obviously other attributes of the retailers will also affect the consumer's choice of retailer. These attributes fall within the rubric of general retail services such as ambience, accessibility, availability of amenities, etc. However, the general belief is that because of the primacy of brand decision, it is mostly the product price, and not the retailer's general retail service, that affects a consumer's choice of retailer.

The bottom line is that to consumers, the primary choice is brand and the secondary choice is retailer. Inter-brand competition takes precedence over intra-brand competition. This type of consumer behavior is most often observed with products "where brands enjoy strong consumer franchises and tend to be heavily advertised."⁶⁴ It is unlikely to be observed when brands have relatively low visibility and consumers do not have strong preference between brands. Brand reputation is more likely to be important to consumers where product quality is not immediately apparent or readily verifiable, or where, as in the case of luxury goods, the appeal of the product partly comes from the appeal of the brand and not solely the product itself.⁶⁵

This conception of competition results in the visualization of the manufacturer-retailer relationship as a "vertical structure."⁶⁶ This is a structure in which the manufacturer sits on top of its retailers in the form of an inverted tree. Each brand has its own structure, which runs parallel to other brands' distribution structures. Competition is supposed to take place between these parallel vertical structures and then move on to between different branches within the same structure. This conception of market structure explains why economists attempt to justify RPM specifically, and vertical restraints in general, from the perspective of maximizing economic efficiency and minimizing externalities within a vertical structure.⁶⁷

⁶³ Mathewson & Winter I, *supra* note 4, at 73.

⁶⁴ Robert L. Steiner, *Exclusive Dealing + Resale Price Maintenance: A Powerful Anticompetitive Combination*, 33 SW. U. L. REV. 447, 454 (2004).

⁶⁵ Niraj Dawar & Philip Parker, *Marketing Universals: Consumers' Use of Brand Name, Price, Physical Appearance, and Retailer Reputation as Signals of Product Quality*, 58 J. MARKETING 81, 88, 90 (1994).

⁶⁶ Rey & Vergé I, *supra* note 12, at 360.

⁶⁷ *Id.*

The conception of inter-brand competition as rivalry between parallel vertical structures is evident in economists' formulation of horizontal externalities. Recall that horizontal pecuniary externality refers to the fact that when a retailer raises the price of a manufacturer's product, it increases demand for the product in competing retail outlets through positive cross elasticity of demand.⁶⁸ This externality makes sense in an inter-brand primacy model, in which consumers select the brand before choosing the retailer. By the time a consumer arrives at a retailer to check out the price of a product, what is left for her to decide is from which retailer she will purchase the chosen product. With this kind of consumer behavior, the primary effect of the increase in product price by a retailer is to drive consumers to other retailers to purchase the same brand, hence horizontal pecuniary externality. This is considered an externality because each retailer does not incorporate the full effect of its price increase, resulting in the under-supply of price increase from the perspective of the vertical structure overall. However, as will be explained below, horizontal pecuniary externality may no longer hold outside the inter-brand primacy model. The same is true for horizontal promotional externality as well. Recall that due to horizontal promotional externality, individual retailers undertake an insufficient amount of promotional activities because each retailer does not capture the full benefits of its promotional activities. Some of the benefits redound to other retailers. There is thus an under-supply of promotional activities from the perspective of the vertical structure overall. However, if product-specific retail services provided by one retailer (general retail services do not benefit other retailers as they are retailer-specific) no longer benefit other retailers, the concern about under-supply disappears.

The assumption of the inter-brand primacy model is apparent in some economic models justifying RPM. Mathewson and Winter argue that the main justification for RPM is to correct retailers' bias toward price competition because they tend to focus on consumers on the inter-retailer margin.⁶⁹ According to their argument, because of the correlation between information costs about prices and information costs about the product across consumers, consumers who are along the inter-retailer margin are indifferent between buying at different retailers, but are infra-marginal with respect to their purchase decision.⁷⁰ The consumers are relatively price elastic but service inelastic. In contrast, consumers along the product margin are

⁶⁸ Mathewson & Winter II, *supra* note 11, at 32–33.

⁶⁹ Mathewson & Winter I, *supra* note 4, at 73.

⁷⁰ *Id.* at 72.

indifferent about buying the product and are relatively price inelastic and service elastic.⁷¹ They are more likely to be swayed by an increase in retail service but less so by a decrease in price. The correlation between information costs about prices and information costs about the product across consumers leads to a bias for the consumers along the inter-retailer margin as opposed to those along the product margin.⁷² In other words, retailers tend to focus on price competition to the neglect of service competition. According to Mathewson and Winter, “[r]etailers accommodate the preferences of consumers on the wrong margin, from the perspective of collective profit maximization, leading to a bias towards too much price competition.”⁷³ The word “collective” strongly suggests that Mathewson and Winter view the manufacturer and its retailers as the relevant unit of analysis. The retailers are there to help maximize the profit of the manufacturer’s overall structure.

⁷¹ *Id.*

⁷² *Id.* at 73.

⁷³ *Id.*

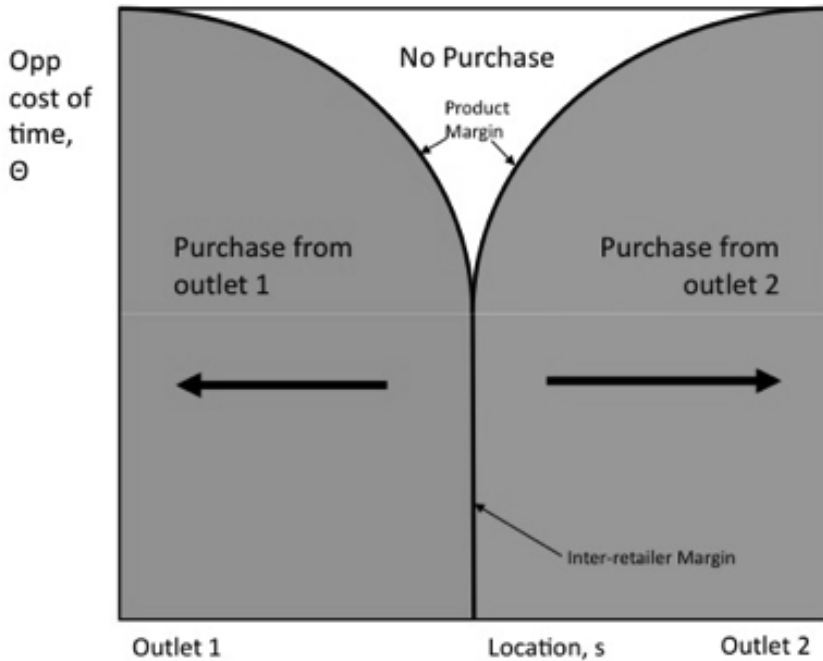


Diagram 1

Diagram 1, which is reproduced from Mathewson and Winter's work, is a representation of the inter-brand primacy model.⁷⁴ The shaded areas under the two curved lines at the top represent consumers' purchase decision with respect to the product of one brand. The two curved lines represent the boundary between the purchase and no purchase of the brand. This signifies the fact that consumers primarily choose a brand first. The secondary decision is a choice between retailers, which is represented by the inter-retailer margin between the two shaded areas. Mathewson and Winter simplify the considerations in consumers' choice between brands and retailers down to two parameters: opportunity cost of time and location. Opportunity cost of time is the relevant parameter in product choice because Mathewson and Winter assume that whether consumers are persuaded to purchase a brand comes down to the amount of retail service they receive, which presumably reduces the time costs they incur to gather product information.⁷⁵ They

⁷⁴ *Id.*

⁷⁵ *Id.*

further assume that consumers' choice of retailer is determined by their location, which, in turn, determines the consumer's information costs for price.⁷⁶

Mathewson and Winter's justification for RPM is premised on a number of assumptions. The most important assumption is that information costs about price are correlated with information costs about the product across consumers. In other words, those who are familiar with the product, and hence less concerned about service, are also most sensitive about price. This means that consumers along the inter-retailer margin are the most price sensitive. This obviously need not be the case. This assumption is most plausible under the inter-brand primacy model, in which consumers who have spent time to get to know the product and have chosen it would no longer require much more product information. The remaining parameter of concern to Mathewson and Winter is price. Therefore, consumers who do not require much service are also the most price sensitive. However, under alternative models of consumer behavior this ceases to be true.

B. The Inter-Retailer Primacy Model

Under the inter-retailer primacy model, the sequence of choices by consumers is reversed. Instead of choosing the brand before picking the retailer, consumers decide on the retailer first, browse around, and choose from the product selection available in the store. Cobb and Hoyer call these consumers "partial planners," for whom "the decision to buy [the product category] was made prior to entering the store, but the actual brand selection was made at the point of purchase."⁷⁷ These consumers probably fall within Levels 2 (only product chosen) and 3 (only product category chosen) of the typology proposed by Kollat and Willett.⁷⁸ Partial planners are said to have the weakest brand preference among the three types of consumers surveyed.⁷⁹ Obviously, this model only works with multi-brand retailers. For single-brand retailers that only carry one brand of, say luxury watches, handbags, or cars, the choice of retailer coincides with the choice of brand.

There are two main scenarios where inter-retailer primacy would be observed. The two scenarios differ by the number of products consumers are looking to purchase on a single shopping trip. The first scenario is where

⁷⁶ *Id.*

⁷⁷ Cobb & Hoyer, *supra* note 59, at 394.

⁷⁸ Kollat & Willett, *supra* note 60, at 21.

⁷⁹ Cobb & Hoyer, *supra* note 59, at 397–99.

consumers are looking for a product in general, such as a piece of clothing or an accessory, and do not exhibit a strong preference for a brand. Consumers who are looking to buy an iPhone are unlikely to fit into the inter-retailer primacy model. In contrast, a consumer may walk into a retailer looking for a handbag. The consumer will examine the selection offered by the retailer and choose one among the many brands on offer based on price, quality, or service of the brand. These can be called single-purchase consumers. Steiner notes that this model “tends to prevail in many apparel categories, and generally in categories in which there is little brand advertising.”⁸⁰ The second scenario is when consumers are looking to purchase a large variety of products on one shopping trip. The quintessential example is grocery shopping.⁸¹ With the amount of products involved in one trip, consumers are likely to be less insistent on the brands of one product. They are more likely to focus on the general product selection and product quality across the board when choosing a retailer.⁸² They may also focus on the general retail services provided by a retailer, such as ambience and amenities.⁸³ These consumers are called basket-purchase consumers.⁸⁴

Inter-retailer competition as the relevant dimension of competition for consumers has been well studied by marketing scholars. These scholars generally classify retailers according to types,⁸⁵ formats,⁸⁶ or categories⁸⁷ and juxtapose intra-type/intra-format competition with intertype/inter-format competition, just like antitrust scholars speak of intra-brand and inter-brand competition. Much of the discussion has been in the context of the grocery/supermarket sector,⁸⁸ even though the same framework of analysis

⁸⁰ Steiner, *supra* note 64, at 454.

⁸¹ David R. Bell & James M. Lattin, *Shopping Behavior and Consumer Preference for Store Price Format: Why “Large Basket” Shoppers Prefer EDLP*, 17 *MARKETING SCI.* 66, 66 (1998).

⁸² *Id.*; Torben Hansen, *Intertype Competition: Specialty Food Stores Competing with Supermarkets*, 10 *J. RETAILING & CONSUMER SERV.* 35, 41 (2003).

⁸³ Hansen, *supra* note 82, at 41.

⁸⁴ Admittedly this type of consumption behavior is unlikely to be common across product categories. It is most likely to be associated with grocery shopping.

⁸⁵ Chip E. Miller et al., *The Effects of Competition on Retail Structure: An Examination of Intratype, Intertype, and Intercategory Competition*, 63 *J. MARKETING* 107, 107 (1999).

⁸⁶ Bell & Lattin, *supra* note 81, at 66; Kathleen Cleeren et al., *Infra- and Interformat Competition Among Discounters and Supermarkets*, 29 *MARKETING SCI.* 456, 456 (2010); Oscar Gonzalez-Benito et al., *Asymmetric Competition in Retail Store Formats: Evaluating Inter- and Intra-Format Spatial Effects*, 81 *J. RETAILING* 59, 59 (2005).

⁸⁷ Miller et al., *supra* note 85, at 117.

⁸⁸ See e.g., Bell & Lattin, *supra* note 81; Maria Grazia Cardinali & Silvia Bellini, *Interformat Competition in the Grocery Retailing*, 21 *J. RETAILING & CONSUMER SERV.* 438 (2014); Cleeren et al., *supra* note 86; Steven Cummins et al., *Retail-Led Regeneration and Store-Switching Behavior*, 15 *J. RETAILING & CONSUMER SERV.* 288 (2008); Gonzalez-Benito et al., *supra*

has also been applied to department stores,⁸⁹ restaurants and grocery stores,⁹⁰ and more.⁹¹ Levy and Weitz define intra-type competition as that existing between the same type of retailers selling similar merchandise, whereas inter-type competition is between different types of retailers selling similar merchandise.⁹² While the distinction between intra-type and inter-type competitions seems clear, what constitutes a type, format, or category is not always well defined.

Most marketing scholars seem to prefer to use the term “type.” “Format” and “category” are used less frequently. Miller and his co-authors define “types” according to the range of products carried by a retailer—they cite limited-line specialists, broad-line specialists, and general merchandisers as examples of different types of retailer.⁹³ Limited-line specialists “are retailers that offer the highest level of consistency of product lines to fulfill complementary and specific product market end-use needs.”⁹⁴ An example would be Ace Hardware Store.⁹⁵ Broad-line specialists “are retailers that offer a broader level of consistency of product lines to fulfill complementary and more generic market end-use needs.”⁹⁶ An example would be Home Depot.⁹⁷ General merchandisers “are retailers that offer relatively inconsistent product lines to fulfill noncomplementary and independent market end-use needs.”⁹⁸ An example would be Sears.⁹⁹

note 86; Hansen, *supra* note 82; Angela Hoffmann & Heike Senkler, *Interformat Price Competition of Multi-Product Retailers: Evidence for German Grocery Retailing*, (EAAE 2011 Congress, Paper No. 114533, 2011), <http://econpapers.repec.org/paper/agseaae11/114533.htm>; Lal & Rao, *supra* note 38; Miller et al., *supra* note 85; Peter T. Popkowski et al., *Consumer Store Choice Dynamics: An Analysis of the Competitive Market Structure for Grocery Stores*, 76 J. RETAILING 323, 336–42 (2000); Vishal P. Singh et al., *Market Entry and Consumer Behavior: An Investigation of a Wal-Mart Supercenter*, 25 MARKETING SCI. 457 (2006).

⁸⁹ See Nancy L. Cassill et al., *Department Store Cross-Shoppers*, 10 J. APPLIED BUS. RES. 88 (2011); Elizabeth C. Hirschman, *Intratype Competition Among Department Stores*, 55 J. RETAILING 20 (1979).

⁹⁰ See Charles A. Ingene, *Intertype Competition: Restaurants Versus Grocery Stores*, 59 J. RETAILING 49 (1983).

⁹¹ See e.g., Richard M. Alt, *Competition Among Types of Retailers in Selling the Same Commodity*, 14 J. MARKETING 441 (1949) (discussing intertype competition between various kinds of retailers).

⁹² MICHAEL LEVY & BARTON WEITZ, *RETAILING MANAGEMENT* 17–18 (3d. ed. 1998).

⁹³ Miller et al., *supra* note 85, at 108.

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

Hirschman puts forward a classification of department stores that seems to focus on price, product type (instead of product range), and customer demographics. According to her, there are three types of department stores: traditional department stores, national chain department stores, and discount department stores.¹⁰⁰ Traditional department stores offer high quality for high price, and tend to focus on fashion apparel.¹⁰¹ Their customers tend to be wealthier and better educated.¹⁰² National chain department stores “focus on the middle of the price/quality spectrum” and sell “soft goods staples and major appliances.”¹⁰³ Their customers also tend to lie at the median in distribution of wealth and educational attainment.¹⁰⁴ Finally, discount department stores’ customers tend to be poorer, more price-conscious, and less educated.¹⁰⁵

Format seems to be most often used in the context of the grocery retailing sector. Gonzalez-Benito and his co-authors define store formats as “broad, competing categories that provide benefits to match the needs of different types of consumers and/or different shopping situations,”¹⁰⁶ even though they admit that definitions of format are “often inexact and sometimes confusing.”¹⁰⁷ They further note that even though the concepts of intra-format and inter-format competition are intuitive, “the delimiting of store formats is not always obvious because it implies divisions in the continuum of competitive positioning.”¹⁰⁸ Cardinali and Bellini enumerate hypermarkets, supermarkets, convenience stores, and discounters as various formats of grocery retailers.¹⁰⁹ Cleeren and co-authors draw a distinction between hard discounters such as Aldi and Lidl and the so-called “everyday-low-price” retailers such as Wal-Mart.¹¹⁰ Bell and Lattin’s study focuses on “everyday-low-price” retailers and the so-called “HILO” retailers. The former “adopt[] a constant Every Day Low Price for every product category,”¹¹¹ while the latter “offer temporary deep discounts in a smaller

¹⁰⁰ Hirschman, *supra* note 89, at 20.

¹⁰¹ Ingene, *supra* note 90, at 54.

¹⁰² Hirschman, *supra* note 89, at 31.

¹⁰³ Ingene, *supra* note 90, at 54.

¹⁰⁴ Hirschman, *supra* note 89, at 32–33.

¹⁰⁵ *Id.* at 33; Ingene, *supra* note 90, at 54.

¹⁰⁶ Gonzalez-Benito et al., *supra* note 86, at 59.

¹⁰⁷ *Id.* See also John Dawson, *Retailing at Century End: Some Challenges for Management and Research*, 10 INT’L REV. RETAIL, DISTRIBUTION & CONSUMER RES. 119 (2000).

¹⁰⁸ Gonzalez-Benito et al., *supra* note 86, at 70.

¹⁰⁹ Cardinali & Bellini, *supra* note 88, at 446.

¹¹⁰ Cleeren et al., *supra* note 86, at 456.

¹¹¹ Bell & Lattin, *supra* note 81, at 68.

group of categories,”¹¹² with higher prices for the non-discounted categories. Thus, it seems like the main distinction between different formats is pricing strategy, even though retailers in different formats may also differ in store layout and the amount of service offered.¹¹³ Based on these examples, it is not easy to see the difference between formats and types. The categorization of grocery retailers into different formats is similar to the same classification of types of department stores by Hirschman.

Inter-category competition seems to be a concept coined by Miller and his co-authors in a study that, contrary to the previously cited studies, is not limited to grocery retailers. They define inter-category competition as that “between specialists and general merchandisers selling similar merchandise.”¹¹⁴ They argue that the traditional dichotomy of intra-type and inter-type competition in analyzing retail structure is no longer sufficient and that more sophisticated classification is necessary. What is more, they submit that “[t]he results of this study demonstrate that a general merchandiser competing with a limited-line specialist in inter-category competition is different from a broad-line specialist competing with a limited-line specialist in inter-type competition.”¹¹⁵ Finally, they further argue that, “intertype competitors are more likely than inter-category competitors to share similar resource bases.”¹¹⁶ Apart from different resource bases, it seems that retailers in different categories also share a more remote competitive relationship than retailers in different types.¹¹⁷

The main significance of the categorization of types, formats, and categories is that marketing scholars believe that competition within types, formats, and categories is stronger than competition across types, formats, and categories. According to Miller and his co-authors, intra-type competition tends to exhibit a strong Darwinian effect.”¹¹⁸ Intra-type competition tends to produce outcomes of a “zero-sum game”¹¹⁹ and “survival-of-the-fittest.”¹²⁰ This is hardly surprising because intra-type competitors are the most similar to each other and often sell substitutable products.¹²¹ In contrast, Miller and his co-authors observe a symbiotic

¹¹² *Id.* at 67.

¹¹³ Hoffmann & Senkler, *supra* note 88, at 2–4.

¹¹⁴ Miller et al., *supra* note 85, at 108.

¹¹⁵ *Id.* at 117.

¹¹⁶ *Id.* at 111.

¹¹⁷ *Id.* at 115–16.

¹¹⁸ *Id.* at 117.

¹¹⁹ *Id.* at 110.

¹²⁰ *Id.* at 109.

¹²¹ *Id.* at 110.

relationship between intertype and inter-category competitors.¹²² This symbiotic relationship is uni-directional, however. The presence of general merchandisers benefits broad-line specialists and the presence of broad-line specialists benefits limited-line specialists, but not vice versa.¹²³ Such disparate relationships between intra-type and intertype competitors are somewhat surprising given that, as conceded by many commentators, their categorization is fraught with difficulty and is imprecise at best.

