

ANTITRUST, FRANCHISE AND DISTRIBUTION PRACTICE GROUP

DR. MILES IS DEAD?

Another one bites the dust. There is a new entrant among the Supreme Court's list of landmark antitrust cases; one which is certain to create much debate.

Last week, the United States Supreme Court overturned *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911) which established the almost century-old doctrine that vertical price maintenance agreements are *per se* unlawful. In *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, S. Ct. No. 06-480, the Supreme Court ruled that minimum vertical price restraints are to be judged on a case-by-case basis under the rule of reason analysis commonly employed in other § 1 Sherman Act antitrust cases. Under the rule of reason, a court takes into account all of the circumstances surrounding the implementation of the vertical price maintenance agreement, including the history of the restraint, its nature, and its effect before deciding whether the restraint is illegal. Rule of reason treatment is important, as it is informally known as a euphemism for a defendant's verdict. *Per se* treatment, on the other hand, forbid the arrangements automatically, no matter what procompetitive benefits could be articulated.



The Dr. Miles Rule

In 1911, Justice Hughes, speaking for the Supreme Court stated: "The argument appears to be that, as the manufacturer can make and sell, or not,

as he chooses, he may affix conditions as to the use of the article or as to the prices at which purchasers may dispose of it...But because a manufacturer is not bound to make or sell, it does not follow in case of sales actually made he may impose upon purchasers every sort of restriction." The Supreme Court held that it was *per se* illegal for a manufacturer to place minimum pricing restrictions on the resale of its products, reasoning that property rights are passed from the manufacturer of a product to the purchaser of a product through a commercial sale. Once the property

rights are passed to a buyer, he may resell the products for whatever price he chooses—even if that includes a drastic discount on a manufacturer's suggested retail price.

Over the past ninety-six years, the *Dr. Miles* rule has been often called into doubt, and antitrust lawyers moved numerous courts towards a more tolerant view, vastly limiting the strict rule with respect to price restraints by fashioning a variety of subtle exceptions and tactics to avoid its reach. Nonetheless, companies have had to confront the prospect of automatic liability if their distribution plans were not carefully crafted and consistently applied. One such narrow exception, found in the *Colgate* Doctrine, used almost existential logic to permit resale price maintenance as long as the policy was announced in advance and the punishment for violation was immediate termination without exception. *United States v. Colgate & Co.*, 250 U.S. 300 (1919). Numerous other methods, such as advertising restrictions, pre-marked prices, and special agency or consignment arrangements, have also emerged. This creative lawyering and the implementation of gymnastic distribution procedures may now be unnecessary.

Leegin and the Rationale for Overturning Dr. Miles

In *Leegin*, a manufacturer of women's goods sold under the Brighton's label refused to sell products to a small retailer, Kay's Kloset, because the retailer was selling Leegin's goods at discounted prices. Leegin justified its decision by asserting that discounts on its goods made its brand name less marketable. The retailer brought suit, claiming that Leegin's attempt to control the retailer's prices violated the antitrust laws. A jury, directed to apply the *per se* rule, found for the retailer and awarded treble damages in the amount of \$3.6 million dollars and \$375,000 in attorneys' fees. The Fifth Circuit, which saw no alternative to applying the *per se* unlawful rule espoused by *Dr. Miles*, affirmed. The Supreme Court overturned the ruling.

In a 5-4 decision authored by Justice Kennedy, the Supreme Court held that manufacturers are no longer automatically violating antitrust laws by setting a minimum price for the sale of their merchandise in retail stores.

The Supreme Court began with a discussion of when *per se* rules should be used to outlaw restraints in antitrust cases. To justify *per se* illegality, the restraint must have “manifestly anticompetitive effects” and “lack any redeeming virtue.” Accordingly, *per se* unlawful rules should only be adopted after courts have had “considerable experience with the type of restraint at issue,” and if those courts “can predict with confidence that [the restraint] would be invalidated in all or almost all instances under the rule of reason.” The Court will only part from a rule-of-reason analysis if there is a “clearly demonstrable economic effect,” as opposed to mere “formalistic line drawing.”

