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Lawfully Controlling Resale Price Erosion: Written Materials

by Eugene F. Zelek, Jr., Partner, Marketing Law Group

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Gene Zelek focuses on marketing law, with an emphasis on pricing and channel management, including lawful resale price setting, price signaling and price and promotional discrimination. For more than 20 years, he has helped design, implement and enforce at least 70 successful resale price polices and minimum advertised price (MAP) programs for a variety of B2B and B2C marketers in diverse industries.

Gene's clients include many prominent companies and consulting firms located throughout the world for which he provides antitrust and distribution counseling, as well as assistance with branding, licensing, strategic alliances, vendor relationships, complex contracts and new product development. In addition to frequently writing and speaking, he has been a member of the marketing faculty at the Kellogg School of Management for 25 years, where, among other things, he taught "The Legal Aspects of Marketing Strategy."

After concurrently receiving a law degree *cum laude* from Northwestern University School of Law and a MBA in marketing from Kellogg with Distinction, Gene practiced marketing law at a large international law firm and The Quaker Oats Company. He then became a Quaker product manager before returning to the law.

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Nine Options to Address Problem Discounting

by Eugene F. Zelek, Jr., Partner, Marketing Law Group

A FREEBORN & PETERS CONTEMPORARY LEGAL ISSUES WHITE PAPER

ABOUT THIS WHITE PAPER:

There are a number of methods to deal with problem resale price discounting over the Internet or otherwise. This White Paper highlights nine of them, which may be used individually or in combination to achieve manufacturer goals.

Faced with problem discounting over the Internet or otherwise, manufacturers have used various methods to combat it in the United States, including the following—some of which are not mutually exclusive and all of which can be lawful:

(1) QUIETLY CULLING DISCOUNTERS

Over time, manufacturers simply stop doing business with discounters, so only those resellers that keep prices up are retained.

(2) DISCUSSIONS WITH RESELLERS

Manufacturers may suggest resale prices, provide price elasticity data or otherwise urge resellers to keep their prices up.

(3) FORMALLY RESTRICTING DISTRIBUTION

Using something called "vertical nonprice restrictions," manufacturers can control the amount of reseller overlap and the pricing friction that can go with it by confining resellers to certain geographic or other markets, allocating customers to whom they may sell or restricting what they may sell. For example, all resellers or only certain ones can be banned from advertising or selling over the Internet. The law assumes that these restrictions are lawful, unless proven otherwise, a test called the "rule of reason." As a result, they are commonly used with little legal risk.

(4) SELECTIVELY RAISING PRICES

On the theory that the higher the price charged by the manufacturer, the higher the price charged by the reseller, manufacturers may raise prices generally or just to those likely to discount. As an example of the latter, a manufacturer could increase its prices to every reseller, but provide rebates to those with showrooms, trained salespeople or repair facilities. Since Internet sellers tend to lack these things, they pay more and likely can't cut resale prices as deeply.

(5) DIRECT DEALING

Unless prohibited by contract or applicable reseller protection statute, it is lawful for a supplier to negotiate a price directly with end users and then

Although this area continues to be both complex and evolving, resale price policies are the preferred choice for a comprehensive solution to problem discounting, followed by MAP policies (rather than agreements) and other hybrid approaches.

offer a reseller the opportunity to sell to those end users at that price. If the reseller is willing to do so, there is no agreement on resale price or, at worst, one subject to the rule of reason. If the reseller declines, nothing happens to it, and the manufacturer finds another reseller that will participate.

(6) MAP PROGRAMS

Strictly speaking, under a conventional MAP program, resellers agree to uphold a minimum advertised price (hence, the "MAP" acronym) in return for promotional payments like co-op advertising funds. At the same time, resellers are free to sell at any price they choose or, if they are willing to forego the supplier's promotional funds associated with an ad, resellers may advertise at any price they want in it. Traditional MAP programs are agreement-based, so they are subject to the rule of reason.

(7) TARGET PRICE REBATES

Under this approach, if a reseller sells the manufacturer's products at or above a certain price level or within a particular price band, it receives a rebate. Although not as common as MAP programs, target price rebates also are subject to the rule of reason.

(8) RESALE PRICE POLICIES

Since 1919, it has been lawful for a manufacturer to establish a policy that sets a maximum, minimum or exact resale price (covering both the advertised and actual sales price) and cease selling those resellers that fail to comply. As long as such a policy is unilateral (*i.e.* no agreement is reached with any reseller), it is exempt from the principal federal antitrust statute regarding pricing and even avoids the rule of reason test.

(9) RESALE PRICE AGREEMENTS

As of 2007, federal law applies the rule of reason to all agreements regarding resale price (maximum, minimum or exact), including those that are explicit, implicit or coerced. However, this position regarding minimum or exact prices has been under attack in Congress and by various states, with limited success. Nevertheless, this topic remains a hot button to some.

Although this area continues to be both complex and evolving, resale price policies are the preferred choice for a comprehensive solution to problem discounting, followed by MAP policies (rather than agreements) and other hybrid approaches.

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Stopping Resale Price Erosion

by Eugene F. Zelek, Jr., Partner, Marketing Law Group

A FREEBORN & PETERS CONTEMPORARY LEGAL ISSUES WHITE PAPER

ABOUT THIS WHITE PAPER:

Corrosive price competition between traditional resellers and those with lower costs (like pure online sellers) has eroded resale prices, placing pressure on both brand value and maintaining a diverse reseller mix. This White Paper discusses various lawful means of preventing or controlling such erosion.

Although many manufacturers or suppliers seek a balance between traditional resellers and others with substantially lower costs of doing business (such as Internet resellers or big boxes), corrosive price competition between these intermediaries remains one of the most common causes of channel conflict and the resale price erosion that goes with it. At the same time, there are a number of lawful approaches that a supplier can take to avoid or control this situation.

The Problem

When certain resellers of products (Internet based or otherwise) substantially undercut the prices charged by competing resellers of the same brands, at least some of the latter react by no longer doing certain things that suppliers value to help differentiate their products from those of competitive brands. To cope with diminished margins, resellers subject to intense price competition often drop services, limit inventories or otherwise cut costs. Alternatively, they look to the supplier for extra financial subsidies to help maintain their margins. Unless managed carefully, corrosive price competition not only can erode resale price points and supplier profitability, but also can jeopardize brand value, resulting in commoditization.

Underlying this problem may be the "free-rider effect," where some resellers that have not invested in services or inventories take a free ride on those that do. So, for example, a consumer visits a knowledgeable, full-service dealer to identify what automotive accessory works best for a particular application, but then goes to an Internet reseller to make the buy on price. While the pricing of full-service dealer usually reflects its higher costs, the discounting Internet reseller takes a free ride on these services.

Vertical Non-Price Restrictions

Sometimes, suppliers are their own worst enemies because they sell to anyone and everyone and use no post-sale controls. Vertical non-price restrictions can be used to manage channel conflict by managing the nature and extent of the competition among the supplier's resellers, regardless whether this control is exercised using incentives (carrots) or by contracts (sticks). For the last 30 years, this approach has been commonly used with considerable success and little legal risk in the United States and Canada, as it is judged in the former under the legal standard known as the "rule of reason," where such restrictions are presumed lawful until proven to be unreasonably anticompetitive, while a similar test is used in Canada.

One type of vertical non-price restriction is customer restraints that permit the supplier to allocate customers or customer types among its resellers, effectively telling them to whom they may or may not sell. Another kind is territorial or market restrictions, which designate a geographic area or market for the intermediary and encourage or require it to stay there or keep out. The third type is product restrictions that can: (1) limit the products made available to competing resellers (in general, the supplier does not have to sell all products to all resellers), (2) require that resellers buy the whole line or at least certain core products to avoid cherry picking or (3) prohibit or reduce the reseller's sale of competitive products.