Cleeren and her co-authors have observed the same relationships between intra-format and inter-format competitors.¹²⁴ They note that intra-format competition “is assumed to be more pronounced than the extent of inter-format competition, because stores of the same format target a similar consumer segment with similar marketing policies.”¹²⁵ They attribute this phenomenon to the fact that “store formats consist of relatively homogeneous groups of stores in terms of positioning strategy,”¹²⁶ and thus “[g]iven the substantial differences in positioning, assortment composition, pricing, and store environment, the extent of inter-format competition is expected to be smaller than the extent of intra-format competition.”¹²⁷ In fact, it was not until recently that commentators “have started to recognize a greater competition between store format[s].”¹²⁸ Hoffmann and Senkler find that inter-format competition in the grocery sector in Germany is mostly along the price dimension.¹²⁹ However, Lal and Rao note that competition between “everyday-low-price” retailers and “HILO” retailers extends to service levels and communications strategies with customers as well.¹³⁰ Given the imprecise boundaries between different formats, it should be no surprise that commentators have observed that the boundary has blurred over time. To meet competition from inter-format competitors, some retailers have sought to “combine the characteristics of different store formats” to create “new ‘hybrid’ formats.”¹³¹ These retailers have engaged in “trading up” and “trading down” policies that have blurred the boundary between different formats.¹³² With the blurring boundaries between different formats, Cardinali

¹²² *Id.* at 114.

¹²³ *Id.*

¹²⁴ Cleeren et al., *supra* note 86, at 458.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.* at 457.

¹²⁸ Cardinali & Bellini, *supra* note 88, at 447.

¹²⁹ Hoffmann & Senkler, *supra* note 88, at 12.

¹³⁰ Lal & Rao, *supra* note 38, at 62.

¹³¹ Cardinali & Bellini, *supra* note 88, at 438.

¹³² *Id.*

and Bellini have even found inter-format competition to be more intense than intra-format competition.¹³³

For our purposes, we need not attempt to clarify or reconcile the overlapping and potentially conflicting definitions of type, format, and category. What matters is that retailers within certain classifications compete keenly with each other for customers. What is more important is that not only do retailers compete, the choice of retailers is the primary choice made by consumers. Brands are not the overriding consideration for these consumers. Miller and co-authors identify store scale, retail saturation, and personal service levels as the “three critical elements” of a retailer that are affected by competition.¹³⁴ Retail saturation refers to the density of retailers in relation to population and is measured by “stores per household.”¹³⁵ Store scale and retail saturation correspond with store size and location and have been previously classified as part of general retail services. Personal service levels seem to refer to the amount of attention and assistance offered by sales staff. Personal service levels could also refer to general availability of sales staff or specialized product knowledge at the staff’s disposal. Lastly, personal service levels could even refer to the amount of product demonstration available from the staff of a certain retailer. Miller and co-authors suggest that personal service levels can be measured by number of employees,¹³⁶ however, implying that personal service refers to general staff availability, which falls more within general retail service than product-specific retail services. They assert that sales levels are positively affected by personal service levels,¹³⁷ which suggests that retailers compete on personal services. In other words, Miller and co-authors believe that where competition predominantly takes place between retailers, i.e., the inter-retailer primacy model, the main dimensions of competition are general retail services. Conspicuously absent from their analysis is individual products, especially their prices.

The relative unimportance of individual product prices to inter-retailer competition is confirmed by Hansen. He undertook a study of the critical success factors for supermarkets and specialty food stores, which shows that from the perspective of consumers, price was only the twentieth and seventeenth most important factor out of a list of twenty-five respectively for

¹³³ *Id.* at 447.

¹³⁴ Miller et al., *supra* note 85, at 108.

¹³⁵ *Id.*

¹³⁶ *Id.* at 108–09.

¹³⁷ *Id.* at 111.

these two types of retailer.¹³⁸ This is despite the fact that customers at supermarkets tend to be more price-sensitive. Instead, the overriding considerations for consumers in their choice of grocery retailer are product quality, service level, range of selection, and general shopping environment.¹³⁹ Other studies have shown location to be an important factor in consumers' choice of retailer.¹⁴⁰ Consumers have also been found to value time saving more than money saving.¹⁴¹ Even in cases in which consumers are found to exhibit considerable price sensitivity, they seem to respond to overall price levels or price expectations of a retailer rather than the price of specific brands.¹⁴² This has to be the case because it is simply impossible for consumers to know the price of every product in a multi-brand retailer.¹⁴³ This is especially true for basket-purchase consumers.

How consumers respond to a price cut on an individual product by a retailer depends on whether the retailer is single-brand or multi-brand and whether the inter-brand primacy model or the inter-retailer primacy model predominates. Under the inter-brand primacy model, when a single-brand retailer cuts prices, the main effect is an intra-brand, inter-retailer substitution effect. The retailer will attract customers from other retailers carrying the same brand. In contrast, when a multi-brand retailer does the same on one of its brands, not only could it take business away from competing retailers, it could, as mentioned earlier, also attract customers away from other brands sold in the same store. In other words, there could be both intra-brand inter-retailer substitution effect and intra-retailer inter-brand substitution effect.¹⁴⁴ Which of these effects predominates will likely depend on the composition of consumers. If the consumers are mainly of the inter-brand primacy kind, they are unlikely to be attracted by other brands in the same store. Intra-retailer inter-brand substitution effect will be small. The main effect will be an inter-retailer substitution effect, i.e., intra-brand competition in the standard antitrust literature. If the consumers are of the inter-retailer primacy kind, they are unlikely to be attracted to switch retailers. Instead, they will be

¹³⁸ Hansen, *supra* note 82, at 41, 42.

¹³⁹ *Id.* at 41, 43.

¹⁴⁰ See Cummins et al., *supra* note 88; Gonzalez-Benito et al., *supra* note 86. However, the focus of these studies on grocery shoppers may skew the result, as it is generally agreed that grocery shoppers prefer to shop close to their homes.

¹⁴¹ Cardinali & Bellini, *supra* note 88, at 445.

¹⁴² Bell & Lattin, *supra* note 81, at 80–81.

¹⁴³ Lal & Rao, *supra* note 38, at 64.

¹⁴⁴ Obviously, there could also be inter-retailer, inter-brand substitution effect. However, this effect is likely to be much weaker given that the product at issue is now twice removed from a competing brand in a rival store.

attracted by competing brands in the same store. Therefore, intra-brand inter-retailer substitution effect will be weak. The main effect will be an inter-brand substitution effect. This is consistent with the notion that individual product prices have little impact on the inter-retailer competition under the inter-retailer primacy model.

Under the inter-retailer primacy model, consumers choose a retailer based on a number of criteria, such as individual shopping needs,¹⁴⁵ general retail services such as store location,¹⁴⁶ store size, layout, and display,¹⁴⁷ general price expectations,¹⁴⁸ and retailer reputation.¹⁴⁹ The price and service elasticity of these consumers depends on whether they are single-purchase consumers or basket-purchase producers. Basket-purchase consumers are service elastic, as they are sensitive to store size, layout, display, etc. The product-specific services of individual products matter less to these consumers given the size of their purchase. They are hence more focused on the general retail services and less focused on product-specific services.

Basket-purchase consumers are price elastic in their store decisions. Their focus, however, is on a basket of products and not on a particular product, with respect to which they are price inelastic.¹⁵⁰ They may be relatively indifferent between brands within the same retailer; the main decision is which retailer to visit, which is made with consideration to their general price expectations of the retailer.¹⁵¹ They have been described as “captive to pricing across a wide variety of categories and . . . relatively lacking in flexibility to take advantage of occasional price deals”¹⁵² for individual products. Bell and Lattin note that for this type of consumer, “price expectations for the basket influence store choice” and that they are “more sensitive to the expected cost of the overall portfolio (the market basket) when choosing a store.”¹⁵³ However, they “are relatively *less* price elastic in their individual category purchase incidence decisions.”¹⁵⁴ Yet while this type of consumer “may have relatively poor knowledge of individual product prices, they can make accurate distinctions about price levels in different

¹⁴⁵ Lal & Rao, *supra* note 38, at 76.

¹⁴⁶ Popkowski et al., *supra* note 88, at 336–42.

¹⁴⁷ Cardinali & Bellini, *supra* note 88, at 441.

¹⁴⁸ Bell & Lattin, *supra* note 81, at 66.

¹⁴⁹ Cardinali & Bellini, *supra* note 88, at 441; Lal & Rao, *supra* note 38, at 62.

¹⁵⁰ Bell & Lattin, *supra* note 81, at 66; Hoffmann & Senkler, *supra* note 88, at 2.

¹⁵¹ Bell & Lattin, *supra* note 81, at 66.

¹⁵² *Id.* at 68.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 69.

stores.”¹⁵⁵ They form their general price expectations of a retailer based on price advertising of specific products and price expectations of the non-advertised products.¹⁵⁶ Even then, it has been reported that this type of consumer displays a relatively low level of price sensitivity even on a store level.¹⁵⁷ Studies have found that store managers tend to overestimate consumers’ price comparison behavior and cross-shopping behavior.¹⁵⁸ This may explain the high retention rate of customers by retailers. In the UK, for example, studies have shown that in the grocery sector, stores generally have an annual customer retention rate near 75%.¹⁵⁹

The price and service elasticities of single-purchase consumers are somewhat different from those of basket-purchase consumers. These consumers will compare between different brands within a store based on their price, product quality, and product-specific services. In terms of service elasticity, while single-purchase consumers are concerned about general retail services—after all, these services are one of the bases on which these consumers choose retailers—they are also more sensitive to the product-specific services of individual products. Given the smaller size of their purchase, they will pay much more attention to the attributes of individual products, including their relative prices with other products. These consumers are, therefore, price elastic at the individual product level. They are less price elastic at the retailer level. However, these consumers may still respond to price cuts by a competing retailer. This is especially true if the consumer at issue is price conscious. It is thus possible that a single-purchase consumer may choose a retailer based on a variety of attributes, browse through the brand selection, and settle on one product, but still decide to engage in price comparison across retailers, especially if the product at issue is a big-ticket item.

What is clear is that under the inter-retailer primacy model, different types of consumers are no longer neatly aligned along price elasticity and service elasticity. The two groups are both price and service elastic to some extent. The correlation mentioned by Mathewson and Winter—that between a consumer’s price and service elasticity—breaks down and there will no longer be a bias toward price competition. The main justification for RPM thus disappears.

¹⁵⁵ *Id.* at 67.

¹⁵⁶ Hoffmann & Senkler, *supra* note 88, at 2.

¹⁵⁷ *See* Hansen, *supra* note 82, at 39.

¹⁵⁸ *See id.*

¹⁵⁹ Cummins et al., *supra* note 88, at 289–90.

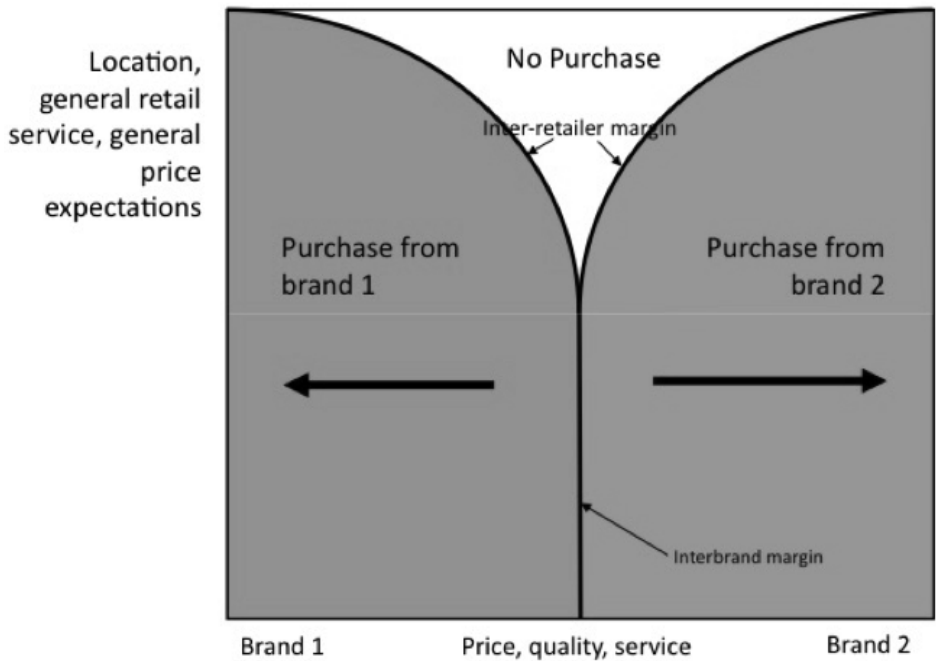


Diagram 2

Diagram 2 is a representation of the inter-retailer primacy model. The shaded areas under the two curved lines at the top represent consumers' purchase decision with respect to the product of one brand. The two curved lines represent the boundary between a purchase and no purchase at the retailer, the inter-retailer margin. This signifies the fact that consumers primarily choose a retailer first. The secondary decision is a choice between brands, which is represented by the inter-brand margin between the two shaded areas. Unlike Mathewson and Winter's simplification, the parameters in a consumer's choice between retailers and brands are elaborated. Within a retailer, consumers focus on the relative price between products, their quality, and their product-specific services to determine which brand to purchase. When choosing a retailer in the first place, consumers will pay attention to its

location, their general price expectations of the retailer,¹⁶⁰ general retail services, and retailer reputation.¹⁶¹

Horizontal pecuniary and promotional externalities have limited relevance under the inter-retailer primacy model, even though the rationale for vertical promotional externality is unaffected by the model and will continue to be relevant. As suggested earlier, under the inter-retailer primacy model, the primary effect when a retailer raises the price of a product will no longer be an intra-brand inter-retailer substitution effect, or horizontal pecuniary externality, but an intra-retailer inter-brand substitution effect. Under this effect, a price increase by a retailer does not result in increased sales of the same product by a different retailer, but rather results in a loss of sales to a competing manufacturer altogether within the store. From the perspective of the vertical structure, if it is still appropriate to conceptualize distribution structures as such, there is no under-supply of price increase by retailers. Likewise, it is no longer clear that there will be an under-supply of retail services. If consumers choose a retailer before selecting the product, the provision of product-specific retail services only affects the consumer's brand choice within the store. Once her retailer choice is made, the consumer is unlikely to defect to a different store simply because of the service offering of one of the brands. If the quality of retail service is unsatisfactory to the consumer, she will simply choose a different brand. In that case, there is no horizontal promotional externality, because consumers will not go to a different store to look for the same product after obtaining product demonstration. The product-specific retail services provided by one retailer do not have spillover effects on other retailers. The product-specific retail services create little externality from the perspective of the vertical structure.

C. The Impulse Purchase Model

The two models examined so far both presume that consumers will undertake a somewhat diligent process to search for either a brand or a retailer before moving on to the next stage of the selection process. The only difference is the sequence of the selection. As it turns out, there is another model of consumer behavior under which consumers are largely impulse buyers who do not undertake much of a search at all. They enter a store they happen to pass by on a whim and make a purchase if they see something appealing, and abstain from purchasing if they do not. If they find the price-

¹⁶⁰ Bell & Lattin, *supra* note 81, at 66.

¹⁶¹ Cardinali & Bellini, *supra* note 88, at 441; Lal & Rao, *supra* note 38, at 62–63.

quality-service combinations offered by the various brands in the store to be unattractive, they do not search further and simply walk away. This is called an impulse purchase, which can be defined as “unplanned, sudden, and spontaneous impulse to buy, which lacks careful evaluation of product and purchase consequences.”¹⁶² It has also been defined as a situation where “a consumer experiences a sudden, often powerful and persistent urge to buy something immediately. The impulse to buy is hedonically complex and may stimulate emotional conflict.”¹⁶³ One distinguishing feature of the impulse purchase is that consumers have not made any prior decisions concerning the purchase and have not evaluated reasonable alternatives. Cobb and Hoyer observe that impulse buyers do not make any product category or brand decision in advance and only decide in the store.¹⁶⁴ Impulse purchases are distinguished by the fact that “the consumer does not evaluate or identify all the shopping alternatives.”¹⁶⁵

Some scholars regard impulse purchases as similar to unplanned buying,¹⁶⁶ while others do not.¹⁶⁷ Some have further distinguished between pure impulse buying and reminder impulse buying; a pure impulse buyer has no prior knowledge or experience with the product bought while a reminder impulse buyer is literally reminded to buy a product upon seeing it even though she had no prior intention to buy the product.¹⁶⁸ The two groups of buyers are shown to have different product preferences and respond to different promotional strategies.¹⁶⁹ Impulse purchasers probably fall within Levels 4 (need recognized) and 5 (need not recognized) of the typology proposed by Kollat and Willett, with a majority in Level 5.¹⁷⁰ One interesting, and perhaps somewhat surprising, observation is that impulse buyers have an intermediate level of brand preference between planners and partial planners.¹⁷¹

¹⁶² Mirela Mihic & Ivana Kursan, *Assessing the Situational Factors and Impulsive Buying Behavior: Market Segmentation Approach*, 15 MGMT. 47, 49 (2010).

¹⁶³ D.W. Rook, *The Buying Impulse*, 14 J. CONSUMER RES. 189, 191 (1987).

¹⁶⁴ Cobb & Hoyer, *supra* note 59, at 397.

¹⁶⁵ Ruzica K. Znidarsic, *Impulsive Consumer Behavior*, 2 INT'L J. MULTIDISCIPLINARITY BUS. & SCI. 81, 84 (2014).

¹⁶⁶ See Kollat & Willett, *supra* note 60, at 21; Aastha V. Vohra, *Materialism, Impulse Buying and Conspicuous Consumption: A Qualitative Research*, 17 GLOBAL BUS. REV. 51, 55 (2016).

¹⁶⁷ See Mohan et al., *supra* note 36, at 1712.

¹⁶⁸ See Shu-Ling Liao et al., *The Effects of Sales Promotion Strategy, Product Appeal and Consumer Traits on Reminder Impulse Buying Behavior*, 33 INT'L J. CONSUMER STUD. 274, 274, 282 (2009).

¹⁶⁹ *Id.* at 277, 282.

¹⁷⁰ Kollat & Willett, *supra* note 60, at 21.

¹⁷¹ Cobb & Hoyer, *supra* note 59, at 397.

Even though impulse purchasers have received scant attention from the antitrust literature, impulse purchasing is in fact a very common consumption behavior and is well studied in the marketing literature. The frequency of impulse purchases has been estimated to be as high as 90%.¹⁷² Impulse purchases were found to represent between 27% and 62% of all department store purchases,¹⁷³ 50.5% of all grocery purchases,¹⁷⁴ and almost 40% of online sales.¹⁷⁵ Using one company as an example, impulse purchases account for 70% of Coca-Cola's sales.¹⁷⁶ Consumers do not exhibit the same general tendency to impulse purchase across all product categories. Impulse purchase tendency has been found to be product-specific.¹⁷⁷ However, it has been noted that "[a]ll products may be purchased impulsively and all consumers engage in impulse buying on occasion."¹⁷⁸ Impulse purchases have a strong psychological component to them and have been extensively studied from this perspective.¹⁷⁹ It has been suggested that impulse purchases are responses to the purchaser's emotional needs,¹⁸⁰ performing a range of roles such as confirmation, compensation, and redefinition.¹⁸¹ Impulse purchases have also been studied from a cultural perspective.¹⁸²

Marketing scholars have studied impulse purchasers in detail and segmented them into three groups: (1) markedly rational, (2) somewhat

¹⁷² Mihic & Kursan, *supra* note 162, at 49.

¹⁷³ Sharon E. Beatty & M. Elizabeth Ferrell, *Impulse Buying: Modeling Its Precursors*, 74 J. RETAILING 169, 169 (1998).

¹⁷⁴ Kollat & Willett, *supra* note 60, at 23.

¹⁷⁵ Kathy Ning Shen & Mohamed Khalifa, *System Design Effects on Online Impulse Buying*, 22 INTERNET RES. 396, 396 (2012).

¹⁷⁶ Geetha Mohan et al., *supra* note 36, at 1723.

¹⁷⁷ Michael A. Jones et al., *The Product-Specific Nature of Impulse Buying Tendency*, 56 J. BUS. RES. 505, 510 (2003).

¹⁷⁸ Shen & Khalifa, *supra* note 175, at 396.

¹⁷⁹ See, e.g., Anant J. Badgaiyan & Anshul Verma, *Intrinsic Factors Affecting Impulsive Buying Behavior—Evidence from India*, 21 J. RETAILING & CONSUMER SERV. 537 (2014); Geoff Bayley & Clive Nancarrow, *Impulse Purchasing: A Qualitative Exploration of the Phenomenon*, 1 QUALITATIVE MKT. RES. 99 (1998); Angela Hausman, *A Multi-Method Investigation of Consumer Motivations in Impulse Buying Behavior*, 17 J. CONSUMER MARKETING 403 (2000); Jihye Park & Sharron J. Lennon, *Psychological and Environmental Antecedents of Impulse Buying Tendency in the Multichannel Shopping Context*, 23 J. CONSUMER MARKETING. 56 (2006); Piyush Sharma et al., *Looking Beyond Impulse Buying: A Cross-Cultural and Multi-Domain Investigation of Consumer Impulsiveness*, 48 EUR. J. MARKETING 1159 (2014); Shen & Khalifa, *supra* note 175.