The question of a “clearly demonstrable economic effect” of vertical minimum resale price maintenance agreements has been at the heart of the economic debate surrounding *Dr. Miles*. The *Leegin* Court noted that the *Dr. Miles* rule was based on an antiquated common-law rule forbidding the general restraint of a property owner’s ability to dispose of his property. Once a seller parted with title to goods, it simply had no business restraining the buyer’s resale pricing. The *Leegin* Court stated that the policy concerns on which this antiquated rule was based, namely, removing land from the stream of commerce for multiple generations, were no longer relevant, especially with respect to “vertical distributional restraints in the American economy today.” *Dr. Miles’ per se* unlawful rule that had governed for nearly 100 years was a “flawed antitrust doctrine that serve[d] the interests of lawyers—by creating legal distinctions that operate as traps for the unwary—more than the interests of consumers[.]”

Based on the findings of a majority of modern economic studies, the *Leegin* Court was convinced that, even if the effect of a vertical minimum resale price maintenance agreement is an increase in retail prices, vertical minimum price maintenance restraints may actually promote interbrand competition by reducing intrabrand competition between competitors selling the same products at different stores. Instead of competing by undercutting one another, retailers may now compete (and consumers ultimately benefit) by improving the quality and level of distribution and customer service functions. Other pro-competitive effects include elimination of “free riding” on the part of discount retailers who take advantage of the advertising promotion and informed sales force, inventory, and customer support of their competitors and facilitation of new entry into the market by other firms and brands.

The majority recognized that vertical price maintenance may also have anticompetitive effects, including the formation of cartels at the dealer or manufacturing level that could use resale price maintenance as a tool to help discipline or cut off dealers or manufacturers who are undercutting the cartel’s minimum prices. In cases such as this, price maintenance agreements should be held illegal.

Nonetheless, because vertical minimum resale price maintenance agreements can yield both procompetitive and anticompetitive results, only a case-by-case analysis under the rule of reason is fair to both consumers and corporations.

Ramifications of the Rule-of-Reason Analysis and Other Considerations

Although manufacturers and franchisors have greater latitude and control over resale pricing following *Leegin*,

there are important considerations to weigh before implementing a unilateral pricing policy or resale price maintenance agreement.



Significantly, *Leegin* does not make vertical minimum price resale maintenance agreements *per se* lawful. The restraint must still pass muster under the rule-of-reason analysis, which may

lead to additional litigation and liability risks for manufacturers and franchisors.

A manufacturer or franchisor should bear in mind that they must document the procompetitive effects of the resale price maintenance agreement, which are often difficult to quantify. In addition, as both the majority and dissenting opinions recognized, manufacturers and franchisors should be careful to avoid conduct that would suggest or facilitate horizontal collusion.

Finally, manufacturers and franchisors may still be precluded from controlling resale prices under state antitrust laws, independent distribution or franchise contract provisions, and the obligation of good faith and fair dealing. The state attorneys general, in their NAAG Guidelines, follow the strict liability treatment of resale price controls and there is no indication *Leegin* will change their views. There is also the risk that Congress may enter the fray and seek to restore application of the *per se* rule, and some Senators have already voiced their concern with the decision.

The reactions to the decision are quite varied. Some analysts predict the demise of national discounters. Others, including Justice Breyer in his dissenting opinion, foresee significantly higher prices for consumers. It appears that independent distributors and franchisees may be subject to significantly reduced margins. Others view the situation more temperately, suggesting that the decision simply places minimum resale price maintenance arrangements on the same legal footing as other antitrust claims, while maintaining the ability of the enforcement agencies and the

courts to deal with those arrangements that are competitively harmful.

Time will tell us the ultimate impact of the decision, but in the near term there will be some legal turbulence, as companies will be scrambling to review their pricing policies to determine whether direct minimum resale price control policies should be developed. What is clear, however, is that the Roberts Court, in its three major antitrust decisions this term, has set a course that favors business interests

and limits the ability of launching antitrust challenges to business conduct once thought problematic.

If you have questions about the Leegin case and its application to your business practices, or any other antitrust planning, compliance, or litigation issues, we would welcome the opportunity to discuss these issues with you in more detail. Please feel free to contact any member of our Antitrust, Distribution and Franchise Practice Group.

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