So, for example, a reseller can be prohibited from selling over the Internet or even confined to only that type of selling. Of course, customer and market restrictions can be combined to allocate particular types of end-users to Internet sales. Moreover, the Internet intermediary can be provided with only certain products to further lessen conflict.

Account-Specific Marketing

Suppliers often exacerbate channel conflict by assuming that they must treat all traditional and lower-cost channel members the same or on a "fair and equitable" basis—unrealistic standards that have never been part of the law. Instead, the requirement in the United States under the Robinson-Patman Act is that only competing customers must be treated more or less alike, unless there is a good reason to differentiate.

So, another strategy to cope with pricing and distribution issues over the Internet and otherwise is to develop or refine account-specific marketing programs to compensate resellers for their efforts which are consistent with the supplier's goals. In addition, non-price vertical restrictions can be used to control the amount of overlap so that *competing* customers are treated appropriately.

Careful design of pricing programs can avoid Robinson-Patman issues, as can the use of certain defenses like availability, cost justification and meeting competition. So, for example, if the supplier values technical support or depth and breath of inventory, the conventional reseller providing it may receive a better price than the Internet reseller that does not. Equally important, the supplier can re-allocate its trade spending to deliver the appropriate rewards without an increase in the aggregate spend.

Where a reseller has both a bricks-and-mortar and Internet presence, one solution is for the supplier to provide discounts and other benefits on a weighed-average basis based on the extent to which the reseller wears each hat.

Setting or Encouraging Resale Prices

Sometimes, resellers shoot themselves in the foot when they believe that they have to discount high-value products in order to make sales. For example, Michelin was faced with this problem when a number of its independent dealers believed that, in spite of their greater costs of doing business, they had to price at the level of the big boxes. The company commissioned an elasticity study which demonstrated that because of the high perceived value of the products involved, retail prices could be raised substantially without unacceptable fall-off in sales. Unfortunately, the dealers did not believe the study and continued to look to Michelin for discounts and the like to help keep them competitive. Worse, as the independents dropped prices, the big boxes dropped them more to maintain their discount positioning, something that caused a downward price spiral. Another solution was needed.

Through account-specific marketing or otherwise, suppliers long have influenced resale prices through the prices they charge to their customers, something that may be useful to address corrosive price competition by affecting the minimum resale prices for both traditional and lower-cost resellers. However, the U.S. Supreme Court has made it clear that it can be lawful for the supplier to go beyond this to actually specify the resale price by either contract or policy in order to level the playing field.

Based on recent decisions, U.S. law at the federal level currently applies the rule of reason to maximum, minimum or exact resale prices set by contract and permits them, unless they are shown to be unreasonably anticompetitive. This standard is the same one that applies with minimal legal risk to commonly used vertical non-price restrictions, but has been somewhat more controversial in the United Sates for pricing. Interestingly, Canada amended its competition statute in 2009 to embrace essentially the same concept, regardless how the resale price is set.

An even safer approach in the United States is to set such prices by unilateral policy, a practice allowed for more than 90 years. Here, the supplier typically announces a floor, ceiling or exact price and refuses to sell to any reseller that does not follow it—a practice that is entirely lawful in the United States, provided there is no agreement between the supplier and the customer on resale price levels. In this regard, a reseller that complies is considered not to have made an illegal agreement. As a result of this freedom, many suppliers of attractive branded products have successfully implemented resale price policies to tackle corrosive price competition for such diverse products as appliances, electronics, automotive products and sporting goods on the consumer side and construction products, professional tools and electronic test equipment in industrial markets.

By the way, Michelin adopted a resale price policy to deal with its price erosion issues, becoming the first in the tire industry to do so. Not only did leveling the playing field stop the problem, but sales also *increased*, perhaps because retail prices more closely matched perceived value associated with the brand.

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Another method to control resale prices is for the supplier to negotiate the sale directly with the end user. Here, the supplier may establish a price with the ultimate customer and make it available to a reseller to implement. The voluntary nature of the reseller's participation subjects this arrangement to the rule of reason. Alternatively, the intermediary can be used as an agent for the sale or for order fulfillment. As an agent, the intermediary lawfully can be told by the supplier what price to charge.

Rather than control resale prices, some suppliers prefer to encourage certain pricing behavior, usually by providing some form of discount or allowance. One common version is the Minimum Advertised Price (MAP) program, which pays an advertising allowance to those resellers which do not advertise below the floor price, although they remain free to sell at any price they please. Another variant is the target price rebate, which gives intermediaries rebates for following target prices set by the supplier. Here too, the voluntary nature of these approaches results in rule-of-reason treatment.

Summary

While retail price erosion caused by corrosive price competition between resellers remains a problem for many suppliers, there are a variety of lawful ways to avoid or manage this situation. These include things such as non-price vertical restrictions, account-specific marketing and resale price setting or encouragement, which are not mutually exclusive.

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Establishing and Maintaining an Effective Minimum Resale Price Policy: A *Colgate* How-To

by Brian R. Henry and Eugene F. Zelek, Jr.

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Establishing and Maintaining an Effective Minimum Resale Price Policy: A *Colgate* How-To

BY BRIAN R. HENRY AND EUGENE F. ZELEK, JR.

FEATHERY GOLF COMPANY MANUFACTURES PREMIUM GOLF EQUIPMENT. Through extensive research efforts, The company has developed a new premium golf ball that provides an explosive, high launch for maximum airtime and a high spin rate—hence its trademark, Launch Control®. Feathery's President is concerned that once distribution is expanded to off-course golf specialty shops, Internet retailers, and mass merchandisers, significant discounting will occur and retailers will place pressure on the company to reduce its prices to them. Such discounting would detract from the premium image of Launch Control golf balls, lead to claims of inferiority by tour professionals not sponsored by Feathery and make further investment in new golf equipment technology unattractive to the company. According to Feathery's finance and market research departments, the Launch Control ball must be sold at retail for at least $60 per dozen to achieve the correct market positioning and to recover the company's investment. The Division President asks you, as Feathery's antitrust counsel, for advice on how to lawfully achieve this pricing objective. Where do you begin?

Significant discounting of a product can adversely affect the manufacturer, its resellers and the product itself by eroding brand image, jeopardizing the manufacturer's ability to invest in new technology and product improvements, and discouraging the provision of desirable pre- and post-sale customer support services.[1] An increasingly popular way to address these concerns is through the implementation of so-called "*Colgate* policies"—whereby a supplier, without reaching an agreement, suggests a minimum or exact resale price and refuses to make further sales to any reseller that does not comply.[2] Indeed, many well-known manufacturers have adopted these policies successfully in such diverse industries as consumer electronics, furniture, appliances, sporting goods, luggage, handbags, agricultural supplies, and automotive replacement parts.[3]

While a resale price policy is not a panacea, it can be a powerful and effective tool to curb discounting. Provided that such a policy is carefully designed, implemented, and applied, the legal risk is sufficiently low so as to be acceptable to many companies. The notion that this area is an antitrust minefield is largely driven by high-profile government enforcement efforts against suppliers that knowingly, recklessly, or ignorantly used defective policies, applied them in a sloppy way, or otherwise reached illegal agreements on minimum resale prices.[4] The fact remains that, with little fanfare, many companies have employed resale price policies for years, and new ones have been adopted that achieve the desired results. Indeed, successful policies rarely get attention, except, perhaps, in limited-distribution trade publications. Although no statistics exist on this issue, our experience suggests that there are far more lawful policy successes than illegal failures.