¹⁸⁰ V. Bhuvaneshwari & Jayasree Krishnan, *A Review of Literature on Impulse Buying Behaviour of Consumers in Brick & Mortar and Click Only Stores*, 2 INT'L J. MGMT. RES. & SOC. SCI. 84, 84 (2015).

¹⁸¹ Bayley & Nancarrow, *supra* note 179, at 110.

¹⁸² See Badgaiyan & Verma, *supra* note 179; Sharma et al., *supra* note 179.

impulsive, and (3) mostly rational.¹⁸³ Impulse purchasers are evaluated based on their responsiveness to what have been called situational factors, which are defined as “external factors coming from the shopping environment when buyer comes into contact with particular visual stimuli (product or promotion) that create the unplanned purchase.”¹⁸⁴ The situational factors studied by Mihic and Kursan include “store design, sales staff, music, aroma, store location, displays, product packaging, larger quantity of displayed merchandise, and shelf arrangement . . . promotional aspects, advertising, and point of sale events.”¹⁸⁵ These situational factors (sometimes also called external stimuli) by and large fall within two categories: either general retail services or product-specific retail services. Store design, general ambience (music and aroma), store location, and shelf arrangement constitute general retail services. Displays, promotion, advertising, and point of sale events fall under the general rubric of in-store promotion and are product-specific retail services. Other scholars have focused on similar situational factors.¹⁸⁶ Mohan and co-authors found that environmental store factors such as music, lighting, layout, and adequate and well-informed sales staff help induce impulse buying.¹⁸⁷ Product price has also been found to be the main factor in attracting impulse purchases in both large and small sized stores.¹⁸⁸

The markedly rational purchasers, the first group of impulse purchasers, who accounted for 22.2% of the sample size in Mihic and Kursan’s study, are immune to influence and presumably only focus on product characteristics.¹⁸⁹ The second group, the somewhat impulsive purchasers, who are said to be “sensitive to some situational stimuli”¹⁹⁰ and accounted for 39.5% of the sample size, respond to both general retail services and product-specific retail services.¹⁹¹ They were found to be most sensitive to promotional activities, and also quite responsive to general ambience.¹⁹² The last group, the mostly

¹⁸³ Mihic & Kursan, *supra* note 162, at 55–56.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at 53. Of course, for online impulse sales, the situational factors become online system design features. Shen & Khalifa, *supra* note 175, at 397.

¹⁸⁶ See Bhuvaneswari & Krishnan, *supra* note 181, at 85–86; G. Muruganatham & Ravi S. Bhakat, *A Review of Impulse Buying Behavior*, 5 INT’L J. MARKETING STUD. 149, 152–55 (2013); Parmar Vishnu & Ahmed Rizwan Raheem, *Factors Influencing Impulse Buying Behavior*, 100 EUR. J. SCI. RES. 67, 68–69 (2013).

¹⁸⁷ Geetha Mohan et al., *supra* note 36, at 1715–16, 1723.

¹⁸⁸ Suneet Gupta et al., *Impact of Store Size on Impulse Purchase*, 8 IUP J. MARKETING MGMT. 7, 16 (2009).

¹⁸⁹ Mihic & Kursan, *supra* note 162, at 55.

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 55–56.

¹⁹² *Id.* at 56.

rational purchasers, who are said to be “generally immune to influence” and accounted for 38.3% of the sample size, respond to a wide range of general and product-specific retail services.¹⁹³ Again, they were found to be most responsive to promotional activities.¹⁹⁴ Even though the purchase decisions of two of the three types of impulse purchasers are informed by general retail services, the point remains that none of these services produce any inter-retailer substitution effect under the impulse purchase model. Product-specific retail services continue to create intra-retailer inter-brand substitution effect. Interestingly, in the case of impulse purchasers, general retail services not only affect their retailer choice decision, but also their product choice decision. However, it is not clear how these retail services do. The most likely explanation is that superior general retail services increase an impulse purchaser’s general willingness to buy, but not her choice of product.¹⁹⁵ This is confirmed by studies showing that “highly stimulating and pleasant store environments lead to enhanced impulse buying.”¹⁹⁶

Products for which impulse buying could be common include books,¹⁹⁷ clothes, accessories, or drinks and snacks for instant consumption. The common feature across all these products is that they account for an insubstantial proportion of the consumer’s overall budget.¹⁹⁸ Schulz describes this type of consumer as follows:

A consumer strolling through a city may suddenly decide to visit a store and to find out what is on offer, although he had no intent to do so, when he decided to go downtown. Customers of this type typically do not actively search. Once a store is entered he only decides whether or not a good that he finds promising is worth its price. But he will not visit another store in order to search for a better price (in a world without RPM). If all consumers were of this type there would be no essential role for competition among retailers but for showy appearances in order to attract the consumer’s

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ Anna S. Mattila & Jochen Wirtz, *The Role of Store Environmental Stimulation and Social Factors on Impulse Purchasing*, 22 J. SERV. MARKETING 562, 564 (2008); Vishnu & Raheem, *supra* note 186, at 67.

¹⁹⁶ Mattila & Wirtz, *supra* note 195, at 564.

¹⁹⁷ Norbert Schulz, *Does the Service Argument Justify Resale Price Maintenance?*, 162 J. INST’L & THEORETICAL ECON. 236, 246 (2007).

¹⁹⁸ *Id.*

attention. A bookstore could more or less act like a local monopolist.¹⁹⁹

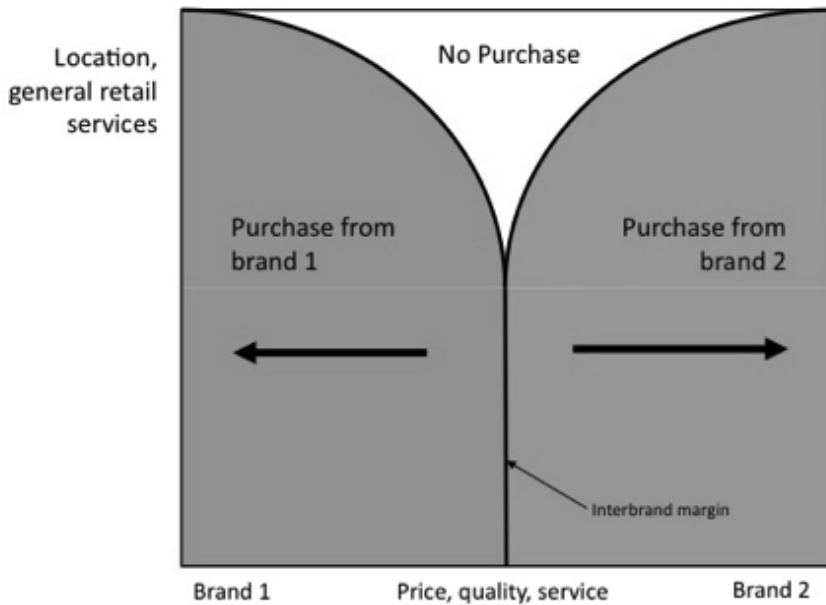


Diagram 3

Diagram 3 is a representation of the impulse purchaser model. It is in many ways similar to the inter-retailer primacy model in that consumers are choosing between brands at the retailer. They probably focus on similar criteria when choosing a product within the store. The main difference between the impulse purchaser model and the inter-retailer primacy model is that there is no inter-retailer margin in the impulse purchaser model. This is obvious, as consumers do not shop between different retailers. When they leave a store they simply do not purchase anything anywhere. Therefore, there is little inter-retailer competition at the product stage, i.e., once the consumer has settled on a product.

¹⁹⁹ *Id.* at 240.

What about inter-retailer competition at the retailer stage, i.e., do retailers compete to attract consumers into the store in the first place? Much of the marketing literature on impulse purchasing has little to say on how consumers arrive at their choice of retailers in the first place. There is discussion about the relevance of general retail services such as ambience and amenities, but mostly in the context of situational factors to spur product choice. There are two possibilities for retailer choice under the impulse purchase model. The first possibility is that a consumer may have entered the store for other reasons, such as looking for a particular product under the inter-brand primacy model or looking to make a general purchase within a product category under the inter-retailer primacy model. While shopping in the store for other products, the consumer chances upon the product which she had no intention of buying prior to entering the store and makes an impulse purchase. Under this possibility, there is no independent retailer choice under the impulse purchase model. The retailer choice simply follows the choice that has been made under a different behavioral model.

The second possibility is that a consumer randomly wanders into a store in her free time and stumbles upon a product she wants to buy. This probably falls within the “need not recognized” category by Kollat and Willett. This is the kind of scenario described by Schulz above, and may be called pure impulse purchasing. A consumer enters a retailer if it happens to be at the right place and looks attractive enough.²⁰⁰ In this case, general retail services still matter. For example, the longer the operating hours, the more likely that a retailer will be open when a consumer passes by. The more pleasant the ambience and the better the amenities, the more likely it is that a consumer will walk in. However, the fact that consumers still make a choice of retailers based on the quality of general retail services does not mean that there is inter-retailer competition. The fact is that under the impulse purchase model, consumers do not compare retailers before choosing one to go in. They evaluate retailers on a case-by-case basis. Therefore, it is safe to say that under the impulse purchase model, especially of the pure kind, there is essentially no inter-retailer competition at the product stage or the retailer stage.

The implications of the impulse purchase model of consumer behavior for the various kinds of horizontal externalities are clear. If consumers do not shop around between different retailers at all, there is essentially no inter-retailer competition. When a retailer raises the price of a product, it will not create greater demand for the product at other retailers. The impulse buyer

²⁰⁰ Jones et. al., *supra* note 177, at 506.

will simply walk out of the store without making any purchase if she deems the price too high. There is, therefore, no horizontal pecuniary externality. In that case, the only pricing pressure facing a vertical structure would be vertical pecuniary externality, which means vertical maximum price fixing would be the most appropriate remedy. Likewise, in the absence of inter-retailer competition, retail services and other in-store promotion undertaken by a retailer will have no impact on the business of other retailers. A consumer will not consume the retail services at one retailer and purchase the product at a different, cheaper retailer. There is simply no spillover effect. Accordingly, there is no horizontal promotional externality and no under-provision of retail services from the perspective of the vertical structure.

From the perspective of RPM, the absence of a horizontal promotional externality means that free riding is unlikely to be a concern. This is independent of the kind of retail service in question. Even for product demonstration of a technically complex product, the quintessential free riding scenario, the lack of externality means that retailers need not worry about competing retailers free riding on their efforts.²⁰¹ This is because the lack of free riding is not due to the unsuitability of the product or the service, but is due instead to the lack of inter-retailer competition. This nullifies the very premise of the free riding defense. At least with respect to products that are mostly purchased by impulse buyers, the prevention of free riding is unlikely to be a valid justification for RPM. This does not mean, however, that RPM can never be justified for products dominated by impulse buyers. The manufacturer-retailer relationship still suffers from vertical promotional externalities. Whether it is justified to use RPM to tackle the under-provision of retail services due to vertical promotional externalities will be addressed in Section IV.C.

IV. REEXAMINATION OF THE PRO-COMPETITIVE JUSTIFICATIONS FOR RPM

As suggested earlier, much of the theorization of RPM, both in terms of theories of harm and pro-competitive justifications, is premised on the inter-brand primacy model of consumer behavior. These theories of harm and justifications adopt a certain conceptualization of the relationship between

²⁰¹ Admittedly, the impulse purchase model is unlikely to apply to the purchase of technically complex products. Most of these products are likely to be expensive enough that few consumers will buy them on impulse. Schulz cites the purchase of books as a plausible application of this model. Schulz, *supra* note 197, at 256.

brands and retailers in the competitive process, which affect the conclusions that follow. It was argued in the previous Part that it is unrealistic to assume that consumer behavior conforms only to one model. Consumer behavior is in fact highly heterogeneous. Once alternative models of consumer behavior are incorporated into the various theories about RPM, some of their conclusions necessarily change. Some of them may be no longer valid, while some of them take on added importance. All this will affect how the courts should analyze RPM and how the Rule of Reason analysis mandated by *Leegin* could and should be structured.

A. The Free Riding Defense

1. The Defense

The free riding defense is probably the most well known of the justifications for RPM. It was pioneered by Lester Telser and has been elaborated and widely debated since.²⁰² Under the free riding defense,²⁰³ the manufacturer would like the retailers to provide retail services such as product demonstration, display, and promotion. Some retailers heed the manufacturer's request and invest in staff training to provide the product demonstration and in-store promotion of the product. They incur a cost from all these investments, which they need to recoup by raising the retail price of the product. Meanwhile, some other retailers choose not to invest in the provision of these services and instead position themselves as no-frills retailers. The lack of service lowers their cost and allows them to charge a lower retail price for the same product. As consumers discover both types of retailers, their rational response would be to go to the full-service retailers to obtain all their desired product demonstration and then purchase the product from the no-frills retailers. Over time, the full-service retailers realize that they incur costs to provide retail services while failing to attract any sales. They decide that it is no longer worth their while to provide the desired services and join the no-frills retailers in pursuing the low-price, no-service strategy. The manufacturer thus fails to motivate its retailers to provide retail services even though it believes, rightly or wrongly, that the services will increase demand for its product. The only way to ensure that free riding does not erode the incentives of the full-service retailers to provide retail services is to prevent the no-frills retailers from discounting. This is where RPM comes

²⁰² Telser, *supra* note 6, at 89–96.

²⁰³ The following formulation follows Telser's approach. *See id.*

in. It prevents free riding by preempting price-cutting by the no-frills retailers, hence allowing the manufacturers to obtain the desired retail services from the retailers.

The free riding explanation does not apply to every product, because some products simply do not require any sales services. According to Telser, new branded products²⁰⁴ and “old branded products purchased infrequently by relatively few households”²⁰⁵ are the prime candidates for RPM. Nor is the defense applicable to all kinds of retail services. Telser himself points out that the free riding defense is only valid with product-specific services and not with general retail services.²⁰⁶

2. *The Logic of the Defense*

There is no denying the strong intuitive appeal of this account. That is perhaps one of the reasons that the free riding defense has held sway in the antitrust community ever since Telser first articulated it in 1960, despite numerous criticisms of it over the years. It turns out there are a number of crucial assumptions underpinning this free riding account. If any of these assumptions fails, the free riding defense unravels.

The first assumption is that manufacturers cannot obtain the desired retail services through other means. One obvious alternative would be to directly contract for the services. Commentators have disagreed on the extent to which these retail services can be effectively procured through contractual arrangements. Some, including Tesler, have argued that the difficulty in quantification and monitoring compliance means that contractual arrangements will fall short of the objective,²⁰⁷ while others have insisted that contractual arrangements more than suffice for the purpose.²⁰⁸ At the very least they argue that the monitoring problem under a contractual arrangement

²⁰⁴ *Id.* at 95.

²⁰⁵ *Id.* at 96.

²⁰⁶ *Id.* at 89 (“We must understand these retailers’ services to be specific to the commodity and unrelated to the retailers’ methods of generally doing business. If, on the contrary, the retailers’ general business methods are at issue such as whether they provide their customers with a pleasant atmosphere, delivery, credit and the like then there is no need for the protection of resale price maintenance on the particular commodity to be sold jointly with these services.”).

²⁰⁷ *Id.* at 94.

²⁰⁸ *See, e.g.*, WARREN S. GRIMES, RESALE PRICE MAINTENANCE: A COMPETITIVE ASSESSMENT, FED. TRADE COMM’N WORKSHOP ON RESALE PRICE MAINTENANCE 3 (Feb. 19, 2009) [hereinafter Grimes I], https://www.ftc.gov/sites/default/files/documents/publicevents/resale_price_maintenance_under_sherman_act_and_federal_trade_commission_act/wgrimes0219.pdf.

is no more serious than under an RPM. In fact, they argue that RPM imposes a more onerous monitoring burden, because the manufacturer will need to monitor both the price and service levels of a retailer, as opposed to only the service level in the case of a contractual arrangement.²⁰⁹

The second assumption is that the retail service and the product itself can be consumed separately. In other words, it is possible for a consumer to go to one retailer for the retail service and to another retailer to purchase the product. If the retail service was subsumed in the product itself, for example, the special handling and storage required by Coors beer,²¹⁰ free riding would be impossible. A consumer simply cannot purchase the beer without also consuming the retail service. Although it is technically possible to consume product display, in-store promotion, and general retail services separately from the product—in theory, nothing stops a consumer from seeing a product in a retailer with a pleasant environment or on a prominent in-store display and then proceeding to purchase the product at a different retailer—it is highly unlikely to happen in reality.²¹¹ Products for which prominent in-store display or promotion is important are likely to be impulse purchases. For such purchases, consumers will not go to a different retailer to purchase the product. Similarly, consumers are unlikely to visit a retailer with long operating hours, pleasant ambience, abundant amenities and sales staff to view a product and then purchase the product elsewhere. General retail services attract consumers to a retailer. Once a consumer is there, she will probably only go to a different retailer if the prices at the first retailer deviate wildly from her price expectations. General retail services do not enhance a consumer's preference for a particular brand. Consumers may have benefited from those general retail services at one retailer, but it is inaccurate to say that those services provided by the first retailer directly contributed to the consumer's decision to purchase a product at a different retailer.²¹² Therefore, when the consumer does purchase a product at a second retailer, it cannot be said to have free ridden the general retail services provided by the first retailer. In reality, there are not many retail services that fit within the free riding defense paradigm, with perhaps product demonstration being the main one.

²⁰⁹ See Warren S. Grimes, *A Dynamic Analysis of Resale Price Maintenance: Inefficient Brand Promotion, Higher Margins, Distorted Choices, and Retarded Retail Innovation*, 55 ANTITRUST BULL. 101, 112 (2010) [hereinafter Grimes II].

²¹⁰ See Klein & Murphy, *supra* note 47, 280–82.

²¹¹ Klein, *supra* note 14, at 444.

²¹² Klein, *supra* note 14, at 439; Mathewson & Winter I, *supra* note 4, at 69.

The third assumption is that retailers cannot separately charge for the retail services.²¹³ If it were possible for retailers to recoup the costs incurred providing the services by charging customers, there would be no need to fund these services through a guaranteed retail margin. This is in most cases true of the type of retail services at issue in the defense, such as product demonstration and promotion. While it is not technically impossible, it is hard to imagine retailers charging customers for product demonstration, perhaps because customers would refuse to pay for it. Most consumers would only be willing to pay for demonstration of the product she eventually buys, even though she may have seen numerous other product demonstrations before arriving at her final choice. While there is no doubt that demonstrations of the unwanted products are valuable to the consumer, consumer psychology is such that most consumers would not be willing to pay for them. In that sense, it is perhaps reasonable for retail services to be funded by retail margins, which means that consumers only pay for demonstration of the products they buy.

It is worth pointing out that consumers will also implicitly be paying for the product demonstrations for consumers who end up buying another product, or not buying anything at all. This ironically gives rise to free riding of a different kind. Unless all the products in the market yield the same success rate from product demonstrations, there are bound to be products that are indirectly subsidizing other brands by providing product demonstrations that ultimately yield purchases of those other brands. This means that buyers of less popular brands are likely to be indirectly subsidizing buyers of more popular brands. Consumers who buy nothing at all clearly free ride on other consumers' purchases. Therefore, free riding exists even under RPM, albeit of a different kind. The only way in which free riding can be prevented is if those who benefit from a particular service bear the full cost of the service. This would require retailers to charge for retail services.

The fourth assumption is that it is worth the consumers' while to go to a different retailer to purchase the desired product. Although this point seems not to have been made before, it is intuitively obvious. Consumers incur time costs to visit a different retailer to engage in free riding, and they will only do so if they achieve a big enough saving to offset those costs. Consumers are unlikely to take the time to visit a different retailer in search of a lower price if the product price is trivial, such as groceries or a small item of clothing. They will only make the effort to engage in free riding for expensive products, such as electronics, automobiles, or other durable or luxury goods. This also

²¹³ Carlton & Chevalier, *supra* note 45, at 442; Elzinga & Mills I, *supra* note 4, at 1843.

means that free riding is unlikely to be an issue for product display. Prominent product display will likely only have significant impact on consumer choice with respect to simple and cheap products, especially impulse purchases. For more substantial purchases such as an expensive item of clothing or electronics products, consumers are unlikely to grab the first product they see on the shelf.²¹⁴ They are likely to undertake a thorough examination of the various alternatives. Product display is likely to matter less with that kind of consumer behavior.