Based on the Supreme Court's language in *Colgate*, resale price policies initially may appear simple to draft and implement. However, much like peeling an onion, their complexity only becomes apparent when the work begins and the layers of real world relationship intricacies must be taken into account. *Colgate* policies are much more than a one-paragraph, lawyer-drafted piece of paper sent out to resellers at the whim of a corporate executive. They involve the delicate implementation of a complex business strategy and program that carries substantial legal and business risks if not done right.[5]

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In the more than eighty years since the *Colgate* decision, there is surprisingly little, if any, practical written guidance to counsel companies considering the adoption of such policies.[6] Based on our collective experience in drafting, implementing, and applying many successful resale price programs in a wide variety of industries, this article attempts to help fill that void.

When Does a Resale Price Policy Make Sense?

Faced with what they deem as unacceptable discounting on the part of resellers, suppliers typically wish to influence resale prices for one or more of the following reasons: (1) protect reseller margins so that desirable pre- and post-sale services and infrastructure can be provided;[7] (2) support brand image (usually a premium positioning) by, among other things, avoiding its use as a loss leader; (3) insure appropriate price levels to facilitate technology development and new product introductions; and (4) level the reseller playing field to avoid destructive channel conflict.[8] Historically, suppliers either simply raised prices to resellers in the hope that resale prices also would move upward or they carefully selected and retained resellers that did not unacceptably discount. Other common methods include minimum advertised price (MAP) programs, target price rebates, and direct dealing by the supplier with consumers or end-users.[9] However, the shifting bargaining power that goes with reseller consolidation and the increased importance of brand positioning, as well as the price transparency of the Internet and the shopping for discounts it encourages, have made the use of minimum resale price policies more attractive.[10]

Internal Business Considerations. In contemplating whether to adopt a *Colgate* policy for one or more products, a pivotal component for success is widespread support and acceptance throughout the supplier's organization, beginning with senior management and including everyone who has contact with affected resellers.[11] As long as proper steps are taken, the legal risks associated with a *Colgate* policy generally are well within a range most business people would find acceptable. At the same time, such a policy certainly is more aggressive than alternatives like MAP programs and therefore may conflict with the supplier's appetite for legal risk or its tolerance for trade relations risk, particularly if the supplier is conservative by nature or is uncomfortable with adopting what essentially is an ultimatum to resellers and actually refusing to do business with those that fail to comply.[12] It also may conflict with the supplier's corporate culture of dealing with resellers in an "easy-to-do-business-with" mode or an "open-door/discuss-anything" manner. Designing and implementing *Colgate* policies require serious commitment and rigor on the part of the supplier. If either is missing, the program is condemned to failure and the legal risks soar.[13]

External Business Considerations. A minimum resale price policy is most likely to be effective if the covered products have brand power, i.e., they have a strong identity and are highly desirable based on quality or other unique or attractive features.[14] If a supplier were to adopt a *Colgate* policy for a product lacking such power, it is probable that a reseller would simply substitute a product from another supplier or even one sold under the reseller's private label. Similarly, a supplier cannot implement a pricing policy as a revenue prop for an inferior product, as customers will simply choose alternatives. At the same time, there usually is a correlation between the perceived value of a strong brand and reseller willingness to discount it by promoting that the reseller sells the well-known product for less. In other words, the very attractiveness of a product that makes it susceptible to discounting also typically makes it a good candidate for an effective minimum pricing policy.

Likely reactions by competing suppliers and resellers also must be considered. For example, other suppliers may encourage a reduction in the resale prices for their products in an attempt to increase market share. In addition, even with brand power, resellers may balk at a policy that establishes an unrealistic resale price, so it is imperative that the supplier thoroughly understands the market and the demand elasticity for the subject products. Perhaps another concern is whether resellers have sufficient inventories of the covered products to enable them to undermine an unpopular policy until the refusal of the supplier to fill new orders for violators catches up with them.[15] Of course, it is not uncommon for at least some resellers to welcome or even encourage the adoption of *Colgate* policies.[16] Finally, reactions of consumers or end-users must be anticipated if they are aware or become aware that the supplier's product is covered by a policy.[17] If the supplier fails to gauge brand strength accurately, use the appropriate minimum price, and accurately predict the reactions of competitors, resellers, and others, it will have engaged in an interesting, but costly, experiment.

What Are the Elements of a Successful Price Policy?

As with any major business strategy, careful planning of a resale price policy increases its likelihood of success. There are five elements to a well-designed policy: (1) an unambiguous business rationale; (2) the description of the scope of the policy; (3) identification of the consequences of a policy violation; (4) analysis of the structure of the current distribution system and, if necessary, undertaking modifications to accommodate the policy; and (5) consideration of ancillary, but important, issues. The supplier's approach to each of these elements greatly impacts how the policy is viewed by the supplier's resellers and its own employees. These are not just good things to consider, but fundamental parts of the business strategy contained in the policy program.

Unambiguous Business Rationale. Many effective policies originate with the goal of establishing or protecting the equity and market position of an exceptional brand or product. There is little incentive for a company or its resellers to spend substantial marketing and development money on new high-quality products only to see them discounted drastically by free-riding resellers, something which also sends unintended and inconsistent marketing messages to potential consumers or end-users.[18] The price to the ultimate customer of the product, along with the brand name, is one of the key measures used to determine product quality. The names Sony, Rolex, and Mercedes convey much more than the general concept of electronics, watches, and automobiles. If a company is going to continue producing high-quality products and expect its resellers to provide exceptional customer purchasing experiences and services, it may legitimately decide that it needs the assurance of minimum reseller margins to justify the investment and induce reseller support.

A solid, genuine business rationale additionally establishes appropriate internal commitment to implementing and enforcing the policy and provides a clear foundation upon which the company is willing to stand if questioned by the trade press and industry analysts. The rationale must be strong enough that the supplier would have no concern with it appearing publicly. Indeed, a pro-active public relations program may be advisable to address trade relations issues or consumer or end-user perceptions, particularly in those industries that have not seen resale price policies before or where there is a significant risk of backlash.

The Scope of the Policy. There are a host of questions to be considered when evaluating policy scope. Should the policy apply to just a single product, an entire product line, all products of a particular brand, or all of the supplier's products? Should it cover all resellers across the United States or only resellers in particular geographic areas? Should it apply to all distribution channels or just to one or more, like the Internet? The scope of the policy must be customized to achieve the stated business objective in light of the practical issues of enforceability and effectiveness.

A critical issue is picking the right floor price for each of the covered products that strikes an appropriate balance among the marketing goals of the supplier, the demand elasticity for each product, and the realistic margin needs of its resellers.

The Consequences of a Policy Violation. Perhaps the single most critical factor bearing on policy effectiveness is a clear and unequivocal statement regarding the consequences of a violation of the policy. Under *Colgate*, the cautious supplier has but one choice with respect to violators—immediate termination of product purchasing privileges with no warnings, no second chances, and no continued shipments in response to assurances of future compliance—regardless of the size of the violator and the volume of its purchases.[19] Indeed, this requirement has resulted in much nail biting on the part of supplier executives over the prospective loss of substantial business. Warnings, second chances, or some form of economic punishment (e.g., denial of access to other product lines, "lost" orders or late shipments) all significantly raise the level of legal risk by providing the opportunity for the supplier and the reseller to reach an agreement regarding the reseller's future pricing or at least foster the notion that some sort of quid pro quo was involved. Moreover, economic punishment can be a means to coerce an agreement.[20]

Most policies state that a violation will result in indefinite lack of direct access to one or more of the supplier's products or imply such duration through silence.[21] Others may state that the reseller's access is denied for some defined period. The policy must not contain any reinstatement provision that requires express or implied assurances from the reseller regarding its future intentions to adhere to the policy. Thus, to avoid an inference of an agreement with a reseller, reinstatement of purchasing privileges, if allowed, should be objectively-based and available to all resellers on a non-discriminatory basis.[22]

Distribution System Analysis. In order to be lawful under *Colgate*, resale price policies must be unilaterally imposed. As a result, the supplier can only apply the policy one level down in a distribution channel. If the supplier sells the products subject to the policy only to resellers directly (sometimes called "one-step distribution"), the one-level-down issue is of no concern. However, if the supplier sells the covered products to some or all resellers through a wholesaler or other intermediary ("two-step distribution"), policy implementation requires some careful thought.[23]

Due to the requirement of unilateral action, a manufacturer cannot lawfully agree with a wholesaler that the latter will either apply and enforce the manufacturer's policy with downstream resellers or that it will impose a policy of its own.[24] Nevertheless, there are several alternative ways to handle two-step distribution depending upon business needs and supplier capabilities.

1. Apply the Policy Only to Firms that Purchase Directly from the Supplier

(a) Only to Resellers—Here, the policy covers only direct-buying resellers, so those that purchase from wholesalers would not be subject to it. Such an approach could be effective if indirect-buying resellers are not discounting or if only a relatively small volume of sales were made through two-step distribution.[25] Otherwise, the policy likely would be too porous to be effective.

(b) Same Policy for Resellers and Wholesalers—A variant on the previous approach is to recommend a minimum resale price irrespective of the position of the reseller in the distribution channel. In this case, both the direct-buying reseller and the direct-buying wholesaler are subject to the same floor price. Consequently, the supplier influences the resale pricing of those that buy from the wholesaler only indirectly by providing a minimum price to the wholesaler that, when combined with the indirect-buying reseller's margin requirements, hopefully will maintain a rough parity with the prices charged by direct-buying resellers.

(c) Different Policies for Resellers and Wholesalers—Another variation is the use of two policies—one for direct-buying resellers and another for direct-buying wholesalers—in an effort to better address the differences between one- and two-step distribution. However, as before, the indirect-buy-

ing reseller's resale price is only indirectly influenced. Moreover, while this option is theoretically possible, it is difficult to recommend a resale price to wholesalers so that, with the addition of the indirect-buying reseller's margin, the resulting resale price is consistently close to the price charged by the direct-buying reseller.

In any of these situations, resale of the covered product at prices even slightly below the recommended resale price may cause destructive channel conflict and raise questions regarding discriminatory policy enforcement. These alternatives also can send inconsistent signals to consumers or end-users.

2. Recast Wholesalers as Agents of the Supplier. The distribution system could be modified so that indirect-buying resellers have a direct relationship with the supplier for each of the products covered by the policy.[26] Wholesalers can be recast to act as sales and delivery agents (being paid a commission to cover selling, warehousing, and delivery expenses, as well as profit) either by handling the covered products on a consignment basis (where the supplier carries the inventory on its books) or, at the time of the reseller order, selling the relevant covered products back to the supplier out of the wholesaler's inventory. In this fashion, all resellers become direct purchasers, even those serviced by wholesalers.

With this option, the supplier must recognize that it is stepping into the shoes of the intermediary with respect to what otherwise would be wholesale sales and thus will be required to organize a direct account relationship, including the provision of credit for its many new direct-buying customers (or, to reduce the credit risk, processing their purchases through the use of third-party credit cards). Of course, any such modification to the distribution system will require complete documentation of the new relationships with wholesalers and resellers.

3. Authorize Wholesalers to Resell Only to Certain Resellers. Under this alternative, the supplier enters into written distribution agreements with each direct- and indirect-buying reseller, as well as with each wholesaler. The authorized reseller agreement covers such things as the reseller's use of the supplier's trademarks and appropriate business practices relating to the resale of the supplier's products, while the wholesaler agreement, among other things, permits the wholesaler to sell only to authorized resellers. Although the supplier issues a *Colgate* policy to each reseller, the reseller and wholesaler agreements are silent on this issue. If an indirect-buying reseller violates the policy (or breaches the authorized reseller agreement), the wholesaler is notified that its customer has lost its authorization for one or more products and can no longer be sold it or them.[27]

Other Important Considerations. Certain factors may operate as an impediment to the use of a resale price policy. For example, the supplier must determine whether there are any contractual constraints to be addressed in drafting or implementing the policy. Do the terms of a written distribution agreement require the supplier to sell all of its products to the reseller? Is there anything else in the contract that would prohibit or limit the use of a resale price policy? Conversely, does the distribution agreement require the reseller to comply with all policies issued by the supplier? If so, that provision will have to be removed from the agreement prior to adoption of a resale price policy to avoid backdooring an agreement to set resale price.

Counsel for the supplier also should consider whether franchise, distributor, or dealer protection or other industry-specific laws affect the ability of the supplier to refuse to continue supplying the covered products to the reseller in the event of a policy violation.[28] In addition, if the product involved is essential and unique to competition with the supplier in a related market where the supplier has market power, these factors may limit its ability to refuse to deal with a reseller.[29] Finally, certain industry-specific laws simply may prohibit the supplier from interfering with resale prices.[30]

How Should a Resale Price Policy Be Communicated?

It is critical that the resale policy document be carefully crafted so as to provide no opportunity for misinterpretation by resellers or the supplier's employees. Moreover, the more unambiguous the policy, the less opportunity for discussions between the supplier and resellers that could convert the policy into something other than unilateral. While other elements may be necessary to address issues in particular circumstances, the following are the primary points that must be addressed:[31]

Policy Rationale. It may be helpful to include a paragraph setting forth the supplier's rationale for adopting the policy. While not mandatory, a clear and legitimate business explanation for the policy can aid reseller understanding and support.

Policy Coverage. The policy must describe each of the products covered, the resellers or distribution channels to which it applies, and the geographic areas involved. It also must include a policy effective date.[32]

Recommended Resale Price. The policy must clearly set forth the recommended minimum resale price for each of the covered products and expressly define each advertisement, offer, or sale below such price to be a policy violation. The policy should also make clear that resellers are free to advertise or sell the product at any price they deem appropriate, but that the supplier will unilaterally enforce its policy.

Definition of "Price." The supplier must also consider how each covered product is sold to the consumer or end-user and address the policy implications of alternative methods by which resellers may offer the product. Should the value of "free" delivery or installation be included in the resale price of the product? How is the resale price determined if the reseller bundles the covered product with other related products and services? Should the product be excluded from "store-wide-10-percent-off sales" or first-time-credit-card-user discounts? What about discounts associated with frequent purchaser cards or discounted sales to employees of the reseller? The supplier must design the policy with an eye toward how the sales behavior of resellers may inadvertently circumvent the policy or purposely game the supplier's program to gain a competitive market advantage or thwart policy operation. The credibility of the supplier and its policy depends greatly on uniform understanding and application of the policy.

Policy Violations. The policy must clearly describe the consequences when a reseller chooses not to follow the policy—the supplier will immediately and unilaterally refuse further shipments. But what happens to the reseller's inventory? The supplier may wish to consider a provision granting it the option to repurchase such inventory in the event of a violation so as to minimize market disruption caused by sales that are almost certain to be below the floor price. To assist the supplier's enforcement efforts, the policy may include an affirmative obligation on the reseller to maintain point-of-sale (POS) transaction records and the right of the supplier to retain an independent auditor to review such records.[33]

Policy Modifications. The supplier should include language that makes it clear that the supplier may at any time modify, suspend, or discontinue the policy in whole or part or designate promotional periods during which the terms of the policy change or are inapplicable. This ability reinforces its unilateral nature.