A related point is that whether the free riding defense applies depends on the retail service at issue. The defense has much more limited relevance to after-sales services because the dealer can refuse to service a product it did not sell or charge separately for repair services.²¹⁵ The dealer can prevent free riding simply by demanding a proof of purchase. Product demonstration is thus probably the most prominent type of product-specific retail service left. It is clear that not every product requires demonstration. It is only technically complex products or products that are not easy or intuitively obvious to operate that require demonstration. A can of coke or a sweater does not require product demonstration. Yet RPM has been observed in many products that do not require such services, such as candies, pet food, jeans, shampoo, etc.²¹⁶ A number of commentators have noted this limitation of the free riding defense.²¹⁷ In fact, even the necessity of RPM for securing product demonstration for technically complex products has been questioned. In his dissent in *Leegin*, Justice Breyer notes that despite the per se rule against

²¹⁴ Manoj Kumar Sharma, *The Impact on Consumer Buying Behaviour: Cognitive Dissonance*, 6 GLOBAL J. FIN. & MGMT. 833, 836 (2014). See also PHILIP KOTLER ET. AL., PRINCIPLES OF MARKETING 276–78 (4th Eur. ed. 2005).

²¹⁵ Telser, *supra* note 6, at 91. It has long been argued that post-sales services do not fall within the ambit of the free riding defense because retailers can easily charge for them. See William S. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983, 988 (1985); Warren S. Grimes, *Brand Marketing, Intra-Brand Competition, and the Multi-Brand Retailer: The Antitrust Law of Vertical Restraints*, 64 ANTITRUST L.J. 83, 101–02 (1995) [hereinafter Grimes III].

²¹⁶ Marina Lao, *RPM: A Reassessment of Its Competitive Harms and Benefits*, in MORE COMMON GROUND FOR INTERNATIONAL COMPETITION LAW? 75, 80 (Josef Drexler et. al. eds., 2011).

²¹⁷ See Grimes I, *supra* note 208, at 3; Michael E. Jacobs, *Legal Treatment of Vertical Restraints: Some Lessons from the Ongoing International Debates 22* (Research Paper for Fiscalía Nacional Económica, 2012), <http://www.fne.gob.cl/wp-content/uploads/2012/10/Legal-Treatment-of-Vertical-Restraints.pdf>; OVERSTREET, *supra* note 35, at 52; Robert Pitofsky, *Why Dr. Miles Was Right*, 8 REGULATION 27, 29–30 (1984).

RPM, technically complex products continue to be sold in the economy and there is no evidence for the under-provision of such goods.²¹⁸

The fifth assumption underpinning the free riding defense is that retailers would be spurred by the increased retail margin to provide the desired retail services. If the mere provision of financial incentives was sufficient to secure the desired retail services from retailers, manufacturers need not resort to RPM. They could have achieved their objective through direct contracting. The provision of a contractual payment would have sufficed. This suggests that monitoring for compliance is needed for both direct contracts and RPM, or retailers will simply pocket their extra retail margin while withholding retail services.²¹⁹ Defenders of the free riding defense argue that monitoring is not necessary under RPM because retailers will naturally have the incentive to provide the desired retail services. This is because once RPM has eliminated intra-brand price competition, retailers can only compete with each other along non-price dimensions, which means they must compete for customers by providing superior retail services. Therefore, RPM obviates the need to monitor the provision of retail services.

Two further assumptions are necessary for this argument to hold. First, the retailers will choose competition, price or non-price, over a live-and-let-live situation absent any serious effort at non-price competition. Competition at the retailer level may genuinely be weak. Competitors may simply sit tight, continue to free ride, and let consumers choose the retailers on their own.²²⁰ Second, if retailers do engage in non-price competition, they will only do so by providing the kind of retail services desired by the manufacturers. Klein and Murphy have argued that this requires “the unrealistic assumption that the sole avenue of non-price competition available to retailers is the supply of the particular services desired by the manufacturer.”²²¹ This assumption may be more realistic when the retailer is a single-brand retailer, whose business is entirely dependent on the sales of a particular brand’s product. The incentives of the manufacturers and the retailers are aligned; what boosts the manufacturer’s business also boosts the retailer’s business. If product-specific retail services will boost sales, the retailer will have every incentive to provide it. However, this assumption is unrealistic in the case of a market populated by multi-brand retailers and characterized by the inter-retailer primacy

²¹⁸ *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 916 (2007) (Breyer, J., dissenting).

²¹⁹ *See generally* Grimes II, *supra* note 209.

²²⁰ Klein & Murphy, *supra* note 47, at 266.

²²¹ *Id.*

model.²²² In such a market, retailers will focus on providing retail services that will attract consumers into the store, as opposed to services that will draw consumers to a particular brand.²²³ The degree of service elasticity depends on the type of consumer at issue. A basket-purchase consumer would mostly respond to general retail services and would pay little attention to product-specific retail services. Meanwhile, a single-purchase consumer will show more sensitivity toward product-specific retail services. Despite this variation, it is true that general retail services will mainly produce inter-retailer substitution effect while product-specific retail services will mostly create intra-retailer inter-brand substitution effect. Therefore, retailers will naturally focus on general retail services as opposed to product-specific retail services.

On the other hand, a manufacturer is much more concerned about product-specific retail services, because it is these services that drive sales of its own brand. A manufacturer wants the retailers to provide product-specific retail services, and not general retail services. Therefore, in a market populated by multi-brand retailers in which the inter-retailer primacy model applies, incentive incompatibility between the manufacturer and the retailers is highly likely. RPM will fail to generate the kind of product-specific retail services required by the manufacturers. More importantly, in markets in which the inter-retailer primacy model applies, it has been established that free riding is simply not an issue because product-specific retail services of the kind invoked in the free riding defense do not produce spillover effects on other retailers. There are no horizontal promotional externalities. When other retailers do not benefit from the retail services provided by a retailer, there is no free riding issue. The situation is similar, and in fact, more definite under the impulse purchase model. Under that model, there is even less inter-retailer competition as consumers do not fully evaluate their shopping alternatives. The lack of inter-retailer competition means that retail services have little inter-retailer spillover effect, which in turn means that there is little room for free riding.

In sum, the free riding defense is largely irrelevant under the inter-retailer primacy model and the impulse purchase model, and is at most only applicable to a small class of products with respect to product demonstration under the inter-brand primacy model. Even this requires the assumption that the retailers will somehow have the incentives to invest the enhanced retail margins to provide the product-specific retail services desired by the

²²² Schulz, *supra* note 197, at 240.

²²³ Klein, *supra* note 14, at 439.

manufacturers, a situation that is highly unlikely with multi-brand retailers. With all these qualifications, it is not at all clear what is left of the free riding defense.

Even if all these assumptions hold true and RPM is the superior method to secure product-specific retail services for a product that requires such services and for which free riding is likely, it still cannot be assumed that RPM will necessarily improve consumer welfare. In almost all cases, RPM raises retail prices. Empirical evidence seems to confirm this.²²⁴ In that case, RPM produces two opposing effects on output.²²⁵ On the one hand, the increases in retail price should suppress output. On the other hand, the increase in retail services should generate greater demand. Which of these two effects predominates depends on the elasticity of demand with respect to price and the elasticity of demand with respect to service on the margin.²²⁶ If the marginal consumer is more sensitive to a price increase than to an increase in retail service, demand will drop and output levels will fall. If the marginal consumer is more sensitive to an increase in service than to a price increase, then demand will rise and output levels will increase. Consumers should be better off as their consumption of the product increases.

3. *The Infra-Marginal Consumer Welfare Loss Critique*

While it is generally assumed that an increase in output signifies an improvement in consumer welfare, even that premise has been questioned. Based on an insight originally developed by Michael Spence,²²⁷ William Comanor has argued that while RPM may benefit the marginal consumer by increasing retail services, it may harm infra-marginal consumers by forcing them to pay for retail services they do not need.²²⁸ The key insight is that marginal and infra-marginal consumers have divergent preferences in terms of retail services. Marginal consumers are those who are on the fence about purchasing the product, and may therefore be particularly sensitive to any changes in price or quality-adjusted price, which can be affected by the amount of retail services.²²⁹ Marginal consumers are likely to be attracted to the product by the increase in retail services generated by the RPM; they would not have purchased the product without the RPM. Meanwhile, infra-

²²⁴ OVERSTREET, *supra* note 35, at 106–116.

²²⁵ F.M. Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687, 702–03 (1983).

²²⁶ *Id.*

²²⁷ See A. Michael Spence, *Monopoly, Quality and Regulation*, 6 BELL J. ECON. 417 (1975).

²²⁸ Comanor, *supra* note 215, at 991–92.

²²⁹ *Id.* at 991.

marginal consumers are those consumers whose valuation of the product well exceeds the current market quality-adjusted price, with or without RPM, and who would have purchased the product regardless of the extra retail services generated by RPM.²³⁰ Their purchase of the product would not decrease as a result of RPM, due to their high valuation of the product. Raising the retail price to induce extra services will be a waste from the perspective of these consumers, who would prefer to pay a lower price for the product with less service.²³¹

The problem for the infra-marginal consumers is that the manufacturer's decision on the price-service combination is determined by the marginal consumers.²³² However, once the price is set, it must be applied across the board unless price discrimination is possible. Infra-marginal consumers will be harmed if the retailers cannot engage in price discrimination and charge these consumers a lower price.²³³ There are two reasons for this. The first reason is the classic explanation for the difficulty in implementing price discrimination: retailers are unable to distinguish between different types of consumers and prevent arbitrage between them. The second reason is that the costs of providing retail services are fixed costs, which must be shared across all outputs, as opposed to marginal costs.²³⁴ This means that infra-marginal consumers must share the burden of supporting the retail services or an insufficient amount of service will be provided to the marginal consumers. Infra-marginal consumers are indirectly subsidizing marginal consumers.

The crux of the argument is that when a firm tries to expand sales, it only focuses on the marginal consumers.²³⁵ The behavior of the marginal consumers determines the manufacturer's profitability. However, the overall welfare effect of a firm's policy depends on its impact on both the marginal and the infra-marginal consumers.²³⁶ Consumer welfare will suffer if the consumer welfare loss of the infra-marginal consumers outweighs the gain of the marginal consumers.²³⁷ This will be the case if either infra-marginal consumers outnumber marginal consumers, or the welfare loss of individual

²³⁰ *Id.*

²³¹ *Id.*

²³² *Id.*

²³³ Howard P. Marvel & Stephen McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J.L. & ECON. 363, 371 (1985) [hereinafter Marvel & McCafferty I].

²³⁴ *Id.* at 372.

²³⁵ William S. Comanor & John B. Kirkwood, *Resale Price Maintenance and Antitrust Policy*, 3 CONTEMP. POL'Y ISSUES 9, 14 (1985).

²³⁶ *Id.*

²³⁷ *Id.*

infra-marginal consumers far exceeds that of marginal consumers.²³⁸ Infra-marginal consumers may be knowledgeable consumers who do not require product demonstration and other information at the store while marginal consumers, on the other hand, may be relative novices to the product.²³⁹ Thus infra-marginal consumers are more likely to outnumber marginal consumers when there are more knowledgeable consumers around. Consequently, Comanor argues that there is a much weaker justification for RPM for established products, for which there is likely to be a higher proportion of knowledgeable consumers.²⁴⁰ The welfare loss of individual infra-marginal consumers is likely to exceed that of marginal consumers when the two groups of consumers are less homogenous and have dissimilar price and service preferences, which is more likely when consumers lack choices.²⁴¹ If inter-brand competition is sufficient and consumers have ample choices, the infra-marginal consumers can simply switch to an alternative brand if they are dissatisfied with the unwanted service foisted upon them.²⁴² Therefore, weakness in inter-brand competition is more likely to lead to greater overall consumer harm. The precedence of inter-retailer competition means that consumers of a given product are likely to be less homogenous and their price and service preferences are more likely to diverge. Harm to infra-marginal consumers is likely to be greater. Overall consumer welfare loss is more likely for products that are sold in multi-brand retailers.

This critique of RPM based on the welfare effects on infra-marginal consumers is not without criticism. A number of commentators have argued that focusing on the distributional welfare effects of RPM on different groups of consumers is misguided.²⁴³ The gist of their criticism is that the kind of detrimental welfare effect created by RPM is not unique to RPM. Rather, it materializes any time a manufacturer invests in advertising or promotion, or enhances the product's quality, and raises the product's price as a result. Correia argues that "[t]he fact that this conclusion applies in the case of all consumer goods and is not unique to supplier-dealer relationships makes it an inappropriate basis for antitrust policy."²⁴⁴ Elzinga and Mills note that

²³⁸ Comanor, *supra* note 215, at 999–1000.

²³⁹ *Id.* at 992.

²⁴⁰ *Id.* at 1001.

²⁴¹ Elzinga & Mills I, *supra* note 4, at 1849.

²⁴² Patrick Rey, Vertical Restraints—An Economic Perspective 13 (October 13, 2012) (Fiscalía Nacional Económica, Revised Draft Report), <http://www.fne.gob.cl/wp-content/uploads/2013/11/Patrick-Rey.-Vertical-Restraints.pdf>.

²⁴³ See Edward O. Correia, *Resale Price Maintenance—Searching for a Policy*, 18 J. LEGIS. 187, 217 (1992); Elzinga & Mills I, *supra* note 4, at 1849; Klein, *supra* note 14, at 463.

²⁴⁴ Correia, *supra* note 243, at 217.

“[u]sing antitrust to regulate RPM agreements that a manufacturer implements to induce retail services would be similar to using antitrust to govern the firm’s advertising and new product introduction policies.”²⁴⁵ Finally, Klein asserts:

The role of antitrust is not to microregulate this competitive process by calculating whether a particular marketing practice in a particular circumstance produces a net consumer welfare gain or not. It is highly unlikely that a court could empirically estimate these differential effects between marginal and infra-marginal consumers and accurately determine when total consumer welfare was or was not reduced.²⁴⁶

If the criticism is about the practical implementation of weighing the welfare gain of marginal consumers against the welfare loss of infra-marginal consumers, it is certainly valid. Any time welfare analysis in antitrust cannot be settled by qualitative arguments and requires empirical measurements, it ventures into perilous territory. Klein is correct to note that it is probably beyond judicial capability to quantify precisely the welfare gains and losses for the various groups of consumers. However, difficulty in quantification does not mean that we should throw the baby out with the bath water and jettison the consumer welfare standard altogether. It is probably too late in the history of antitrust to question the primacy of consumer welfare as the benchmark for legality. If we cannot measure the welfare effects precisely, we can simplify the comparison with some qualitative proxies.

Infra-marginal consumers who do not require elaborate product demonstration and the provision of detailed product information are likely knowledgeable customers who are already familiar with the product.²⁴⁷ Marginal consumers are likely to be those who are relatively new to the product and possess less familiarity. If there is any reliable way to measure the relative size of the two groups of consumers, then it may be possible to arrive at a rough weighing of welfare effects (which would require the assumption that the welfare loss of individual infra-marginal consumers is commensurate with the welfare gain of individual marginal consumers). If the relative size of these two groups of consumers cannot be reliably

²⁴⁵ Elzinga & Mills I, *supra* note 4, at 1849.

²⁴⁶ Klein, *supra* note 14, at 463.

²⁴⁷ Comanor, *supra* note 215, at 999.

estimated, a further approximation can be made by hypothesizing that a new product is likely to have a much larger group of novice consumers as opposed to knowledgeable consumers. This is especially true if the product is the first one to emerge in its category. In this way, overall welfare loss as a result of RPM is less likely for new products than for long-established products.

If, however, the criticism is that because implementing an RPM is qualitatively similar to engaging in product advertising or improving product quality, the fact that antitrust does not regulate the latter means that it should not meddle with the former; one only needs to be reminded that antitrust has always drawn a sharp distinction between multiparty and unilateral conduct.²⁴⁸ There are many business practices that are beyond the purview of antitrust when engaged in unilaterally, but would be subject to antitrust scrutiny when pursued in concert. Conduct as simple as raising the price of one's product is one example. Antitrust never questions a single firm's prerogative to raise the price of its own product.²⁴⁹ When firms agree to do so together, however, it becomes highly problematic. Another, and perhaps more apt, example is an increase in market share achieved by organic growth as opposed to through a merger. An increase in market share by organic growth is per se legal, while mergers are subject to review by regulatory agencies. Thus if a manufacturer undertakes promotion or product enhancement on its own, it is rightly immune from antitrust scrutiny. However, when a manufacturer must enlist its retailers to achieve the desired product promotion, it should be subject to the full force of antitrust laws.

B. Justifications Premised on Other Kinds of Retail Services

There are a host of other justifications for RPM that similarly rely on the premise that RPM is needed to secure retail services of various kinds. Some of them concern product-specific retail services, while others involve general retail services. Some of them are variations of the free riding defense, while others expressly reject free riding as a required element. The analysis below shows that most of these justifications are premised on assumptions that are hard to defend once one explicitly incorporates multi-brand retailers in the analysis or adopts the two alternative models of consumer behavior. Others suffer from infirmities of their own. The conclusion is that none of these justifications holds up under scrutiny. Together with the rejection of the free

²⁴⁸ HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE § 4.1 (4th ed. 2011).

²⁴⁹ See *Texaco Inc. v. Dagher*, 547 U.S. 1 (2006).

riding defense under the inter-retailer primacy model and the impulse purchase model, and the dramatic limitation of the defense under the inter-brand primacy model, the pro-competitive justifications for RPM, at least those based on horizontal promotional externality, are cast in serious doubt.

1. *Quality Certification*

Marvel and McCafferty propose an alternative explanation for RPM to the free riding defense. As opposed to the prevention of free riding, which requires retailers to provide tangible services, they argue that RPM is useful in inducing retailers that serve as quality certifiers in the eyes of consumers to carry a product.²⁵⁰ These quality-certifying retailers:

[S]erve as their customers' agents, selecting from a wide variety of available merchandise those items [that are] most likely to appeal to their clientele. By stocking a particular product on its shelves, the retailer attests that the quality and suitability of the item in question are consonant with the retailer's overall reputation.²⁵¹

This explanation is only valid when the retailer's reputation is greater than the reputation of the product brand.²⁵² This could often be the case in the grocery market, where consumers are likely to be more familiar with the retailer, such as Whole Foods or Wal-Mart, than the brand name of a particular food item. It is less likely to be the case with well-known fashion brands such as Louis Vuitton and Chanel, which will not require quality certification, even by retailers as exclusive as Neiman Marcus and Bergdorf Goodman. Marvel and McCafferty themselves concede that this explanation is likely to be particularly relevant to a new entrant.²⁵³

The question is what the greater retail profit margin actually covers. There are three possibilities. The first is actual product examination costs, which include the time and human resources needed to examine the products. This may be true for some products, such as food items, but may be less true for products whose quality can be readily observed. The second is the costs needed to maintain a better ambience or provide higher quality customer

²⁵⁰ Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346, 347 (1984) [hereinafter Marvel & McCafferty II].

²⁵¹ *Id.* at 348.

²⁵² *Id.*

²⁵³ *Id.* at 349.

service to maintain the quality image.²⁵⁴ The enhanced profit margin is needed to provide the general retail services necessary to maintain the exclusive image of a quality-certifying retailer. In these two instances, RPM is necessary because consumers will otherwise observe the product at a quality-certifying retailer, but proceed to purchase it at a cheaper retailer that does not sustain the various costs of quality certification. The third is that the additional retail margin does not cover any extra costs at all. The higher retail price is necessary only because consumers rightly or wrongly perceive expensive products to be of higher quality. There is, in fact, no certification of quality at all. The high price itself contributes to the quality image. In this case, RPM is needed directly to protect the quality image.

Scherer is among the most vocal critics of the quality certification justification. He raises three main criticisms. First, he argues that if consumers were unable to discern the quality of a product, they would be unable to know that products carried by a particular retailer are of high quality.²⁵⁵ Second, Scherer doubts that a higher retail margin is necessary for the quality-certifying retailer to recoup its costs. If the retailer is the first to sell the product, it will enjoy first-mover advantage and will be the only retailer of the product for some time.²⁵⁶ Finally, Scherer's more fundamental criticism of the justification is that quality certification amounts to a "status phenomenon," which is to say that consumers judge the quality of a product by the price level.²⁵⁷ This means that, "the utility of diverse consumers is interdependent. And when the utility of consumers is interdependent, the whole foundation of welfare economics—that is to say, the branch of economics on which many of these judgments have been based—crumbles."²⁵⁸

Other commentators have also criticized this justification. Klein and Murphy mostly question the justification on empirical grounds. They argue that Marvel and McCafferty's prediction that new products are more likely to benefit from RPM does not comport with empirical evidence, which suggests that it is usually well-established brands that employ RPM.²⁵⁹ Klein further notes that "[m]any, if not most, cases of resale price maintenance involve

²⁵⁴ Terry Calvani & Andrew G. Berg, *Resale Price Maintenance after Monsanto: A Doctrine Still at War with Itself*, 1984 DUKE L.J. 1163, 1186–87 (1984).

²⁵⁵ Scherer, *supra* note 225, at 695.

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ *Id.* at 696.