Antitrust Disclaimer. The policy must include unambiguous language stating that the supplier is not seeking agreement from any reseller to adhere to the policy and that it is entirely within the reseller's discretion whether to comply with the floor price. While the policy might also state that resellers are not to report any policy violations (so as to minimize the appearance of supplier/reseller collusion with respect to another reseller), such provisions are not required and, more importantly, have almost no effect.[34] In all likelihood, the supplier will get flooded with reports of violations regardless of such language. At the same time, some suppliers rely on such reports to find violations, although a number of such complaints inevitably will prove to be untrue when investigated.

Contact Information. The policy should include the name and contact information of the supplier's designated policy administrator as the person to deal with questions, comments, and complaints.[35]

Supplementary Materials. Separate from the policy document itself, many suppliers have found it effective to issue the policy with a frequently-asked-questions (FAQs) document which raises and answers policy-related questions most likely to be posed by resellers. Such a document provides consistent answers and avoids discussions regarding the policy with resellers. Creating FAQs during the policy-drafting phase has the added benefit of highlighting policy application issues that might otherwise not have been considered.

How Can a Supplier Successfully Implement and Apply a Resale Price Policy?

A *Colgate* program is much more than a well-crafted policy statement mailed out to resellers. The policy language is only a small part of a well-designed strategy required to insure its success. The reputational costs of an ineffective policy and the legal expenses associated with an unlawful program can be significant, so as little as possible about the policy should be left to chance. The supplier must be committed to the policy from the top down, must carefully coordinate the program, and must provide realistic employee education. Externally, the organization must be perceived by resellers and other market participants as determined, credible, and non-discriminatory. While a successful program can require months of planning, the benefits to the supplier, the brand, and the covered products can be enormous.

Internal Considerations. Given the complexity and the need for considering multiple interests, the development and implementation of a resale price policy should be managed by a small group of marketing, sales, finance, and legal personnel. In addition to investigating the implications of and crafting the policy, this team must establish: (1) the structure for policy administration, (2) a policy operations plan, and (3) an employee education plan.

1. Who Administers the Policy? The supplier's internal administration of the policy should be centralized to assure uniform application, as well as consistent reporting to senior management. The designated policy administrator, preferably a business person with extensive knowledge of the customer base, is the company's "face" with respect to all policy matters. The designation of a senior executive for this role evidences the company's commitment to implementing and enforcing the policy. It is critical that the designee have the authority or be a part of a small team with the authority to make all policy application decisions. The role of such executive or team is to: (1) insure that all policy documents are consistent with the supplier's objectives; (2) effectively communicate the policy to resellers and, as necessary, to others; (3) coordinate employee education; (4) answer policy application questions; (5) conduct investigations and audits; and (6) make all enforcement decisions.

Use of an inter-disciplinary team assures the inclusion of the perspectives of sales, marketing, and finance in all policy-related decisions. In addition, it is critical that antitrust counsel, whether inside or outside, be assigned to work closely with the administrator or the administration team. In the early stages of policy implementation, it is not uncommon for teams to meet several times each week to consider issues that arise during implementation, but that could not realistically have been foreseen in the planning process.

2. How Are Policy Violations Discovered and What Happens Next? Either the policy administrator or the administration team should develop a complete internal policy operations plan. The plan should contain written protocols for centralizing and handling unsolicited reports of policy violations, conducting investigations, defining the process to be used in determining whether a violation of the policy has occurred, and communicating decisions to resellers regarding the policy. To maintain credibility and avoid unacceptable legal risk, the policy must be enforced uniformly and fairly, and the establishment of written guidelines substantially aids in this effort. Additionally, a policy violation investigation form should be developed to track information regarding alleged violations, including receipt of unsolicited reports of violations, descriptions of investigative steps (such as supplier mystery shops or calls,[36] review of advertisements and invoice audits), recording of decisions made and copies of all purchase authorization withdrawal notices.

Given the market advantage that intentional policy violators can have over those resellers that have chosen to follow the policy, the policy administrator's fax machine will hum with the receipt of copies of advertisements and invoices of alleged violators. Regardless of whether the policy expressly instructs them not to do so, every reseller becomes a self-deputized informant. Resellers have been known to conduct their own mystery shops and even to cajole violations. Indeed, it is not uncommon to receive doctored invoices from a complaining reseller—designed to create the impression that a competitor is violating the policy—accompanied by a demand that the competitor no longer be provided access to the covered product or products. While the supplier may take comfort that the policy is effective, safeguards for handling such requests are required to avoid even the appearance of an unlawful conspiracy.

It is risky from both a legal and business perspective to rely upon reseller reports of policy violations alone. Many companies establish a verification process that does not involve any confrontation of the allegedly offending reseller regarding its sales practices, but instead uses multiple mystery shops or calls and invoice audits to confirm policy violations.[37]

Many large resellers (particularly in the consumer goods arena) have thousands of sales employees, and it is inevitable that unintentional pricing errors will occur.[38] Moreover, the timing and placement of advertisements is far from an error-free process. Particularly with respect to products that are advertised frequently, inadvertent violations can easily result from printer error and go unnoticed by the reseller. It is not illegal for the supplier to unilaterally determine that a formal policy violation has not occurred where a very small fraction of a retailer's sales appear to be inadvertently below the recommended resale price and do not appear to evidence intentional policy violations. However, the supplier risks creating the potentially policy-fatal perception among resellers that the policy is not being uniformly enforced.

Without having any conversations with the reseller regarding its pricing intentions, the supplier must walk a fine line in unilaterally assessing the retailer's intent and making the policy violation determination. In those cases where the available data demonstrates a possible violation, but does not provide adequate clear evidence, some companies simply resend copies of the policy (without any further comment or communication). As a rule, it is important to have as many independent sources of data as is feasible and to document all decisions.

To decrease credibility problems with under-enforcement, a number of suppliers create formal policy audit programs. Such audit programs can take several forms. The most informal is a request to company employees to watch and listen for, but not to solicit, reports of policy violations. A more formal program might include the retention of a marketing research company, accounting firm, or detective agency to conduct mystery shops or calls and field audits of reseller records.[39] The use of outside auditors assures no communication between business teams and resellers in the audit context and provides an independent source of information with which to make enforcement decisions.

Regardless of the investigatory method used, the process needs to move relatively swiftly to avoid creating any reseller perception that the company is not enforcing the policy. The pressure on resellers to lower their prices to compete with local policy violators is significant and their tolerance in waiting for supplier enforcement actions normally is rather limited. The policy will rapidly fail if sufficient numbers of resellers determine that there is little to be gained by following the policy and little to lose by ignoring it.

The policy administrator must also establish a protocol for communications with resellers regarding violations and updates of the policy. The letter exercising the supplier's unilateral right to refuse to continue selling to confirmed violators must be carefully crafted to avoid any suggestion that the supplier is seeking some assurance of future compliance. The supplier must insist that once the letter is sent, there can be no communication with the offending reseller regarding the violation or the reseller's willingness to bring its prices to the level desired by the supplier.

A difficult issue that should be resolved prior to implementation is whether, and at what time, the supplier will unilaterally offer a reseller whose purchasing privileges have been revoked the opportunity to begin purchasing the product or products again. Some companies have policies stating that violators will not again be offered the product for resale for a defined lengthy period, such as one year, following termination. Many do not inform customers regarding the reinstatement policy so as to prevent them from attempting to game the policy by placing enough advance orders to support their selling below the minimum prices for a significant period."

However, under the Sherman Act, reinstatement cannot be linked to any promise by the reseller to comply with the policy in the future. As a result, beyond merely offering the customer the opportunity to once again purchase the product or products (subject to the policy), there must be no communication regarding the reseller's future pricing plans. There is obviously a rather delicate balance between the sup-

Sample Minimum Resale Price Policy

Feathery Golf Company Launch Control® Golf Ball Distribution Policy

Effective January 1, 2004

FEATHERY GOLF COMPANY has determined that in order to better compete against existing premium golf balls and to properly position the Launch Control golf ball in the market, it must exercise a greater degree of control over the distribution of Launch Control golf balls. Therefore, all sales of Launch Control balls will be subject to this Distribution Policy. This Policy has been unilaterally adopted and will be enforced strictly and uniformly.