²⁵⁹ Klein & Murphy, *supra* note 47, at 289.

products that already have well-established brand names,” for which quality certification is unlikely to be a pertinent issue.²⁶⁰

2. Ensuring an Efficient Number of Outlets

Another justification for RPM is that it can be used to induce retailers to open outlets in remote locations that will attract customers with high time costs.²⁶¹ Klein argues that wide retailer distribution will increase the probability of impulse purchases.²⁶² The idea is that retailers need a higher margin to cover the costs of opening new outlets in remote locations, which would capture customers who otherwise would not have purchased the product.²⁶³ Klein articulates the logic of this defense best: “[b]y creating and protecting an increased retailer margin the manufacturer supports a larger number of retail outlets, which, through the resulting greater quantity of point-of-sale product display and other retailer promotional efforts, increases the demand for the manufacturer’s products.”²⁶⁴ Using RPM for this purpose entails a trade-off. On the one hand, a supplier would lose some sales from the higher retail price resulting from the RPM.²⁶⁵ On the other hand, the supplier would gain sales from the improved availability of its product to a wider group of consumers.²⁶⁶ Whether it is worthwhile to use RPM to induce the opening of more outlets comes down to whether the latter effect outweighs the former effect.

Three conditions are required for this use of RPM to be justified. First, the retailers’ role must be to reduce the consumers’ time costs in obtaining the product.²⁶⁷ The product must be the same no matter where it is bought. Second, retailers must be differentiated by their location.²⁶⁸ Third, consumers must have different opportunity costs of time.²⁶⁹ Some consumers have very high search costs and would only purchase the product from a nearby store. Other consumers have low search costs and will travel long distances to

²⁶⁰ Klein, *supra* note 14, at 434.

²⁶¹ See J.R. Gould & L.E. Preston, *Resale Price Maintenance and Retail Outlets*, 32 *ECONOMICA* 302 (1965).

²⁶² Klein, *supra* note 14, at 450.

²⁶³ Ittai Paldor, *RPM as an Exclusionary Practice*, 55 *ANTITRUST BULL.* 309, 312–13 (2010).

²⁶⁴ Klein, *supra* note 14, at 450.

²⁶⁵ Calvani & Berg, *supra* note 254, at 1183; Mathewson & Winter I, *supra* note 4, at 67.

²⁶⁶ Calvani & Berg, *supra* note 254, at 1183; Mathewson & Winter I, *supra* note 4, at 67.

²⁶⁷ Ralph A. Winter, *Vertical Control and Price Versus Nonprice Competition*, 108 *Q.J. ECON.* 61, 62 (1993).

²⁶⁸ *Id.*

²⁶⁹ *Id.*

purchase a product. Consumers with low search costs are likely to be more price sensitive, as they are willing to travel longer distances to save money. Therefore, when an RPM is introduced, the trade-off is a balance between the number of new, high-search-cost consumers attracted by the new outlets and the number of low-search-cost customers lost due to the higher retail price.

Winter argues that consumers with low search costs, which tend to have lower demand for improved accessibility, tend to be overrepresented in the retailer's calculus.²⁷⁰ Thus, when retailers try to accommodate the consumers' average preferences, they tend to focus on the low search cost customers who value low price and require low level of services. Retailers tend to inadequately improve accessibility and underprice their products.²⁷¹ Winter posits that this explanation for RPM should be most relevant for small-ticket items such as clothing, grocery, and drugs.²⁷² He also predicts that RPM should be most common "in markets or geographical areas in which the dispersion in income among consumers is the greatest. These markets, one can reasonably assume, have the greatest variation in opportunity costs of time."²⁷³

3. Facilitation of Contract Enforcement

Klein and Murphy propose yet another alternative justification for RPM. They argue that RPM is used not to avoid free riding of sales services, but rather "to optimally compensate dealers on a per unit of sales basis for an increased supply of product promotion services and to prevent price competition that would eliminate the desired targeted marketing scheme."²⁷⁴ They summarize their idea as follows:

The manufacturer accomplishes this by creating an implicit contractual understanding with the dealer whereby the dealer agrees to provide the desired level of promotional services in exchange for a payment from the manufacturer. The contract is implicit because measurement problems prevent the manufacturer and dealer from contracting on the services directly. The payment may be made by the manufacturer with the use of vertical restraints such as an exclusive

²⁷⁰ *Id.* at 63.

²⁷¹ *Id.* at 62–63.

²⁷² *Id.* at 70.

²⁷³ *Id.* at 71.

²⁷⁴ Klein & Murphy, *supra* note 47, at 267.

territory or resale price maintenance arrangement, In any event, the manufacturer must always monitor dealer performance and terminate dealers who violate the implicit contractual understanding regarding the supply of promotional services.²⁷⁵

A manufacturer's RPM policy would serve as a contract enforcement mechanism to procure from retailers' non-contractible retail services, which will boost the demand for the manufacturer's product. The RPM scheme creates quasi rent, which entices dealers to provide the desired services.²⁷⁶ Without the RPM scheme, the quasi rent will be eroded by retail competition.²⁷⁷ The manufacturer uses the quasi rent stream as leverage over the dealers, which replaces contractual enforcement through the courts.²⁷⁸ RPM saves the manufacturer time and effort that would have otherwise been spent writing a contract that exhaustively specifies the services required, often along dimensions that are difficult to articulate and measure.²⁷⁹ If a dealer fails to perform the desired services, the dealer's quasi rent stream will be terminated.²⁸⁰ Klein and Murphy argue that the quasi rent stream need not represent a greater than normal return to the dealers.²⁸¹ In the presence of manufacturer-specific investments, termination of a dealer would inflict sufficient pain on the dealer even if it were only earning normal profits.²⁸² However, Klein and Murphy note that for RPM to serve its intended purpose, the quasi rent created by it must exceed a dealer's short-run shirking potential, which is what a dealer could hope to earn in the short run by not providing the requested services.²⁸³

Paldor criticizes this justification for RPM as inadequate in that it will likely induce an insufficient level of service.²⁸⁴ Dealers are generally compensated on a per-unit basis when using RPM to provide remuneration for retail services.²⁸⁵ Per-unit compensation is likely to under-compensate the

²⁷⁵ *Id.* at 285.

²⁷⁶ *Id.* at 268.

²⁷⁷ Mathewson & Winter I, *supra* note 4, at 74.

²⁷⁸ Klein & Murphy, *supra* note 47, at 268.

²⁷⁹ Elzinga & Mills I, *supra* note 4, at 1844.

²⁸⁰ Kenneth G. Elzinga & David E. Mills, Leegin *and Procompetitive Resale Price Maintenance*, 55 ANTITRUST BULL. 349, 358 (2010) [hereinafter Elzinga & Mills II].

²⁸¹ Klein & Murphy, *supra* note 47, at 268.

²⁸² *Id.*

²⁸³ *Id.* at 276.

²⁸⁴ Paldor, *supra* note 263, at 331.

²⁸⁵ *Id.*

dealers in light of diminishing returns to retail services and an upward-sloping supply for retail services. Under-compensation means there will be an under-provision of services.²⁸⁶

4. Facilitation of Introduction of New Products

One justification often offered for RPM is that it may induce dealers to carry a new product. The idea is that dealers may need RPM to invest in the initial promotion of the new product. In the absence of RPM, subsequent dealers who did not incur such promotional expenses would be able to undercut the initial dealers and prevent the latter from recouping their investments.²⁸⁷ Foreseeing this scenario, no dealers would agree to make the initial investments unless their future retail margins are protected by RPM. While this justification is cloaked in the garb of introduction of new products, it should be obvious that it amounts to nothing more than using RPM to secure product-specific retail services, albeit in the specific context of new products. The kind of special product promotion that is required under this justification falls within product-specific retail services.

This is one justification for RPM accepted by both the majority and the dissent in the Supreme Court case, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*²⁸⁸ In his dissent, Justice Breyer suggested the possibility of creating an exception for new products employing RPM.²⁸⁹ Despite the broad support this justification received in *Leegin*, it has been subject to a number of criticisms. It has been argued that vertical non-price restraints such as exclusive territories would be better suited for the purpose of new product introduction than RPM.²⁹⁰ Furthermore, to the extent that the manufacturer itself can undertake the initial promotion, this justification for RPM becomes questionable. There is reason to believe that the manufacturer can undertake much of the initial promotion itself.

5. Analysis

In order to evaluate these justifications, it is important to classify the type of retail service that is invoked in each defense. This is because, as mentioned earlier, different kinds of retail service have different degrees of inter-brand

²⁸⁶ *Id.*

²⁸⁷ Jacobs, *supra* note 217, at 17.

²⁸⁸ *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 891 (2007).

²⁸⁹ *Id.* at 912 (Breyer, J., dissenting).

²⁹⁰ *See* Jacobs, *supra* note 217, at 17.

spillover effects. While product-specific retail services offered for one brand are unlikely to directly benefit other brands, general retail services will benefit all brands sold in the store even though these services may be paid for by the retail margin of one brand.

Three of the four defenses can be quite easily classified. The number of outlets pertains to the location or accessibility of a retailer to consumers, which obviously falls under the rubric of general retail services. As mentioned earlier, the introduction of a new product is concerned with product-specific promotional services. Although Klein and Murphy do not specify to which type of retail service their defense pertains, it is obvious that what they have in mind is product-specific retail services. Their defense applies to non-contractible retail services that will boost the demand for the manufacturer's product.²⁹¹ It is unlikely that a manufacturer will contract for the retailer to provide longer operating hours, better ambience, or more amenities to boost the demand for its product. This is confirmed by the example Klein and Murphy give to illustrate their argument with regard to the refrigeration and product rotation required for Coors beer.²⁹²

Quality certification presents a more difficult case for classification.²⁹³ Quality certification refers to the service provided by a high-quality retailer to certify the quality of a product before agreeing to carry it in the store. If the service entails an actual examination of individual products and assessment of their quality by the retailer's staff, then it would seem to be a product-specific service. However, if quality certification merely refers to the retailer's decision to stock a particular product, then the classification becomes more complicated. On the one hand, what is being provided by the retailer to the customers is its general reputation and exclusive image, which would seem to mean that it belongs to general retail services. A retailer's general reputation and exclusive image need to be maintained by high quality general retail services. On the other hand, the decision to stock a product amounts to the provision of shelf space to a manufacturer, which means that it should be more appropriately considered as a product-specific service.

Marvel and McCafferty were not entirely clear on the nature of the quality certification process. They state that the retailers "serve as their customers' agents, selecting from a wide variety of available merchandise those items most likely to appeal to their clientele."²⁹⁴ The key then would be what the

²⁹¹ Klein & Murphy, *supra* note 47, at 280–82.

²⁹² *Id.*

²⁹³ Marvel & McCafferty, *supra* note 250, at 347–49.

²⁹⁴ *Id.* at 348.

selection process entails. They proceed to offer conflicting explanations by first noting that their theory obviates the “need to establish tangible services that RPM is designed to protect” while remarking that what is required of the retailers is “an investigation of whether the product in question is of a quality level consonant with the retailer’s reputation.”²⁹⁵ This suggests that a tangible service is being offered. However, subsequent commentators seem to have understood Marvel and McCafferty’s defense as consisting of nothing more than a retailer’s decision to carry the product.²⁹⁶ Regardless of the classification of quality certification based on the nature of the service, what is important for the purpose of this Article is that quality certification has inter-brand spillover effects and is susceptible to free riding. What is being offered by the retailer in quality certification is its general reputation and exclusive image, which cannot be selectively withheld. Similarly, a brand can free ride on the contributions made by other brands to the retailer’s effort to maintain its reputation and image. From the perspective of spillover effects, quality certification is akin to general retail services.

Two main streams of arguments that have been presented in this Article bear on the validity of these justifications. The first one is that in the context of a multi-brand retailer, general retail services are susceptible to inter-brand spillover effect and therefore may give rise to inter-brand free riding. Meanwhile, whether product-specific retail services create an inter-retailer spillover effect depends on which consumer behavior model prevails. Under the inter-brand primacy model, there will be inter-retailer spillover effects, at least for certain retail services. Under the inter-retailer primacy model and the impulse purchase model, the lack of inter-retailer competition at the product stage means that inter-retailer spillover effect will be minimal. The second stream of argument is that in a multi-brand retailer, general retail services tend to create an inter-retailer substitution effect whereas product-specific retail services tend to bring about an intra-retailer inter-brand substitution effect. This is especially true in the context of the inter-retailer primacy model. This means that there will be minimal inter-retailer free riding of product-specific retail services.

As general retail services, quality certification and store locations would be susceptible to inter-brand spillover effects and therefore free riding by other brands. In the context of store locations, there is a huge discrepancy

²⁹⁵ *Id.* at 349.

²⁹⁶ Calvani & Berg, *supra* note 254, at 1186–87; Elzinga & Mills I, *supra* note 4, at 1843; Gregory T. Gundlach et al., *Free Riding and Resale Price Maintenance: Insights from Marketing Research and Practice*, 55 ANTITRUST BULL. 381, 386 (2010).

between the extra retail margins generated by RPM for small-ticket items such as groceries and drugs and the enormous costs required to open a new outlet. Given that most supermarkets and drugstores carry hundreds, if not thousands, of brands, a higher retail margin on one brand will have negligible impact on the overall profitability of the store, let alone generate enough revenue to open a new store. The discrepancy may be a little smaller in the context of quality certification, where the costs involved will be smaller than those of opening a new store, and the margins generated by the luxury products that may benefit from this justification should be greater than those from small grocery products or drugs. Nonetheless, it remains true that the retail margin from one brand is unlikely to be sufficient to fund the expenses needed to maintain the exclusive image of the retailer. Therefore, for these two justifications to hold, a majority of brands sold must simultaneously practice RPM.

Even if there is a good faith effort on the part of the brands to cooperate, the coordination problem will be significant. Each brand will set different retail margins under their respective RPM schemes, subject to their own market position and the competitive landscape of their markets. There is no guarantee that the retail margins set independently by the different brands will altogether be sufficient to support the general retail services at issue. If they were to engage in explicit negotiation to allocate the burden, the allocation would be fraught with difficulty as there is no obvious basis upon which such allocation can be done. It is possible to do so on the basis of the particular brand's sales at a retailer. However, the obvious problem is that sales fluctuate all the time, and it would be completely impractical to adjust the allocation every time relative sales change.

There is the further complication that RPM is set on an industry-wide basis. The prices are not set specifically for each retailer. Therefore, the brands will need to arrive at a retail price that allows it to make a fair contribution to the provision of general retail services at every retailer where its product is sold. To do that, the brands will need to know how much it costs for a retailer to provide the general retail service at issue. Given that it is general retail services, which generate inter-retailer substitution effect, that are at stake, the retailers will have every incentive to try to obtain a greater share of the pie for themselves. There may be a race among the retailers to inflate the figures, which would be difficult for the manufacturers to verify. With all these complications, this would be a monumentally difficult exercise.

Add to this the fact that sales fluctuate, the task facing each manufacturer is close to impossible. Plus it is not only brand sales that fluctuate constantly. A retailer's plans regarding general retail services may also change over time.

Obviously, a retailer will not be constantly opening new store locations. Therefore, a retailer's need for general retail services is not constant, which will introduce yet further complications and require more adjustments in the retail prices. Such adjustments are also highly undesirable from the manufacturer's perspective. A manufacturer may need to adjust the retail price at one retailer simply because its relative sales at another retailer or another retailer's plans for retail services have changed. The need for constant adjustment is highly unsatisfactory as manufacturers generally like to avoid frequent changes in prices.²⁹⁷ In short, it is highly unlikely that brands can resolve all these difficulties and share the expenses among themselves for general retail services across all retailers.

Even if there was a good faith effort to come to an agreement in the first place, the temptation of free riding over time would be overwhelming. If each brand accounts for a negligible proportion of the overall profit of the retailer, which is likely the case in most instances, it will have strong incentives to cheat and free ride on the retail margins generated by other brands. In that case, one brand defecting presumably will not cause the entire scheme to unravel. Given the multitude of brands involved, it will be extremely costly to police against free riding. If the incentive to cheat is so high and detection is so difficult, more and more brands will jump on the cheating bandwagon. With all these practically insurmountable difficulties, one may argue that these two justifications premised on general retail services verge on the unrealistic.

The two justifications premised on product-specific retail services suffer from their own inherent problems. Klein and Murphy's special retail service defense does not suffer from the infirmities of the free riding defense because the special services at issue in their defense cannot be consumed separately from the product. There is, therefore, no possibility of free riding. Their defense is thus immune from the critique that horizontal promotional externalities and the possibility of free riding are negligible under the inter-retailer primacy model and the impulse purchase model. Further, as a product-specific retail service, it does not suffer from the inter-brand spillover effect of general retail services. The main problem for their defense is that it only applies to a very narrow subset of retail services. As mentioned earlier, product display is one of the retail services that cannot be realistically consumed separately from the product. The problem with applying the defense to product display is that product display can be easily compensated

²⁹⁷ Pinelopi Goldberg & Rebecca Hellerstein, *Sticky Prices: Why Firms Hesitate to Adjust the Price of Their Goods*, 13 CURRENT ISSUES IN ECON. & FIN. 10, Nov. 2007, at 1, 1.

by way of slotting fees. One of the assumptions of their defense is that the service at issue must have serious enforcement problems if obtained through a contract. Product display is not one of them. They provide the example of special handling and refrigeration of beer.²⁹⁸ Apart from this example, it is not easy to come up with other examples to which this defense applies.

Introduction of a new product is simply a variation of the free riding defense. It is, therefore, subject to the same criticisms of the free riding defense enumerated above. If most of the services at issue are general product promotion, it is unclear why the manufacturer cannot provide the promotion itself or obtain the service from the retailer contractually. Similarly, there is no guarantee that the retailers will use the enhanced retail margins to provide the service desired by the manufacturers. The retailers will be very tempted to use the margins to provide general retail services instead. Lastly, it is essentially only applicable under the inter-brand primacy model because free riding is negligible under the inter-retailer primacy model and the impulse purchase model.

One other possibility is to look at the defense from the perspective of the vertical promotional externality. The reason for the under-provision of the retail services is not inter-retailer free riding. Rather, the reason is that the retailers benefit less from the increase in sales of the new brand compared to the new entrant. This is especially likely to be the case because increase in sales will be particularly valuable to a new entrant as it allows the manufacturer to take advantage of economies of scale. However, explaining this defense from the perspective of the vertical promotional externality suffers from its own problems, which will be explained in detail below. Suffice it to note for now that this reconceptualization of the defense is only valid if the service at issue is what Klein calls brand-specific salesperson promotional efforts. The discussion below will explain that using RPM to pay for such efforts ultimately amounts to nothing more than a bribe for retailers to steer consumers to the brand. Consumers enjoy no benefit from the RPM arrangement. The only justification for allowing a new brand manufacturer to do so is that antitrust should give a new entrant greater leeway to establish itself because market entry enhances competition. This may be a valid justification if it can be shown that the new entrant needs to resort to RPM to succeed in entering the market. Once the brand is established, however, the justification disappears.

²⁹⁸ See Klein & Murphy, *supra* note 47, at 280–82.

C. RPM in the Absence of Free Riding: Using RPM to Combat The Vertical Promotional Externality

In light of the well known deficiencies of the free riding defense for RPM, Klein proposes an explanation for RPM that does not require free riding of retail services. According to Klein, the main reason that retailers provide an insufficient amount of retail services is not because of the horizontal promotional externality, but because of the vertical promotional externality.²⁹⁹ There are two main reasons that retailers will suffer from insufficient incentives. First, as discussed earlier, in the context of multi-brand retailers, product-specific retail services mainly generate intra-retailer inter-brand substitution effects and create little inter-retailer substitution effects.³⁰⁰ Retailers' overall sales across all brands do not increase as a result of the provision of product-specific retail services. Inter-brand substitution effect means that product-specific retail services mainly benefit the manufacturers. This is especially true under the inter-retailer primacy model and the impulse purchase model. Second, Klein argues that the manufacturer's margin on each product is likely to exceed the retail margin of the retailers.³⁰¹ He attributes this to the fact that "manufacturers often produce goods that are more highly differentiated than retailing services."³⁰² Retailers, therefore, face a more elastic demand curve than do manufacturers.³⁰³ This is the very reason for the vertical promotional externality. If a retail service mainly generates inter-retailer substitution effects, the retailer need not have lower incentives than the manufacturer to provide the service as the increase in sales offsets the lower margin.³⁰⁴ However, if the retail service mainly generates intra-retailer inter-brand substitution effects, the lack of increased sales for the retailer plus lower retail margin will leave the retailer with much lower incentives to provide the service.³⁰⁵ This means that while there will be no incentive incompatibility for general retail services, the problem will exist for product-specific retail services. In fact, to the extent that the provision of retail service largely creates an intra-brand inter-retailer substitution effect, the manufacturer may

²⁹⁹ See Klein, *supra* note 14.

³⁰⁰ *Id.* at 443–44.

³⁰¹ *Id.* at 446.

³⁰² *Id.*

³⁰³ *Id.*

³⁰⁴ *Id.* at 447.

³⁰⁵ *Id.* at 448.

gain little additional sales from the service and may be relatively indifferent to the provision of the service.

Klein enumerates three specific kinds of service that may suffer from vertical promotional externality and may be justified by his theory. These include product display,³⁰⁶ “brand-specific point-of-sale salesperson promotional efforts,”³⁰⁷ and retail location.³⁰⁸ Similar to the free riding defense, in order for Klein’s theory to hold, it must be true that the manufacturer does not have a superior means of compensating the retailers.³⁰⁹ However, unlike in the free riding defense, Klein does not argue that reliance on RPM simplifies the manufacturer’s enforcement efforts. Manufacturers will need to monitor retailers for both the level of service provided and the prices charged.³¹⁰ This is because under his theory, a retailer that cuts the price takes business away from other retailers, which would result in overcompensation of the price-cutting retailer and under-compensation of the remaining retailers.³¹¹ In fact, compensation may drop so low that other retailers will cease to provide the service desired by the manufacturer.³¹²

Klein’s convincing theory sidesteps the many problems besetting the free riding defense because it is not reliant on the elimination of horizontal promotional externality, which, unlike vertical promotional externality, does not exist in all circumstances. However, his theory suffers from other problems, some of which are elucidated by the previous discussion of the inter-brand spillover effect of general retail services. There are two main premises in Klein’s theory. The first is that intra-retailer inter-brand substitution effect means that retailers will have fewer incentives than manufacturers to provide retail services. The second is that the fact that the manufacturer margin generally outweighs the retail margin exacerbates the incentive incompatibility problem created by the intra-retailer inter-brand substitution effect. While the first one is clearly valid, the second one is questionable. At least, there is no reason to believe it to be universally true. There is ample literature that suggests that today’s multi-brand retailers are often as powerful as, if not more so than, the brands.³¹³ Consumers are loyal to the retailer as opposed to the brand. This is especially true under the inter-

³⁰⁶ *Id.* at 441.

³⁰⁷ *Id.* at 442.

³⁰⁸ *Id.* at 450.

³⁰⁹ *Id.* at 453–57.

³¹⁰ *Id.* at 460.

³¹¹ *Id.*

³¹² *Id.*

³¹³ See LARS THOMASSEN, KEITH LINCOLN & ANTHONY ACONIS, RETAILIZATION: BRAND SURVIVAL IN THE AGE OF RETAILER POWER 1–5 (2006).

retailer primacy model, under which consumers choose a retailer first before choosing a brand. When the retailer is more differentiated than the brand, there is every reason to believe that the retail margin will not be smaller than the manufacturer margin. In fact, there is literature that suggests that the retail margin in many instances is greater than the manufacturer margin.³¹⁴ This means that there most likely will not be incentive incompatibility issues regarding general retail services, and manufacturers are even more likely to be indifferent towards them. As for product-specific retail services, a larger retail margin means that to the extent that product-specific retail services produce some inter-retailer substitution effect, it is possible that the increased sales taken from other retailers may generate incentives that are commensurate with the manufacturers. This is especially the case because the manufacturer's incentive for the services has been reduced in light of its lower margin.

Klein enumerates three kinds of services to which his theory applies.³¹⁵ However, upon closer examination, the only one to which it actually applies is brand-specific salesperson promotional efforts, which are akin to product demonstration for technically complex products. First, for product display, while it is clearly a product-specific service, the problem lies in the suitability of the compensation mechanism. The cost of product display can be accurately measured in terms of time and space. Retailers can be more than adequately compensated for product display with the use of slotting fees. Klein himself concedes as much.³¹⁶ Second, for store location, it is unclear how his theory can apply to it when he himself has suggested that the theory only applies to product-specific services and not general retail services. According to the previous classification of retail services, store location clearly falls under the latter category. Using the retail margin to generate general retail services is clearly inefficient given the inter-brand spillover effect. And, as noted earlier, using the retail margin to secure extra store locations faces insurmountable obstacles, especially in the context of multi-brand retailers. Klein attempts to forestall this argument by equating store locations with product display and other retail services.³¹⁷ He argues that more stores mean more opportunities for product display and other retail

³¹⁴ Rajiv Lal & Chakravarthi Narasimhan, *The Inverse Relationship between Manufacturer and Retailer Margins: A Theory*, 15 *MARKETING SCI.* 132, 134 (1996). See also Patrick D'Arcy, David Norman & Shalini Shan, *Costs and Margins in the Retail Supply Chain*, *RES. BANK OF AUSTRAL. BULL.*, June 2012, at 13, 17.

³¹⁵ See Klein, *supra* note 14, at 437–61.

³¹⁶ *Id.* at 454.

³¹⁷ *Id.* at 450.

services.³¹⁸ However, this argument says nothing more than the fact that every store carries products and has sales staff that provides services. By Klein's logic, extending operating hours can be characterized as a product-specific retail service. Perhaps even the provision of more parking can be so characterized because one may argue that by providing more parking, the store brings in more customers, which increases the opportunity that the product display will be seen and other retail services will be rendered. The dividing line between general and product-specific service is whether the service benefits all brands generally or one specific brand. In the case of store location, it is clear that it benefits all brands. The increase of this service does not render any particular brand more attractive to consumers. Therefore, store location is clearly a general retail service, for which Klein himself admits that his theory has no application.³¹⁹

The remaining category of service is brand-specific salesperson promotional efforts. Here the problem lies in the monitoring problem RPM creates and the possible overcompensation of retailers as a result of price-cutting. Klein argues that using the retail margin to compensate retailers creates "increased independent retailer incentive" to provide the service and therefore reduces the need for monitoring of service level.³²⁰ However, while RPM reduces the need to monitor for service levels, it increases the need to monitor for price levels. If a retailer gains greater sales revenue through price-cutting, it will be overcompensated for the service, while other non-price-cutting retailers will be undercompensated. It is worth pondering in what sense are the retailers over- and under-compensated, or, put differently, how the adequacy of compensation should be determined. It seems that there are two possible benchmarks. One is the cost of provision of service. The other is the value of the service to the manufacturer, which would be measured by the manufacturer margin. It is clear that the retail margin created by RPM does not necessarily bear any relation to either benchmark. And Klein does not suggest that the retail margin should be set to match either of them. Therefore, the retailers cannot be over- and under-compensated in the absolute sense. The only sense in which a price-cutting retailer can be said to be overcompensated is in relative terms. This is to say that one retailer is making more profit than others. While this can be upsetting to some retailers, it should not stop these retailers from continuing to provide retail services so long as their costs are covered. In fact, the

³¹⁸ *Id.*

³¹⁹ *See id.* at 439.

³²⁰ *Id.* at 455.

manufacturer should encourage price-cutting because presumably the retailers would only want to cut price down to the level where their costs of providing the service are just sufficiently covered. Price competition helps to prevent excess compensation for the retailers and encourages them to be more efficient in providing services. Monitoring price levels seems to be superfluous.

The obvious response to this line of argument is that the manufacturer needs to ensure that the price-cutting will not go too far and cause the retailers to abandon the services. The reason is that, as Klein himself concedes,³²¹ the kind of retail service at issue does not produce inter-retailer substitution effects and only creates intra-retailer inter-brand substitution effects. This means that if a retailer ceases to provide the service, the main effect will be a shift of consumers to other brands within the same retailer instead of to other retailers. This is especially true under the inter-retailer primacy model and the impulse purchase model. Price-cutting, therefore, will not increase a retailer's overall sales. So long as the retail margin is sufficient to cover the costs of providing services, the retailers should be indifferent between maintaining a higher price while providing service and cutting price while withholding service. The only circumstance under which retailers would have an incentive to cut price is when there is free riding, which Klein specifically ruled out in the outset.³²²

This leads one to wonder if there are superior compensation mechanisms. It is possible to compensate the retailers directly for the cost of the service provided. If the service at issue is brand-specific salesperson promotional efforts, what exactly do these efforts entail, and what are the costs of providing such a service? There are two possibilities. One is the hiring of dedicated staff to promote a brand, which is what Klein seems to have in mind.³²³ Another is the cost of training existing staff to provide the promotional service. It seems that either of them is susceptible to at-cost compensation. If the service entails hiring dedicated staff, the manufacturer can easily compensate the retailers by paying for the staff wages.³²⁴ If the service entails staff training, the manufacturer can also pay for the training costs. Both appear to be superior alternatives to RPM because the retail margin bears no relation to the costs of providing service. The question is why a manufacturer would choose to compensate retailers via RPM when

³²¹ *Id.* at 461.

³²² *Id.* at 435–36.

³²³ *Id.* at 454.

³²⁴ *Id.* at 454.

such obvious alternatives are available. Klein himself provides the answer. He argues that RPM “creates an increased incentive for retailers to promote the manufacturer’s products.”³²⁵ In other words, RPM allows a manufacturer to intentionally overcompensate retailers to induce the retailers to promote its product. RPM is hence not compensation for the provision of services. It is more of a bribe to retailers. This bribe is particularly relevant under the inter-retailer primacy model because consumers choose among the brands available within one retailer. Once a consumer is inside a store, she is especially susceptible to the retailer’s efforts to steer her to a particular brand. Critics may argue that calling the inflated retail margin a bribe is sensationalizing the issue. If a manufacturer wants to pay a retailer to promote its product, antitrust should not stand in its way. This is just part of normal marketing.

There are a few obvious responses to this argument. First, RPM is different from other marketing practices in that it results in a direct increase in price for consumers. Other kinds of marketing practices, such as advertising, no doubt increase the manufacturer’s costs, but need not result in a direct increase in price. Given this direct price effect, RPM should only be sanctioned if consumers directly benefit from it. If RPM simply compensates retailers for their retail services and consumers genuinely value such services, the use of RPM would be defensible. However, if RPM is merely used to allow a manufacturer to steer customers to its brand, then the consumer deception concerns raised by Grimes become relevant.³²⁶

What makes this worse is that the use of RPM will likely simply lead to an arms race among manufacturers to raise retail margins to enlist the retailers’ assistance. Eventually, the elevated retail margins end up cancelling out each other as each brand is provided with the same brand-specific salesperson promotional efforts. If every brand is doing the same, consumers are likely to be desensitized to these efforts, and none of the brands will experience an increase in sales. Meanwhile, consumers are paying a higher price for all the brands. The manufacturers gain no benefit while retailers are enriched at the expense of consumers.

This point is somewhat similar to the wasteful product differentiation argument raised by Comanor, except that it is even worse.³²⁷ According to Comanor’s argument, at least consumers get what they pay for, even though they do not necessarily value the extra promotion or product information.³²⁸

³²⁵ *Id.*

³²⁶ Grimes II, *supra* note 209, at 110.

³²⁷ Comanor, *supra* note 215, at 999.

³²⁸ *See id.*

In our case, however, consumers do not even get what they pay for, as part of the retail price simply goes into the pocket of the retailers without any commensurate benefit to the consumers. RPM has clearly lost its original purpose of eliminating the vertical promotional externality and serves no economic efficiency purposes. The only consequence of RPM is the enrichment of the retailers.

V. REEXAMINATION OF THE THEORIES OF HARM OF RPM

Focusing on the pro-competitive uses of RPM to tackle externalities, as many defenders of RPM have urged us to do, risks neglecting the many instances in which RPM could be anticompetitive. RPM raises the retail price of a product, which would usually reduce the quantity demanded of the product. If other parameters of profitability remain the same, the manufacturer would lose profit. Only when RPM somehow has a positive effect on other parameters of profitability, such as unit sales, costs of production, or wholesale price would a rational manufacturer impose RPM.³²⁹ Addressing the various kinds of externalities may help to boost unit sales. And an increase in output may create economies of scale, which will help to bring per unit cost of production down. Consumers benefit when RPM improves a manufacturer's profitability by increasing unit sales and reducing the cost of production.³³⁰ Consumers are harmed, however, when RPM allows a manufacturer to raise the wholesale price.³³¹

Contrary to the conventional wisdom on RPM, this happens not only when manufacturers are using RPM to facilitate an upstream cartel, but it may also arise absent a cartel arrangement. RPM helps to soften downstream competition among retailers, which in turn allows the manufacturers to raise wholesale prices or otherwise raise their profit margin.³³² This is especially the case when manufacturers sell through common multi-brand retailers, which create common agency or interlocking relationships among the manufacturers. The discussion so far only focuses on instances of RPM voluntarily implemented by a rational manufacturer. It ignores the possibility that the retailers are the ones who pushed for RPM at the expense of the manufacturers. It is a well-known fact that RPM may be initiated by retailers

³²⁹ ORG. ECON. COOPERATION & DEV., POLICY ROUNDTABLES: VERTICAL RESTRAINTS FOR ON-LINE SALES 174 (2013).

³³⁰ *Id.*

³³¹ *Id.*

³³² Patrick Rey & Thibaud Vergé, *Resale Price Maintenance and Interlocking Relationships*, 58 J. INDUS. ECON. 928, 930 (2010) [hereinafter Rey & Vergé II].

in order to forestall competition by innovative, lower-cost rivals, or to facilitate a cartel arrangement among themselves. The U.S. Supreme Court acknowledged both possibilities in *Leegin*.³³³

The theories of harm for RPM can be categorized under two headings, those involving cartels or coordinated action, either at the manufacturer or the retailer level, and those involving a powerful manufacturer or retailer exercising market power. In the first category, the two most prominent theories of harm are the facilitation of a manufacturer cartel and the facilitation of a dealer cartel. In the second category, RPM may harm competition when a powerful dealer uses it to foreclose innovation in distribution and when a powerful supplier uses it to foreclose rivals' access to effective distribution channels. All these theories are premised on the inter-brand primacy model. As it turns out, they take on a slightly different character under alternative models of consumer behavior. Some of them, such as the cartel facilitation theories, become less relevant while others, such as the retailer foreclosure theory, have greater applicability or assume a higher degree of urgency. The prevalence of multi-brand retailers also opens the possibility of price coordination among manufacturers short of outright collusion.

A. Facilitation of Manufacturer Cartels

Telser first articulated the possibility that RPM could be used to facilitate a supplier or manufacturer cartel.³³⁴ More recently, Jullien and Rey explain the function played by RPM in a supplier cartel as follows:

The basic idea is that, because manufacturers can more readily observe rivals' retail prices than rivals' wholesale prices, RPM helps manufacturers to detect deviations from a collusive agreement. Whenever manufacturers cannot perfectly infer wholesale prices from retail prices, they may find it more effective to collude directly on retail prices through RPM. . . . Under RPM, retail prices are centrally set by the manufacturer and thus do not fully adjust to these local shocks on the retail environment. As a result, retail prices are more uniform under RPM and deviations from an

³³³ *Leegin Creative Leather Prods, Inc. v. PSKS, Inc.*, 551 U.S. 877, 893 (2007).

³³⁴ Telser, *supra* note 6, at 96–99.

agreement are thus easier to detect, which facilitates collusion.³³⁵

RPM also reduces the incentive to cheat in a manufacturer cartel. Secret discounts to retailers become less profitable because the retailers cannot pass on the discounts to increase sales.³³⁶ Offering secret discounts to retailers will only lower the manufacturer's revenue.

Apart from simplifying detection, price uniformity helps to stabilize cartels in another way. In the absence of intra-brand uniformity of prices across retailers, cartel members cannot stabilize each other's market shares solely by controlling their wholesale prices. Their ultimate market shares depend on both their own wholesale prices and the retail prices set by the retailers, which may vary. One manufacturer's product not only competes with other brands within the same store, but also with other brands in other retailers. There is, therefore, greater uncertainty in the manufacturers' market shares when there are intra-brand price variations among retailers. But when prices are uniform across all retailers under RPM, this uncertainty is removed and their manufacturers will have greater ability to predict their respective market shares based on their fixed retail prices.

According to Jullien and Rey, fixed resale prices are not without costs. The price rigidity resulting from RPM would prevent prices from adjusting to local shocks.³³⁷ Ironically, RPM may undermine collusion because suppliers may take advantage of retailers' local information and deviate from the colluders' agreed-upon price.³³⁸ Therefore, the supplier faces a trade-off when deciding whether to employ RPM to facilitate the detection of collusion: flexible prices may reap a higher profit and stabilize collusion, but those flexible prices also make it more difficult to detect defections.³³⁹ Fixed prices remove the ability of manufacturers to respond to local cost changes or demand shocks, meanwhile fixed prices facilitate supplier cartels by rendering detection easier.³⁴⁰ RPM would not be worthwhile if the monopoly price level were sustainable without it.³⁴¹ Additionally, RPM would be difficult to sustain financially if local shocks were very important.³⁴²

³³⁵ Bruno Jullien & Patrick Rey, *Resale Price Maintenance and Collusion*, 38 RAND J. ECON. 983, 985 (2007).

³³⁶ Elzinga & Mills II, *supra* note 280, at 359.

³³⁷ Jullien & Rey, *supra* note 335, at 989.

³³⁸ *Id.* at 985.

³³⁹ *Id.* at 989.

³⁴⁰ Mathewson & Winter I, *supra* note 4, at 65.

³⁴¹ Jullien & Rey, *supra* note 335, at 992. This may be possible already with two-part tariffs.

³⁴² *Id.*

Facilitation of supplier cartels is obviously harmful to competition. Jullien and Rey show in their model that RPM is likely to be detrimental to consumer welfare as average prices will increase substantially.³⁴³ RPM is particularly harmful when local shocks are mostly cost shocks as opposed to demand shocks.³⁴⁴ In that case, retail prices will increase and become unresponsive to local cost fluctuations.³⁴⁵

RPM facilitates manufacturer cartels by making deviations from RPM easier to detect, removing incentives to cheat, and stabilizing market shares. While these effects still hold under the inter-retailer primacy model, they become less relevant. First, price uniformity across retailers becomes less important in the context of the inter-retailer primacy model because inter-brand price competition largely takes place in an intra-retailer context. Therefore, the manufacturers should principally be concerned about intra-retailer inter-brand competition. This is not to deny that price uniformity still facilitates detection—it does. However, price uniformity means manufacturer cartels will be largely protected from price variations among different retailers, which may render detection more difficult by concealing cheating by a manufacturer. This is so because it is difficult for rivals to tell whether a decrease in retail price is either due to a cut in the wholesale price by a defecting cartel member or due to local adjustments by retailers. This would remain a relevant consideration even under the inter-retailer primacy model.

Second, if consumers were less prone to making intra-brand price comparisons across retailers, as is the case under the inter-retailer primacy model and the impulse purchase model, the lack of inter-retailer price uniformity would have much less destabilizing effects on manufacturer cartels. Overall market shares of the cartel members would be largely determined by the relative prices of their products within the same retailer, thus it could be argued that the cartel members need not set market-wide prices. In order for the cartel to work, they only need to stabilize their intra-retailer price differentials. This is even more true in the case of the impulse purchase model, under which there is essentially no inter-retailer competition. The destabilizing impact of price variance becomes irrelevant as one manufacturer's product no longer competes with other brands in various retailers.

³⁴³ *Id.* at 985.

³⁴⁴ Jullien and Rey assert that “[i]t is well known that consumers and society as a whole prefer retail prices that adjust to cost shocks but not to demand shocks.” *Id.* at 995.

³⁴⁵ *Id.*

Third, and perhaps more significantly, given that most inter-brand competition takes place at the intra-retailer level under the inter-retailer primacy model, and that there is essentially no inter-retailer competition under the impulse purchase model, consumers should become particularly responsive to product-specific retail services once they are inside a store. A manufacturer would particularly benefit from a retailer “pushing” its product within its brick-and-mortar location since most of these services are provided by the retailers. To the extent that consumers are especially service elastic under the inter-retailer primacy model, manufacturers may have a strong incentive to reduce wholesale price to cheat in a cartel. Even though the manufacturer will not benefit from an increase in demand due to a retail price reduction, it will benefit from an increase in demand due to a rise in product-specific services provided by the retailers. The manufacturer cheats by reducing the wholesale price and hence creating a larger retail margin that serves as a “bribe” to induce retailers to push the manufacturer’s product.³⁴⁶ As Grimes notes, this incentive to bribe retailers “is most relevant to vertical restraints imposed by manufacturers on multi-brand retailers, especially when that retailer is selling products that are typically sold with sales advice, such as complex or image products.”³⁴⁷ Such an incentive is likely less relevant to single-brand retailers.³⁴⁸ In other words, the facilitative effect of RPM for manufacturer cartels will be more attenuated as cartel members retain strong incentives to cheat in the presence of RPM—there will be fewer reasons to worry about industry-wide use of RPM to facilitate manufacturer cartels. All of the foregoing discussion points to a smaller role for RPM in facilitating manufacturer cartels under both the inter-retailer primacy and the impulse purchase model.

B. Facilitation of Dealer Cartels

RPM can be used to facilitate dealer cartels, whereby the dealers effectively use the supplier as an enforcer of the cartel.³⁴⁹ Termination by the supplier will become the punitive mechanism for policing the cartel, which is probably one of the most effective enforcement mechanisms. The dealers agree on a retail price among themselves and ask the supplier to impose the agreed upon price as the minimum resale price on the dealers.