Although resellers remain free to establish their own resale prices, Feathery will, without assuming any liability, cancel all orders and will indefinitely refuse to accept any new orders from any reseller immediately following Feathery's verification to its satisfaction that such reseller has advertised, offered, or sold any Launch Control golf balls at a net retail sales price less than the minimum retail price established and announced by Feathery from time to time (the "Floor Price").

This Policy applies to first-quality goods only. It does not apply to distressed merchandise and close-outs as clearly labeled by Feathery. This Policy also does not apply during the off-season period of November through January of each year. It may be modified at anytime by Feathery, and the Floor Price may be affected by promotions announced by Feathery or may change during promotional periods designated by Feathery.

The Floor Price effective January 1, 2004, is $60.00 per boxed dozen, exclusive of all state and local taxes. Feathery Golf Launch Control balls may not be sold in quantities of less than one dozen and may be sold only in one-dozen increments.

Feathery will not discuss any conditions of acceptance related to this Policy, as it is non-negotiable and will not be altered for any reseller. In addition, Feathery neither solicits, nor will it accept, any assurance of compliance with this Policy. Nothing in this Policy shall constitute an agreement between Feathery and any reseller that the reseller will comply with this Policy.

Feathery sales personnel have no authority to modify or grant exceptions to this Policy. All questions regarding the interpretation of this Policy must be directed to the Launch Control Distribution Policy Coordinator at 1-555-LCH-CTRL.

plier's desire for revenues and taking the risk that the once-offending reseller will violate the policy again.

3. What Should Supplier Employees Be Told? The need for comprehensive antitrust and policy education of all relevant supplier employees—that is, anyone who has contact with resellers—cannot be overstated. A Section 1 violation can occur any time a company employee has any conversation with a reseller regarding the policy in which it is expressed or can be inferred that the reseller has agreed with the supplier to follow the policy. Thus, beyond educating company employees of the business rationale for the policy, explaining the terms of the policy (including outlining why the policy is lawful), and carefully covering the antitrust risk, the critical education message to each company employee is relatively straightforward and can be easily understood by all:

> YOU HAVE NO AUTHORITY TO DISCUSS THE TERMS OR APPLICATION OF THE POLICY WITH ANY CUSTOMER. YOUR FAILURE TO ADHERE TO THIS RULE WILL AUTOMATICALLY RESULT IN DISCIPLINARY ACTION. ALL CUSTOMER QUESTIONS REGARDING THE POLICY MUST BE DIRECTED TO THE POLICY ADMINISTRATOR.

All sales, customer service, finance, marketing, credit, and management personnel (along with new employees as they join the company) must be given this message repeatedly through group meetings, written guidelines, wallet or pocket cards, e-mail reminders, and the like. Supplier personnel (other than the policy administrator) should never have any communication with any violator regarding termination. Sales people must understand that it is not their job to explain, police, or intervene in the operation of the policy, and that they can be disciplined if they try to do so.[40] At the same time, the customer service department must be prepared for calls from consumers or end-users with questions as to why they are unable to purchase the product at a discounted price.

External Considerations.

1. How Will Covered Resellers React? Particularly with respect to product lines and industries in which resale pricing policies are uncommon, a supplier introducing a resale price policy will likely be viewed with great suspicion or scorn. Indeed, a common reseller refrain—until they talk to their own antitrust counsel—is: "You can't do that; it violates the antitrust laws."[41] The supplier's communications with customers and the industry must therefore clearly convey the business rationale for the policy, confidence in the legality of the policy, and a determination to apply it in an even-handed fashion.

Suppliers considering resale price policies should recognize upfront that a unilateral decision to adhere to the policy may not be an easy one for some of its resellers. They may view it as the supplier's unwelcomed intrusion in their business operations and simply refuse to purchase the product subject to the policy. Others may operate on "everyday-low-pricing" models with pre-existing marketing representations to customers that preclude them from placing a margin of more than a certain percentage on the purchase price of the product to the reseller. Suppliers must account for the potential of lost sales to such resellers in evaluating whether to adopt a policy.

While suppliers cannot reduce this burden other than by giving resellers sufficient advance notice of policy adoption (which is a good idea anyway), suppliers should recognize that some resellers may have an enormous employee education effort confronting them if they choose to follow the policy. Large distributors, mass merchandisers, and club stores may have thousands of employees (and often a high employee turnover rate), who need to be educated on the policy, the reseller's position with respect to the policy, and the implications of their failing to comply with their employer's decision to adhere to the policy. It is the reseller's obligation alone to undertake that educational effort. Indeed, it could be a Sherman Act violation for the supplier to take on that role, other than providing copies of the policy and explanatory materials.

The supplier must also anticipate receiving pleas from resellers whose purchasing privileges have been terminated for reinstatement with assurances that they would adhere to the program "if only they were given another chance." It is critical that the business team understand at the outset that such letters will be received and that the supplier simply has no choice but to continue to refuse sales to that customer. Indeed, once such unsolicited assurances are received, it is questionable whether the supplier can legally ever reinstate the reseller even if the supplier has an automatic reinstatement plan in place, unless the supplier or its counsel immediately responds to such assurances in writing by refusing to accept them and emphatically stating that they will not be taken into account in the supplier's unilateral decision making.

2. Should the Supplier Affirmatively Publicize the Policy? Beyond distributing policy information packets to its customers, some suppliers invite or submit to trade journal interviews relating to the policy. While the interviewees must spend substantial time with antitrust counsel preparing for such interviews, such communications can minimize the cloud of mystery that can surround the policy in its early stages of implementation. To avoid the risk of awkward responses to interview questions, some opt to issue press releases. Such public dissemination of policy information can have the positive effect of decreasing fears over the company's intentions and conveying the supplier's commitment to implementation. Antitrust counsel should monitor such communications to prevent any misimpressions.

Conclusion

Minimum resale price polices can be an extraordinarily powerful tool to protect the viability of products, brands, resellers, and suppliers. However, they are complex and time-consuming to develop and may not be practical or effective for every type of product or market. At the same time and while the margin for antitrust error is narrow, the legal risk can be managed to a level that many companies find acceptable through careful policy establishment, implementation, and application. ■

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[1] For purposes of this article, a "reseller" is anyone that takes title to a product and resells it for its own account, including such intermediaries as distributors, dealers, and retailers. (While wholesalers also could be resellers, we discuss them separately later, but do not refer to them as resellers to avoid confusion. *See infra* note 24.) Agents, brokers, and sales representatives are excluded not only because they do not take title, but also because they are extensions of the supplier, which typically controls the prices charged. In addition, "supplier" and "manufacturer" are used interchangeably, although an intermediary could function as a supplier to subordinate members of its distribution channel.

[2] Section 1 of the Sherman Act, 15 U.S.C. § 1, "does not restrict the long recognized right of a trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell." United States v. Colgate, 250 U.S. 300, 307 (1919). Such circumstances may include "suggesting" resale prices, then refusing to do business with any customer that doesn't comply, as long as there is no agreement on maintaining the suggested price. *Id.* at 307–08; Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752, 761 (1984). *See also* Federal Trade Commission (FTC), *Promoting Competition, Protecting Consumers: A Plain English Guide to Antitrust Laws, Frequently Asked Questions* (second question), http://www.ftc.gov/bc/compguide/question.htm. Section 1 does not apply because unilateral policies, by definition, do not meet the statute's jurisdictional requirement of a "contract, combination . . . or conspiracy." As a result, neither the rule of reason nor the per se test are relevant. However, if an agreement on resale prices were present, such an agreement would be judged under the rule of reason if it were for maximum resale prices and the per se rule for minimum or exact resale prices. *See infra* note 10. Under state law, there has been no successful challenge to such policies. *See, e.g.*, Chavez v. Whirlpool Corp., 113 Cal. Rptr. 2d 175 (Ct. App. 2002). In the interest of space, our analysis of the development of the law in this area is necessarily brief. For a discussion of *Colgate* and its progeny, *see* William C. Holmes, Antitrust Law Handbook § 2.15 (2003). Note that such policies and vertical price setting in general are unlawful in Canada, Competition Act, R.S.C. ch. C-34, § 61(3) (1985), and in certain other jurisdictions outside the United States.

[3] Most policies seem to involve higher-end consumer products (both durables and non-durables), but industrial suppliers also have found them useful.

[4] Unfortunately, programs that ostensibly are illegal tend to surface primarily in consent orders and decrees, which usually are short on a description of the facts and analysis of the relevant law. *See infra* notes 5 and 13.

[5] Although not involving a resale price policy, the manufacturer of George Foreman grills is the most recent addition to the list of suppliers that apparently have crossed the line and entered into illegal express or implied resale price agreements with resellers when what was characterized as its minimum advertised price (MAP) program seems to have gone too far. *See* State of New York v. Salton, Inc., No. 02 Civ. 7096 (LTS), 2003 WL 21254723 (S.D.N.Y. May 30, 2003) (settlement of enforcement action joined by 47 states, the District of Columbia, and Puerto Rico alleging manufacturer coercion by forcing retailers into agreements to fix the retail prices). For additional background, see the Web site of the National Association of Attorneys General (NAAG), which includes the Amended Complaint, the Settlement

Agreement, the Final Judgment and Consent Decree, and other significant documents, at http://www.naag.org/issues/20020909-multi-salton.php. MAP programs are discussed *infra* at note 9.

[6] The authors are aware of no published articles or conference materials that address in depth the practical aspects of the design and implementation of a *Colgate*-permitted policy. Case law in this area is helpful overall, but tends not to address the nuts-and-bolts issues. As previously noted, consent orders and decrees usually present rather limited facts and even a more limited discussion of the law. (A number of relevant orders and decrees are found *infra* at note 13.) Presentations made by government officials are useful for conveying their perspectives, but there are relatively few speeches to consider. Two examples of such presentations are Commissioner Sheila F. Anthony, Vertical Issues in Federal Antitrust Law, Address at the 13th Annual Advanced ALI-ABA Course of Study, (Mar. 19, 1998), transcript *available at* http://www.ftc.gov/speeches/anthony/aliabaps.htm; and Commissioner Christine A. Varney, Vertical Restraints Enforcement at the FTC, Address at the ALI-ABA Eleventh Annual Advanced Course on "Product Distribution and Marketing" (Jan. 16, 1996), transcript *available at* http://www.ftc.gov/speeches/varney/varnmg.htm. Ms. Anthony currently is an FTC Commissioner, while Ms. Varney is not.

[7] Such services and infrastructure may include such things as product demonstrations, repairs, showrooms, highly trained salespersons, and extensive on-site inventory.

[8] Destructive channel conflict occurs when resellers spend so much time fighting among themselves for sales of the supplier's brand ("intrabrand competition") that they fail to compete sufficiently with other brands ("interbrand competition").

[9] With MAP programs and target price rebates, the reseller receives a financial incentive from the supplier (usually in the form of a rebate or allowance) to advertise prices at or above minimum levels or, in the case of target price rebates, to sell at a specified price or within a price range. Like most promotional programs, reseller participation is voluntary and, for that reason, such approaches are governed by the rule of reason. *See* 6 Trade Reg. Rep. (CCH) ¶ 39,057 at 41,728 (FTC May 31, 1987)(MAP programs); *see also* Sony Music Distrib., Inc., [1997–2001 FTC Complaints and Orders Transfer Binder] Trade Reg. Rep. (CCH) ¶ 24,746 (Aug. 30, 2000) (consent order in which five major suppliers agreed to drop their MAP programs, allegedly because they collectively eliminated price competition). Of course, such incentives also are subject to the Robinson-Patman requirements of the Clayton Act, 15 U.S.C. § 13. The voluntary nature of these approaches means that, unless the financial incentives are sufficient, the reseller will refuse them if it can make more profit through the increased volume associated with discounting. Moreover, MAP programs address the advertised price only, so the reseller may pocket the incentive and still sell at a discounted price. In direct dealing, assuming that there are no contractual or regulatory impediments, the manufacturer bypasses the intermediary to negotiate price or sell directly to the ultimate reseller or customer (or converts the reseller into an agent) and thereby sets the price. For a discussion of the various alternatives to affect resale prices, see Eugene F. Zelek, Jr., *The Legal Framework for Pricing*, in THE STRATEGY AND TACTICS OF PRICING 376–78 (Thomas T. Nagle & Reed K. Holden, 3d ed. 2002).

[10] Although *Colgate* policies can be used to suggest maximum, minimum, or exact resale prices, their primary use is in establishing minimum or "floor" prices. By far the most common business concern in this area is price discounting. In those instances where a supplier believes that resale prices are too high, the Supreme Court in *State Oil Co. v. Khan*, 522 U.S. 3 (1997), provided another tool by holding that the rule of reason, rather than the per se test, applies to agreements that set maximum resale prices. Except for the fact that they allow no pricing variation at all, exact resale price policies are conceptually the same as minimum price policies. After *Khan*, a resale price policy that sets a maximum price is subject to the rule of reason if, due to the way it is implemented or otherwise, the policy steps over the line and becomes an express or implied agreement on resale prices. However, a policy regarding minimum or exact prices that is or becomes an agreement is per se illegal. *See, e.g.*, Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752, 761 (1984).

[11] Buy-in at all levels is essential, including the sales force. *See infra* note 40.

[12] The conduct of some companies is closely watched due to their prominence, industry, or large market share. While the law permits them to compete, they typically are more cautious about throwing their weight around. Moreover, another risk factor is regulator efforts to narrow *Colgate* or make it go away. For example, in *Russell Stover Candies, Inc.*, [1979–83 FTC Complaints and Orders Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,933 (1982), *rev'd*, 718 F.2d 256 (8th Cir. 1983), the FTC launched a frontal attack on *Colgate*, but was rebuffed by the appellate court.

[13] While policies can be changed or dropped at any time by the supplier, special deals and secret exceptions tend to support the notion that the policy is based on illegal agreements, rather than being unilateral. There also is the issue of supplier integrity, or as one of our clients has said, "Never implement a program that you are not prepared to enforce against your biggest customer." A number of consent orders and decrees illustrate the consequences of ignoring *Colgate* or attempting to skirt it and falling into the trap of illegal resale price agreements. *See, e.g.*, FTC v. Onkyo U.S.A. Corp., 1995-2 Trade Cas. (CCH) ¶ 71,111 (D.D.C. 1995) (action for civil penalties for violation of FTC Order, 100 F.T.C. 59 (1982)); Nine West Group Inc., [1997–2001 FTC Complaints and Orders Transfer Binder] Trade Reg. Rep. (CCH) ¶ 24,707 (Apr. 11, 2000); Reebok Int'l, Ltd., [1993–1997 FTC Complaints and Orders Transfer Binder] Trade Reg. Rep. (CCH) ¶ 23,813 (July 18, 1995); United States v. Playmobil USA, Inc., 1995 WL 366524 (D.D.C. May 22, 1995); Keds Corp., [1993–1997 FTC Complaints and Orders Transfer Binder] Trade Reg. Rep. (CCH) ¶ 23,463 (Apr. 1, 1994); Nintendo of Am., Inc., [1987–1993 FTC Complaints and Orders Transfer Binder] Trade Reg. Rep. (CCH) ¶ 22,968 (Apr. 10, 1991). *See also Salton*, *supra* note 5 (multistate enforcement action claiming illegal conduct in implementing and conducting a MAP program for Salton's George Foreman grills by improper agreements with retailers to fix prices and coercion of retailers beyond a refusal to deal).