³⁴⁶ Grimes III, *supra* note 215, at 107–109.

³⁴⁷ *Id.* at 107–108.

³⁴⁸ *Id.*

³⁴⁹ Elzinga & Mills II, *supra* note 280, at 359.

The obvious question to ask is why a supplier would agree to facilitate a dealer cartel—a supplier has nothing to gain from acquiescing to it.³⁵⁰ Many commentators agree that for this theory of harm to be plausible, the supplier must have an adequate incentive.³⁵¹ For the dealers to be able to cajole the supplier into cooperating, they must collectively wield market power. Baxter posits that this theory of harm would only apply if there were limited distributors and substantial obstacles to hinder suppliers from introducing new distribution outlets.³⁵² Mathewson and Winter argue that one of the conditions for the dealer cartel theory is that the dealers must have made substantial investments in traditional, low-volume outlets, which are then threatened by the entry of discount outlets.³⁵³ The traditional retailers would then use a supplier-facilitated cartel to block the entry of the discounters to protect their quasi rent.³⁵⁴ The dealer cartel theory is not without criticism. Commentators have noted that the theory is implausible given the conditions necessary for the theory to hold true.³⁵⁵

The dealer cartel theory is what motivated the Supreme Court to argue in *Leegin* that RPM arrangements initiated by retailers are inherently more suspect than RPM originating from manufacturers.³⁵⁶ This seemingly intuitive argument has not been universally accepted. Commentators have argued that first, it is not always easy to determine the originator of an RPM arrangement,³⁵⁷ and second, RPM initiated by retailers is not necessarily motivated by anticompetitive intent.³⁵⁸ An RPM may seem to be initiated by retailers when it was implemented by a manufacturer in response to legitimate complaints by retailers about free riding.³⁵⁹ When genuine free riding takes place, retailers are harmed and may want the manufacturer to stop the free riding with an RPM. This may ostensibly seem like an instance of retailers pushing the manufacturer to impose higher prices, which usually does suggest

³⁵⁰ Calvani & Berg, *supra* note 254, at 1184.

³⁵¹ See, e.g., Marvel & McCafferty, *supra* note 233, at 374 (“A second requirement of an acceptable theory is that it establish some direct benefit to the manufacturer sufficient to warrant participation. While manufacturers sometimes capitulated to dealers’ pressure, such pressure is inadequate to explain manufacturers’ apparent fondness for RPM.”).

³⁵² William F. Baxter, *Vertical Restraints and Resale Price Maintenance: A ‘Rule of Reason’ Approach*, 14 ANTITRUST L. & ECON. REV. 13, 24 (1982).

³⁵³ Mathewson & Winter I, *supra* note 4, at 65.

³⁵⁴ *Id.* at 65–66.

³⁵⁵ See Elzinga & Mills I, *supra* note 4, at 1846.

³⁵⁶ *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 897–98 (2007).

³⁵⁷ See Correia, *supra* note 243, at 237.

³⁵⁸ See Ippolito, *supra* note 2, at 160; Klein, *supra* note 14, at 470.

³⁵⁹ Ippolito, *supra* note 2, at 160; Klein, *supra* note 14, at 470.

an anticompetitive intent, except that in this instance it was spurred by a legitimate, pro-competitive reason.

Correia describes a number of different scenarios in which dealer cartels may arise. The first is an inter-brand cartel, under which the colluding retailers require all brand manufacturers to impose an RPM.³⁶⁰ The effect of such a cartel would be no different from an industry-wide supplier cartel.³⁶¹ However, Correia argues that such a cartel is difficult to organize and maintain.³⁶² The second is the conventional intra-brand cartel, under which only the prices are fixed by a single supplier for all the dealers.³⁶³ The impact of such a cartel is less pernicious because consumers are still afforded other options, which should constrain the extent of price increases that the dealers can demand. The third scenario is parallel conduct by multiple dealers.³⁶⁴ A number of dealers may make the same demand on the supplier to raise resale prices. Correia argues that such a situation presents great difficulty for antitrust enforcement as it could be the result of a cartel or completely legitimate requests from dealers to secure a normal return for their investments in sales and after-sales services.³⁶⁵ As suggested earlier, such parallel requests need not be anticompetitive.³⁶⁶

RPM's potential to facilitate retailer cartels is less likely to produce harm to consumers under the inter-retailer primacy model, which presumes multi-brand retailers. With single-brand retailers, inter-brand cartels should be very difficult to achieve given the multitude of retailers involved. Intra-brand cartels, however, would be a meaningful threat to consumer welfare because single-brand retailers would have substantial incentives to eliminate competition among the involved brands; they stand to benefit tremendously from the elimination of competition within the one brand they carry. The situation is different for multi-brand retailers. Assuming consumers' primary choice is a retailer and the relative prices of different brands will only affect their product choice within the store, retailers should be largely indifferent about the price of one product.

³⁶⁰ Correia, *supra* note 243, at 224.

³⁶¹ *Id.*

³⁶² *Id.* at 225.

³⁶³ *Id.*

³⁶⁴ *Id.* at 227.

³⁶⁵ *Id.* at 228 (“When high price dealers demand that their suppliers terminate discounters, they may not be attempting to force retail prices over competitive levels in order to earn excess profits. They may simply be complaining that they cannot earn normal profits at the price charged by discount dealers.”).

³⁶⁶ See Ippolito, *supra* note 2, at 160; Klein, *supra* note 14, at 470.

Given intra-retailer inter-brand substitution effect, each retailer stands to gain little by raising the price of one product under an intra-brand retailer cartel—the consequence will be that consumers will switch to other brands. Unless other brands provide a substantially higher retail margin—and this is unlikely since the retail margin of the cartelized product should have been raised by the RPM—retailers should be relatively indifferent about consumers' choice of brand within the store. This is even more likely under the impulse purchase model, under which there is essentially no inter-retailer competition. The absence of such competition should mean that the retailers have very little incentive to cartelize intra-brand competition. Intra-brand retailer cartels should be highly unlikely, unless the brand at issue has a great deal of market power and consumers do not assume there are meaningful substitutes, in which case an intra-brand retailer cartel should increase the retailer's profitability.

Inter-brand cartels should be more feasible with multi-brand retailers. It is much easier to cartelize the market if five retailers carry all the brands in the market as opposed to each brand being carried by its own five retailers. Inter-brand retailer cartels should also be more probable than intra-brand retailer cartels under the inter-retailer primacy model and the impulse purchase model. When inter-retailer competition (at least at the product stage) is weak or absent, retailers have few reasons to be concerned about intra-brand price differences across retailers and little motivation to organize an intra-brand retailer cartel. In contrast, an inter-brand retailer cartel that raises the retailers' retail margins across the board would benefit the retailers so long as lost sales due to the higher prices are outweighed by the inflated retail margins. The redeeming quality is that inter-brand cartels should be relatively easy to detect. It would certainly arouse suspicion if the retailers approach the manufacturers one by one and demand an RPM. The timing of the requests is likely to be close because presumably individual manufacturers will be reluctant to accede to the request unless other manufacturers also acquiesce.

In summary, in the presence of multi-brand retailers where consumer behavior follows either the inter-retailer primacy model or the impulse purchase model, the only scenario in which facilitation of retailer cartels would be of concern is if the brand commands significant market power and the retailers form an intra-brand cartel.

C. Cumulative Effects of Multiple RPM Schemes Absent Cartel

While the presence of multi-brand retailers may render the cartel facilitation theories less relevant, it also presents other possibilities for price coordination among manufacturers short of outright collusion. This is a potentially more problematic scenario as anticompetitive price increases can be achieved without forming a cartel, thus avoiding the instability issues that afflict many cartels. What is more problematic is that monopoly prices can be achieved regardless of retailers' market power. Such price coordination would thus seem more durable and also more difficult to prosecute as antitrust law has long faced difficulty with price coordination by multiple parties short of express collusion.

Rey and Vergé propose a model in which RPM can be used by multiple suppliers to coordinate their prices at the monopoly level even in the absence of an outright cartel.³⁶⁷ There are two conditions that must hold for the model to apply. First, there must be an interlocking relationship between the suppliers—they must sell through the same multi-brand retailers. Second, suppliers must be able to charge a two-part tariff, consisting of both a per-unit wholesale price for the product and a flat fee.³⁶⁸ Before manufacturers are able to coordinate their prices through the retailers, they need to achieve a few things. First, they need to be able to pool together their revenue to internalize the adverse effect on their rivals' upstream profits when they reduce the price of their own products. According to Rey and Vergé, “manufacturers only take into account the retail margin on rival products, and thus fail to account that a reduction in their own prices hurts their rival's upstream profits.”³⁶⁹ This is where multi-brand retailers come in. If manufacturers only sell their products through single-brand outlets without overlap between their distribution networks, there would be no possibility for them to pool together their revenue. Multi-brand retailers effectively allow them to behave as if they had merged.

However, the fact remains that the supra-competitive profits reside with the retailers. Manufacturers need to be able to obtain their own share of the supra-competitive profits, and the two-part tariff closes this gap. The two-part tariff functions to allow the suppliers to share in the monopoly profit (or even expropriate the entire monopoly profit).³⁷⁰ The amount of retailer

³⁶⁷ See Rey & Vergé II, *supra* note 332, at 928.

³⁶⁸ *Id.* at 930, 943.

³⁶⁹ *Id.* at 936.

³⁷⁰ *Id.* at 943.

market power will determine how the monopoly rent is split between the manufacturers and the retailers.³⁷¹ The flat fee to be collected from the retailers facilitates the pooling of revenue among the manufacturers because it is calculated based on the overall revenue of the retailers, which includes sales of all products. This profit sharing mechanism effectively internalizes the externalities of each manufacturer's pricing decisions and causes the manufacturers to take into account the impact of those decisions on other manufacturers. When that happens, prices tend to converge to the monopoly level.³⁷²

There is one last piece of the puzzle necessary to enable this price coordination mechanism to work: manufacturers need to eliminate intra-brand competition to maintain prices at the monopoly level. Monopoly prices can only be attained in the absence of intra-brand competition among retailers. Once retailers engage in intra-brand competition, retail prices will drop below the monopoly level and manufacturers will raise wholesale prices to capture more of the overall profit through wholesale margin rather than flat-fee profit sharing.³⁷³ Upstream and downstream competition is interrelated. The lack of downstream intra-brand competition could curtail upstream inter-brand competition.³⁷⁴ According to Rey and Vergé, without RPM, "the existence of competition at both the upstream and downstream levels maintains retail prices below the monopoly level. . . . The situation is then formally the same as if the two manufacturers were directly competing against each other."³⁷⁵ This is where RPM comes in. RPM eliminates intra-brand competition, which helps to maintain retail prices at the monopoly level, which in turn gives the manufacturers the incentive to keep wholesale prices at cost.

At-cost wholesale prices and the possibility of revenue pooling via the multi-brand retailers minimize inter-brand competition.³⁷⁶ Intra-brand competition is eliminated by the RPM, which helps to sustain monopoly prices. With RPM, it is always possible for wholesale prices to be at cost and for retail prices to be at the monopoly level.³⁷⁷ RPM is essential to such price coordination, as these anticompetitive effects cannot be produced by other

³⁷¹ *Id.* at 945.

³⁷² *Id.* at 930, 935.

³⁷³ *Id.* at 930, 938.

³⁷⁴ *See* Rey, *supra* note 242, at 47.

³⁷⁵ Rey & Vergé II, *supra* note 332, at 936.

³⁷⁶ *Id.* at 930, 937.

³⁷⁷ *Id.* at 938.

vertical restraints.³⁷⁸ RPM essentially creates an industry-wide cartelized outcome by allowing the manufacturers to take advantage of the revenue pooling opportunities presented by the multi-brand retailers.³⁷⁹

While the presence of multi-brand retailers makes it possible for the manufacturers to pool their revenue, the inter-retailer primacy model and the impulse purchase model mean that intra-brand price competition poses less of a threat to the monopoly prices set by the manufacturers. One of the premises for the need for RPM in Rey and Vergé's model is that intra-brand competition will drive retail prices down and eventually lead manufacturers to raise wholesale prices to obtain a greater share of the profit.³⁸⁰ The whole price coordination scheme will unravel and the monopoly price cannot be sustained. However, under the inter-retailer primacy model, intra-brand price competition takes on less significance, especially if the majority of the consumers are basket-purchase consumers who show relatively low sensitivity to the prices of individual brands. Intra-brand price competition may still have some role to play if the bulk of the consumers are single-purchase consumers who are still relatively price sensitive. Depending on which type of consumers predominates, the manufacturers may have less of an anticompetitive motive to resort to RPM. This is even more likely in the case of the impulse purchase model. This means that the use of RPM may be less likely to be motivated by the need to protect the profit pooling potential of multi-brand retailers.

Thankfully, this anticompetitive use of RPM should be easier to detect than under the two cartel facilitation theories. Under those theories, the most apparent outward manifestation of a nefarious scheme is the industry-wide use of RPM. However, it has been argued that the prevalence of RPM can also simply indicate the efficiency of RPM. The prevalence of RPM therefore does not necessarily reflect an anticompetitive motive. Under Rey and Vergé's price coordination theory, in addition to the prevalence of RPM, there will be the further signal of the prevalence of the two-part tariff in the industry. While two-part tariffs are relatively common with single-brand retailers such as franchised retailers, they are relatively unusual with multi-brand retailers.³⁸¹ Therefore, industry-wide use of two-part tariffs with multi-

³⁷⁸ *Id.* at 952–53.

³⁷⁹ *Id.* at 930.

³⁸⁰ *See id.* at 937–38.

³⁸¹ *See generally* Markus Reisinger & Tim Paul Thomes, Distribution Channels and Collusion of Manufacturers: Common versus Independent Retailers, Presentation at the BECCLE Competition Policy Conference 22–26 (April 24, 2015); Markus Reisinger & Tim Paul

brand retailers, together with RPM, should be telltale signs that an anticompetitive price coordination scheme is afoot.

D. Foreclosure by a Powerful Manufacturer

There are circumstances in which RPM can lead to anticompetitive outcomes without the involvement of multiple suppliers. The first circumstance is when a powerful supplier uses RPM to foreclose rival suppliers by denying them access to effective distribution channels.³⁸² Under the manufacturer foreclosure theory, the manufacturer can use RPM to generate quasi rent to purchase exclusivity or privileged access to distribution channels.³⁸³ If access to retailers was essential to entry, the potential entrant would be willing to offer incentives, such as a lump-sum payment, to the retailers.³⁸⁴ In fact, given that the alternative is complete exclusion from the market, the entrant would be willing to offer as much as “the maximal profit that can be earned in the current period, if entry occurs, plus the discounted value of all future profits” in the post-entry competitive market,³⁸⁵ minus the fixed costs of entry. Therefore, the incumbent would need to outbid the entrant by offering retailers, in the form of the discounted value of future enhanced retail margins, a payment that exceeds the lump-sum payment that the entrant can offer.

Under this theory, RPM effectively serves as “a rent-shifting device.”³⁸⁶ By sharing the manufacturer’s profit with the retailers, RPM essentially gives retailers a stake in the continual ability of the incumbent to maintain supra-competitive prices by excluding a potential entrant. RPM “forces individual retailers to internalize the impact of competition on the profitability of the incumbent’s product and on the margins of all retailers.”³⁸⁷ The reason RPM is needed for the rent-shifting scheme to work is because without RPM, retail competition would compete away all the excess retail margins that the manufacturer attempts to provide to the retailers. The manufacturer needs to be able to generate rent to be shared with the retailers in the first place. This

Thomes, *Manufacturer Collusion: Strategic Implications of the Channel Structure*, 26. J. ECON. & MGMT. STRATEGY (forthcoming 2017).

³⁸² Elzinga & Mills II, *supra* note 280, at 360.

³⁸³ *Id.* See also John Asker & Heski Bar-Isaac, *Exclusionary Resale Price Maintenance* 20 (National Bureau of Economic Research, Working Paper No. 16564, May 12, 2011), http://pages.stern.nyu.edu/~jasker/RPM_Final.pdf.

³⁸⁴ Asker & Bar-Isaac, *supra* note 383, at 18.

³⁸⁵ *Id.* at 18.

³⁸⁶ Paldor, *supra* note 263, at 315.

³⁸⁷ Asker & Bar-Isaac, *supra* note 383, at 9.

requires the manufacturer to have market power. Assuming that the manufacturer was a monopolist, it would have very strong ability to generate such rent.³⁸⁸ And since monopoly profit is greater than duopoly profit, a monopolist would always be able to share some profit with a retailer to exclude a rival that leaves both the monopolist and the retailers better off.³⁸⁹ In contrast, if the upstream market is crowded, the supplier will have less ability to generate quasi rent.³⁹⁰ Such a scheme will be more likely to succeed if there is a limited number of distribution channels or a scarcity of prime retail locations.³⁹¹ Otherwise, the manufacturer will need to share rent with many retailers, leaving itself with little monopoly profit.

Most formulations of the manufacturer foreclosure theory do not clearly specify whether the retailers involved are single-brand retailers or multi-brand retailers.³⁹² Foreclosure would be less of a concern if entry was less probable. And it would seem that entry would be more difficult in the case of single-brand retailers because if a retailer can only carry one brand, as in the case of a franchised retailer for example, the entrant would have to compensate a retailer for its entire profit lost from ceasing to sell the incumbent brand. Meanwhile, for a multi-brand retailer, its expected loss from carrying a new entrant brand would be much smaller. The loss may come in the form of lost sales or lost profit margins. Lost sales are unlikely to be significant because, due to the intra-retailer inter-brand substitution effect, most of the lost sales of the incumbent brand will merely be captured by the entrant brand. What may happen to the retail profit margin in light of entry is more complicated. The entry of a second brand means that the previously monopolist profit in the market becomes duopolist profit. Thus industry-wide profit is clearly reduced. However, the retailers need not suffer from this dissipation of profit. If the retail level was competitive, the incumbent manufacturer would be unlikely to have shared any of its monopoly profit with the retailers in the first place. The retailers would only be earning a competitive return. A fall in industry-wide profit would only affect the incumbent manufacturer. And if the entrant is willing to offer a higher retail margin to the retailers, which the entrant may be able to do due to its lower cost, the retailers may in fact gain from allowing entry. Therefore, entry could be more likely in the case of multi-brand retailers, and foreclosure of entry by a dominant manufacturer could be of greater concern.

³⁸⁸ Paldor, *supra* note 263, at 318.

³⁸⁹ *Id.* at 318.

³⁹⁰ *Id.* at 320.

³⁹¹ Rey, *supra* note 242, at 31.

³⁹² *See, e.g.,* Asker & Bar-Isaac, *supra* note 383, at 10.

One may, however, argue that under the inter-retailer primacy model and the impulse purchase model, success in securing entry from one retailer may have less market-wide impact, such that the market will not immediately flip from a monopoly to a duopoly. This is because if consumers choose a retailer before choosing a brand or engage in impulse purchasing, the competitive effect of the entry of a brand at one retailer will be limited. Only consumers who choose to visit that retailer will learn about the brand. There are two implications from this. First, the incumbent manufacturer may have weaker incentives to employ foreclosure tactics because the impact of entry will be limited and localized. This may suggest that manufacturer foreclosure may be a less plausible theory of harm for RPM. On the other hand, it may also be easier for the incumbent manufacturer to implement foreclosure through RPM because the gains from securing access to one retailer may be limited and may not equate with successful market-wide entry. Recall that the entrant will be willing to offer up to its entire profit upon successful market entry to entice a retailer to carry its brand. If the effect of entry is localized to a particular retailer, the entrant will expect a smaller stream of future profit, and hence a smaller possible payment to the retailer. If the entrant is willing to pay less, the incumbent can also offer less to outbid the entrant, which makes foreclosure through RPM easier and more attractive to the incumbent manufacturer. This, contrary to the first implication, means that manufacturer foreclosure by RPM should be a more pertinent concern.

Under the inter-retailer primacy model, the relative weight of these two implications depends on the preponderance of the two types of consumer. The heavy presence of single-purchase consumers means that consumers would still have some sensitivity to intra-brand inter-retailer competition. If consumers find an attractive new brand at one retailer, sooner or later they will put pressure on other retailers to carry the same brand. When that happens, the rational response for other retailers once entry has taken place is to accommodate entry as well.³⁹³ As Asker and Bar-Isaac observe, “[i]f one retailer accommodates entry, then the entrant will get access to the market and be able to generate a retail price that undercuts all retailers that supply the incumbent’s good. This steals the market from the incumbent and retailers who sell the incumbent’s good.”³⁹⁴ This means that the impact of a successful entry could be market-wide and that the incumbent will have to offer a higher bribe to retailers to induce them to shun the entrant. However, if the basket-purchase consumers predominate, or the impulse purchase

³⁹³ *Id.*

³⁹⁴ *Id.* at 15.

model applies, the incumbent would only need to offer a smaller bribe. In that case, manufacturer foreclosure would be less costly to retailers because of the de-emphasis of inter-retailer competition and greater affordability to the incumbent. It would be a matter of graver concern.

E. Foreclosure by a Powerful Retailer

Another circumstance in which RPM can hurt competition in the absence of multi-supplier involvement is if it is used by a powerful dealer to forestall price competition or a more efficient entrant at the retail level. This would be particularly pernicious if rivals were able to undercut the powerful dealer in price due to some innovation in distribution, the benefits of which RPM would prevent the rival dealer from passing on to consumers.³⁹⁵ In order for the powerful dealer to forestall competition from more efficient dealers, it must be able to persuade the supplier to terminate those dealers. Again, one asks why the supplier would cooperate. The answer must be that the dealer possesses a significant degree of market power. Some of the conditions that are relevant to a dealer cartel mentioned earlier would be equally relevant here. In order for the dealer to wield that much market power, alternative and equally effective distributors must have difficulty entering the market. In order for the powerful dealer to forestall competition and earn a supra-competitive profit, it needs to be able to eliminate more efficient rivals.

Doh proposes a model for retailer foreclosure in the context of multi-brand retailers. His model is most apt for our purposes because it is explicitly set up in the multi-brand retailer context. His model specifically permits retailer differentiation,³⁹⁶ which is crucial for the inter-retailer primacy model, which postulates that retailers distinguish themselves in the eyes of the consumers and compete for business by offering superior general retail services such as more pleasant ambience and more abundant amenities. The inter-retailer primacy model is not, and cannot be, premised on completely fungible retailers that are perfectly competitive with each other.³⁹⁷ If retailers were completely fungible, there would be no basis upon which for consumers to choose a retailer.

His model requires a number of assumptions. First, it requires that there be a scarcity of shelf space.³⁹⁸ This is necessary because the retailer

³⁹⁵ Elzinga & Mills II, *supra* note 280, at 360.

³⁹⁶ Doh, *supra* note 31, at 390–91.

³⁹⁷ See Asker & Bar-Isaac, *supra* note 383, at 10.

³⁹⁸ Doh, *supra* note 31, at 363.

foreclosure theory is premised on a retailer's threat to pull a manufacturer's product.³⁹⁹ Such a threat would not be credible unless there is genuine competition among brands for shelf space. If there is ample space, the retailer can still threaten to pull a manufacturer's product and allocate the shelf space to another brand. However, if every brand was amply displayed, allocating extra shelf space to them would experience diminishing marginal returns. The extra shelf space would make negligible contribution to the sales of the brand. Knowing this, the threatened manufacturer would find the threat to pull its product less credible.

Second, there needs to be significant disparity in the size of the customer base for different retailers.⁴⁰⁰ In other words, the threatening retailer needs to possess significant market power. This again is related to the credibility of the threat. If a retailer accounts for a substantial portion of the overall sales of a manufacturer, its threat to terminate the manufacturer will carry more bite. Doh notes that:

[W]hen the sizes of customer bases are similar, it is difficult for a retailer with high product prices to coerce the manufacturer to adopt RPM since his demand magnitude for a manufacturer's product tends to be smaller than rival retailer's. Such coercion is possible only if his rival carries a large number of products and is very inefficient in retail operation.⁴⁰¹

Third, Doh postulates that, "the demand for a brand is a function of the vigor of inter-brand competition with rival brands, the intensity of intra-brand competition among the brand's retailers, relative market power (or market share) of the retailers, and the manufacturer's bargaining power with these retailers."⁴⁰² He argues that the threat of termination is more credible and likely to be issued if inter-brand competition is keen. This is largely due to the intra-retailer inter-brand substitution effect.⁴⁰³ The stronger the effect, the more the sales of a foreclosed brand will be diverted to the substitute brands at the same retailer as opposed to other retailers carrying the foreclosed brand. This effect will be stronger if inter-brand competition is keen, which means that consumers are relatively indifferent between different

³⁹⁹ *Id.*

⁴⁰⁰ *Id.* at 388.

⁴⁰¹ *Id.*

⁴⁰² *Id.* at 367.

⁴⁰³ *Id.* at 379.

brands and less likely to make the effort to go to other retailers to seek the foreclosed brand. In other words, as inter-brand competition gets fiercer, the cost to the retailer of dropping one brand becomes lower, which makes the retailer's threat more credible.⁴⁰⁴ This also means that the target brand is unlikely to command significant customer loyalty. The products targeted by the retailers would tend to be the less popular ones.⁴⁰⁵

According to Doh, whether a retailer can coerce a manufacturer to impose an RPM on itself and other rivals comes down to the incentive compatibility of the decision for the manufacturer and the retailer.⁴⁰⁶ As mentioned earlier, RPM would be incentive compatible for the retailer if inter-brand competition was fierce. The calculus for the manufacturer is slightly more complicated. The cost of refusal to comply with the threat is the loss of sales through the threatening retailer. The cost of compliance depends on other retailers' reaction. If other retailers will continue to carry the product, the main cost will be reduced sales through other channels.⁴⁰⁷ If other retailers terminate the manufacturer's product in response to the RPM, then the cost would be lost sales through these retailers. Ultimately, whether the manufacturer would yield to the threat comes down to the relative magnitude of these two costs. This is where the disparity of customer size of the retailers comes in. The larger the market share of the threatening retailer, the more likely it is that the cost of non-compliance would outweigh the cost of compliance and the more likely it is that the manufacturer would yield to the retailer's demand and RPM would be used for an anticompetitive purpose to attain foreclosure.

It should be obvious that the inter-retailer primacy model increases the possibility of retailer foreclosure. While Doh's model is explicitly premised on multi-brand retailers, it still seems to assume the inter-brand primacy model of consumer behavior. Some of the assumptions of his model take on a different degree of relevance under the inter-retailer primacy model and the impulse purchase model. The importance of the scarcity of shelf space is unrelated to consumer behavior and will not be affected under these two models. The other two assumptions, which implicate the relative leverage of the manufacturer and the retailer, take on different significance under the inter-retailer primacy model. Under the inter-retailer primacy model, retailers take precedence over brands in the eyes of the consumers. This accentuates

⁴⁰⁴ *Id.* at 380.

⁴⁰⁵ *Id.* at 388.

⁴⁰⁶ *Id.* at 387.

⁴⁰⁷ *Id.*

the effect of inter-brand competition and enhances the importance of the market share of the threatening retailer. Under Doh's model, fierce inter-brand competition reduces the cost to a retailer of dropping a brand because most of the sales are diverted to other brands. Under the inter-retailer primacy model, this diversion effect will be even stronger because of the intra-retailer inter-brand substitution effect. If most of the lost sales from brand termination are captured by other brands within the same store, the retailer bears very little cost and its threat to the manufacturer becomes highly credible. A retailer's market share is also a more reliable indicator of market power if competition for consumers mostly exists on the retailer level and not the brand level. This theory of harm should be accorded greater weight in the analysis of the anticompetitive effects of RPM.

The same shift of balance of power in favor of the retailers should be absent under the impulse purchase model. Recall that there are two main types of impulse purchase model as far as retailer choice is concerned: pure and reminder. Under the pure impulse purchase model, there is little inter-retailer competition because consumers do not undertake a meaningful selection process for retailers. Consumer visits of retailers are largely by chance or happenstance. Under the reminder impulse purchase model, consumers enter a store for other reasons before they are reminded that they want to buy a product. It is these other reasons, which are largely determined under the two other consumer behavior models, that decide the consumers' choice of retailers. The impulse purchase model has little to say about retailer choice.

VI. APPLICATION OF THEORIES TO PRACTICE

A. Continued Relevance of the Various Defenses for RPM

The critique in Part 0 of the various pro-competitive justifications for RPM casts serious doubt on their continued relevance. Some critiques question the fundamental premise of these defenses. Others leave them relevant in highly restrictive circumstances.

1. The Free Riding Defense and the Facilitation of Introduction of New Products

A critical examination of the various assumptions of the free riding defense suggests that the defense only applies to highly restrictive circumstances. The same conclusions apply to the facilitation of introduction of new products because, as argued earlier, it is but a variation of the free

riding defense. First, it was argued that the free riding defense does not apply to general retail services and only applies to product-specific retail services. That significantly narrows the applicability of the defense. It was further argued that the defense only applies to a narrow subset of product-specific retail services, in particular, product demonstration. Second, it was observed that the defense only applies to products of substantial value, for which it is worth the consumers' while to shop around for discounted products. Consumers are highly unlikely to incur the costs to shop around for a very small item. Third, the incentive incompatibility problem between the manufacturer and the retailers is likely to be insurmountable where multi-brand retailers are involved and the market is characterized by the inter-retailer primacy model or the impulse purchase model. Multi-brand retailers are much less willing to invest in product-specific retail services as opposed to general retail services, because product-specific retail services will simply bring about intra-retailer inter-brand substitution effects. Therefore, RPM is unlikely to be an effective tool to secure the kind of product-specific retail services desired by manufacturers. In fact, it was argued that the horizontal promotional externality, which is the fundamental basis for the free riding defense, is not a concern under the inter-retailer primacy model and the impulse purchase model. Under these two models, the product-specific retail services provided by a retailer do not create inter-retailer spillover effects. There is hence nothing for other retailers to free ride on. In short, the free riding defense is only applicable where the inter-brand primacy model applies, and where the product sold is an expensive product requiring product demonstration by single-brand retailers.

2. Quality Certification and Ensuring an Efficient Number of Outlets

Both of these justifications are premised on the provision of some general retail services by the retailers. To rely on multiple brands to fund the provision of general retail services is fraught with difficulty. Because of the inter-brand spillover effects of general retail services, there will be huge incentives for individual brands to free ride on each other's contributions. The justifications suffer from the problem of the huge discrepancy between the retail margins that can be generated by RPM from individual products and the necessary costs to open a new outlet or undertake quality certification. Even assuming that none of the brands plan to free ride and are willing to cooperate in good faith, the coordination problems are likely to be daunting given the multitude of brands and retailers involved. What is a sufficient margin for one retailer's new outlet may not necessarily be sufficient for

another retailer. Add to all this fluctuating sales by each brand and changing plans for general retail services over time, and the coordination problem becomes practically insurmountable. In other words, these two defenses are largely inapplicable whenever multi-brand retailers are involved.

3. Facilitation of Contract Enforcement

While this justification is largely theoretically sound, its main limitation is that it has narrow applicability. As argued earlier, this justification does not apply to general retail services at all, and only to product-specific retail services. And even among product-specific retail services, it would not apply to product display and product demonstration, both of which can be consumed separately from the product. It would seem that the only kind of retail service to which this justification applies is the special product care and handling mentioned by the authors. Few products that have been widely subject to RPM require such special product care and handling, which means that this justification adequately accounts for few real-world instances of RPM.

4. Using RPM to Combat the Vertical Promotional Externality

This justification for RPM is superior to many of the aforementioned ones because it is not premised upon the elimination of the horizontal promotional externality, which turns out to be less common than generally assumed. It does, however, suffer from other infirmities. First, it assumes that brands are more heterogeneous and hence wield more market power than the retailers. As has been argued earlier, this needs not be the case. Once this is not true, the whole basis for this justification is severely weakened. Second, like some of the previously discussed defenses, it again suffers from limited applicability. Although Klein argues that it applies to product display, brand-specific salesperson promotional efforts, and retail location, in reality it is only relevant to brand-specific salesperson promotional efforts. There are arguably superior compensation mechanisms for procuring this kind of promotional efforts from retailers. In the end, Klein is forced to defend this justification on the ground that manufacturers need to provide financial inducements to retailers to promote their products, which amounts to an admission that consumers obtain no benefit from the higher prices they are forced to pay as a result of RPM. In fact, consumers get nothing of value from them. One can still call this a justification for

RPM, but it is highly questionable whether it can be characterized as a pro-competitive justification worthy of recognition under antitrust law.

B. Modifications to the Various Theories of Harm

Overall, the presence of multi-brand retailers and the incorporation of alternative models of consumer behavior means that the two facilitation of cartel theories of harm should be relatively less important, whereas on balance, foreclosure by a powerful manufacturer or retailer would be more likely. Moreover, the presence of multi-brand retailers also creates the possibility of price coordination short of collusion.

RPMs are less likely to facilitate cartels, both at the manufacturer level and the retailer level, under alternative models of consumer behavior. Under the inter-retailer primacy model and impulse purchase model, manufacturers have fewer incentives to pursue a cartel, at least across retailers, as inter-retailer price variations become less important. Inter-brand competition mostly takes place within an individual retailer. RPM plays a less important role in stabilizing a manufacturer cartel as inter-retailer price uniformity becomes less pertinent. RPM is also less effective in forestalling cheating in a cartel as service competition becomes more important among brands and the manufacturers would have greater incentives to cheat by offering financial incentives to retailers to push their products. Similar arguments apply to retailer cartels. There are fewer incentives to pursue intra-brand retailer cartels because inter-retailer price variations are of less concern to retailers. Once a consumer has chosen a retailer, she is unlikely to switch to another one due to price disparity. The only exception is when there is a very popular brand for which consumers consider there to be few substitutes, in which case an intra-brand retailer cartel should increase the retailer's profitability. This is tantamount to saying that the brand has market power to which probably the inter-brand primacy model applies. Meanwhile, inter-brand retailer cartels should be easier to organize with multi-brand retailers because relatively fewer retailers need to be involved in such a cartel. However, such a cartel should be relatively easier to detect.

The presence of multi-brand retailers opens the possibility of manufacturer price coordination short of outright collusion. Multi-brand retailers allow manufacturers to pool their sales and therefore internalize the impact of their price reduction decisions on their competitors' profit level. This will lead them to charge monopolistic prices collectively. The use of two-part tariffs allows the manufacturers to share some, if not all, of the monopoly profit, depending on the relative market power between the

manufacturers and the retailers. And the use of RPM forestalls intra-brand competition, which competes away the monopoly profit and forces the manufacturers to raise their wholesale price, which in turn causes the whole scheme to unravel. Such price coordination can only take place in the presence of multi-brand retailers. RPM plays a less integral role in this price coordination scheme under alternative models of consumer behavior because of the reduced role of inter-retailer inter-brand price competition. Intra-brand price competition is less prone to compete away the monopoly profit and cause the whole scheme to unravel.

The presence of multi-brand retailers and the incorporation of alternative models of consumer behavior render the two foreclosure theories of harm more pertinent. Under the manufacturer foreclosure theory, the presence of multi-brand retailers means that the new entrant only needs to pay smaller compensation to the retailers for foregoing the incumbent brand. Introduction of a new brand at the expense of the incumbent brand will result in a smaller loss of profit for multi-brand retailers. This is especially true under the inter-retailer primacy model and the impulse purchase model. The retailer foreclosure theory is premised upon the existence of multi-brand retailers. This theory is particularly relevant under the inter-retailer primacy model because the threat by the dominant retailer will be more credible. This is the case because first, under the inter-retailer primacy model, retailers take precedence over brands in the eyes of the consumers, which means the retailers have greater bargaining power over brands. Second, more of the diverted sales from delisting a brand will be captured by other brands within the same store, which means the retailers stand to lose less by discontinuing a brand, which in turn makes its threat to do so more credible.

Overall, the analysis in this Article suggests that the case for the pro-competitive use of RPM has generally been overstated. Taking into account the characteristics of multi-brand retailers, the alternative models of consumer behavior, and other relevant critiques means that most of these defenses are no longer valid or only of very limited applicability. The conventional theories of harm for RPM remain relevant, although the two cartel facilitation theories probably less so than the two foreclosure theories. The presence of multi-brand retailers creates a new possibility of manufacturer price coordination absent collusion. However, it must be acknowledged that the insights derived from alternative models of consumer behavior only provide guidance to the courts on which theory of harm to emphasize. They are unlikely to allow the courts to come to a quick conclusion about a case.

C. Putting the Insights into Practice

This Article has presented three strands of theoretical insights pertaining to the validity and applicability of the various defenses and theories of harm for RPM. The first pertains to the classification of retail services and its ramifications for the validity of the various defenses for RPM. The second concerns the crucial distinction between single-brand retailers and multi-brand retailers. The third analyzes how the various models of consumer behavior affect the determination of the legality of RPM. The discussion about the various kinds of retail services should sharpen the court's focus and hopefully lead to closer scrutiny of claims of pro-competitive benefits of RPM premised on the procurement of retail services. Courts can reject claims of quality certification or ensuring a sufficient number of retail outlets outright if the product at issue is sold through multi-brand retailers. Defendants should be required to identify a plausible kind of retail service that can justify the use of RPM if they invoke the facilitation of contract enforcement defense. Using RPM to combat the vertical promotional externality should be rejected as a defense for RPM given the lack of consumer benefits from the higher prices. Lastly, the prevention of free riding defense should be similarly rejected if the service claimed by the defendant is anything other than product demonstration or other plausible product-specific retail services that fulfill all the criteria previously discussed, such as being an expensive product sold through a single-brand retailer.

Applying the second strand of insight requires the court to determine whether the product at issue is sold through single-brand retailers or multi-brand retailers. That should not be a difficult inquiry. The parties should be able to provide such information fairly easily. Casual observation suggests that most products are sold through multi-brand retailers. If that is the case, we can reject the prevention of free riding, quality certification, and ensuring an efficient number of retail outlet defenses. On the other hand, the court should pay special attention to the possibility of RPM being used to facilitate a manufacturer cartel as it is easier to organize one with multi-brand retailers. The court should also watch out for the possible use of RPM to achieve price coordination absent outright collusion. This is only possible in the presence of multi-brand retailers. Lastly, manufacturer foreclosure becomes a more plausible theory of harm with multi-brand retailers because switching from the incumbent brand to a new entrant will be less costly for the retailers, making entry more likely in general. Of course there are products that do not rely exclusively on either type of retailer. In that case, the court should determine the relative importance of the two types of retailer to a particular

product. If the product is predominantly sold through multi-brand retailers, the insights offered by this Article pertaining to multi-brand retailers should apply. Again, the reliance on the different retailer type should be information that can be furnished by the parties.

The application of the last strand of insight is probably more complicated. If the court determines that the inter-brand primacy model does not apply to a particular product, it can reject the prevention of free riding defense. It can also pay less attention to the possibility of a manufacturer cartel and an intra-brand retailer cartel, as both are less likely under the inter-retailer primacy model and the impulse purchase model. However, the two foreclosure theories of harm, especially retailer foreclosure, would take on greater urgency under these two models of consumer behavior. Which model of consumer behavior describes consumers' purchasing behavior for a particular product is not something that can be readily determined. Courts would probably need to resort to consumer surveys to find out whether, for a particular product, consumers focus on choosing brands or retailers or engage in impulse purchasing.

One helpful indicator is whether the product is relatively homogenous or differentiated. Brands are likely to be of greater concern to consumers for a differentiated product. Consumers may care more about whether they purchase the product than which brand they purchase for a relatively homogenous product. Another indicator that may be of help in the inquiry is market power. Market power is a more familiar concept in antitrust and courts are familiar with an inquiry into market power. If a brand is deemed to have market power, then it is likely that brands are relatively more important to consumers in their purchase decision and the inter-brand primacy model is more likely to apply. If a retailer is found to have market power, then the inter-retailer primacy model is more likely to apply. If the courts rely on the presence of market power as a proxy for the determination of the appropriate model of consumer behavior, they would need to do no more than what they currently do under the standard antitrust analysis. It is possible that multiple models of consumer behavior describe the same product market. It is conceivable that for a particular strong brand, consumers are more focused on the brand than the retailer while for the remainder of the market, the brands have no market power and consumers are relatively indifferent between the various brands. If that were the case, which model of consumer behavior to apply would depend on which brand is implicated in an RPM scheme. If a prominent brand with market power has adopted RPM, the court should analyze the case under the rubric of the inter-brand primacy

model. If RPM is implemented by a number of relatively weaker brands, then the inter-retailer primacy model should apply.

VII. CONCLUSION

Despite the fact that it is probably one of the most written about topics in antitrust law and economics, there are glaring omissions in the existing literature. In particular, it fails to take into account market realities in the retail sector, namely the various kinds of retail services, retail structures, and models of consumer behavior, and how they affect the plausibility of the myriad theories of harm and defenses for RPM. The main contribution of this Article is to challenge the validity of the various defenses for RPM and demonstrate that many of them are implausible given the market realities and that some are only valid under very limited circumstances. It also suggests adjustments to the prevailing theories of harm and proposes a new theory of harm premised on facilitation of price coordination absent outright collusion. As the courts continue their search for a suitable approach for analyzing RPM post-*Leegin*, they would benefit from taking into account the insights offered by this Article and exhibit greater skepticism towards the various pro-competitive accounts of RPM. In fact, in light of the challenges posed by this Article to the various defenses for RPM, courts may consider reversing the burden of proof in RPM cases by creating a presumption of illegality and requiring the defendant to articulate and prove that its use of RPM serves a pro-competitive purpose. Only if the defendant manages to substantiate a pro-competitive account of RPM would the plaintiff be required to prove that one of the theories of harm applies.