[14] Prestige products—those that sell better at higher prices because they include status, exclusivity, and personalized customer attention in addition to the physical product—are particularly good policy candidates. Indeed, consistently high prices are a vital attribute of prestige goods and are demanded by consumers or end-users who can conspicuously consume. *See* George Ackert, *An Argument for the Exempting of Prestige Goods from the Per Se Ban on Resale Price Maintenance*, 73 TEX. L. REV. 1185 (1995).

[15] Another factor which may frustrate a resale price policy is the diversion of the covered products from markets where the policy does not apply to places where it does, making it important for a supplier to determine beforehand whether the necessary distribution system safeguards are in place to facilitate a successful resale price policy.

[16] In *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 726–27 (1988), the Supreme Court made it clear that suppliers may listen to and even take action based on reseller complaints about the prices charged by other resellers, as long as there is no evidence that the supplier agreed on resale prices with the complaining reseller. Of course, the supplier must be careful to avoid becoming part of an illegal agreement among resellers. *See, e.g.*, United States v. General Motors Corp., 384 U.S. 127 (1966) (agreement between supplier and resellers to cut off resellers that support discounting).

[17] The plaintiffs unsuccessfully claimed in *Chavez* that Whirlpool's minimum resale price policy on KitchenAid dishwashers not only violated California's antitrust statutes, but also was deceptive because its presence was not disclosed to consumers. *See Chavez*, 113 Cal. Rptr. 2d at 178. Of course, sophisticated consumers or end-users may recognize that a pricing policy of some sort is in effect when shopping efforts reveal pricing uniformity or similarity regardless of the reseller or its location, particularly in the Internet age. The likely reactions of other "publics" (such as political or industry activists) also may warrant consideration.

[18] Such discounting may place pressure on the supplier to lower its prices to full-service resellers so that they have sufficient margin to compete against the discounters. However, an overall reduction can rapidly cause prices to spiral downward, as long as discounters continue to underprice other resellers. Apart from resale price policies, the supplier could offer the full-service resellers discounts and allowances to compensate them for the valuable services they provide and the discounters do not. However, a price cut

by the supplier or an increase in allowances erodes the supplier's margin, unless it raises prices to every reseller first, then offers the allowances.

[19] *See, e.g.*, United States v. Parke, Davis & Co., 362 U.S. 29 (1960) (unlawful assurances) and the consent orders and decrees cited *supra* note 13. It may be possible to take steps short of cutting the non-complying reseller off at the knees, such as withdrawing advertising support dollars as an initial response to a violation, with the loss of one or more products to follow if the offending conduct continues. However, at least one enforcement official raised the concern that such a so-called "structured termination" offers the opportunity for discussions which could lead to illegal agreements. Varney Speech, *supra* note 6 (citing Reebok Int'l, Ltd., [1993–1997 FTC Complaints and Orders Transfer Binder] Trade Reg. Rep. (CCH) ¶ 23,813 (July 18, 1995) (consent order where, among other things, Reebok was "fenced in" from using such terminations). Nevertheless, the opportunity for discussions alone is not unlawful, and a case, such as *Acquaire v. Canada Dry Bottling Co.*, 24 F.3d 401, 411 (2d Cir. 1994) (upheld supplier practice of obtaining confirming wholesaler and reseller signatures on pre-printed forms containing suggested resale prices to be charged by wholesalers), seems to indicate that the supplier may go quite far and still avoid an illegal agreement. *But cf.* Russell Stover Candies, Inc. v. FTC, 718 F.2d. 256, 260 (8th Cir. 1983) (discussing the "Doric simplicity" required under *Colgate*). Given the uncertainty in the area and the chances for misstep, the one-strike-and-you-are-out approach still is the most prudent.

[20] *See, e.g.*, Simpson v. Union Oil Co., 377 U.S. 13 (1964) (control of leases to coerce compliance); Lowell v. American Cyanamid Co., 177 F.3d 1228 (11th Cir. 1999)(coercive pricing incentives); DeLong Equip. Co. v. Washington Mills Electro Minerals Corp., 990 F.2d 1186 (11th Cir. 1993) (threatened termination coupled with secret rebates to a competing reseller to punish plaintiff for non-compliance); Isaksen v. Vermont Castings, Inc., 825 F.2d 1158 (7th Cir. 1987) (threats to "mix up" orders). *See also Acquaire*, 24 F.3d at 410 ("[E]vidence of threats of termination or other explicitly coercive conduct that secure adherence to fixed prices is what supports 'a finding of an illegal combination.'"). At the same time, promulgating a resale pricing policy is not considered coercive, and reseller compliance with it alone is not deemed to be an agreement. *See Russell Stover*, 718 F.2d at 258–60.

[21] The policy may state that its violation results in the loss of the product or products with respect to which the violation occurred, an entire product line, or all of the supplier's products. With respect to the last alternative, *see infra* note 28.

[22] Such an approach is easier to defend over one that makes seemingly arbitrary decisions. At the same time, it should be kept in mind that, under *Colgate*, it is within the supplier's prerogative to decide with whom it will deal for whatever reason it deems appropriate, as long as there is no agreement.

[23] This discussion will address only one-step and two-step distribution. If there are more than two layers, the issues become even more complex.

[24] *Spray-Rite*, 465 U.S. at 768 n.13; *Parke-Davis*, 362 U.S. at 45–46. For purposes of this discussion, the term "wholesaler" will be used to describe the intermediary that purchases directly from the supplier and sells to certain resellers, referred to here as "indirect-buying resellers."

[25] One of our clients addressed the two-step problem with a practical twist on this approach. It sold the covered products only to direct-buying resellers, while selling higher-priced assortments not covered by the policy to wholesalers.

[26] *See, e.g.*, Ozark Heartland Elecs., Inc. v. Radio Shack, 278 F.3d 759, 762 (8th Cir. 2002) (Radio Shack and Primestar did not engage in illegal price fixing by setting the fees that Radio Shack dealers were to charge when acting as agents for sales of Primestar satellite television systems).

[27] Under this option, the supplier remains two steps removed from the sale to the ultimate consumer or end-user. As a result, it may have less ability to monitor and quickly react to sales activity at this level.

[28] For example, pulling all the supplier's products in the event of a policy violation may be tantamount to termination of the reseller relationship. Many states have franchise, distributor, or dealer protection laws that restrict the ability of the supplier to do so, although such laws often apply to certain industries only (e.g., motor vehicles, agricultural equipment, and alcoholic beverages). At the same time, some states, like Wisconsin, have statutes of general applicability. *See* Wisconsin Fair Dealership Law, WISC. STAT. § 135. To the extent that such laws apply, it may be prudent to continue the relationship with some products, although Wisconsin law also prohibits changing the reseller's "competitive circumstances" without cause. *Id.* § 135.03. Regardless of the presence of protective laws, termination of the business relationship with a reseller may result in litigation. Whether as part of a complaint or a counterclaim and regardless of the merits, a supplier should anticipate that its resale price policy may be called into question and should take every reasonable step to make sure that it will withstand scrutiny.

[29] *Compare* Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451 (1992) (Kodak's discontinuance of independent repair service access to allegedly unique repair parts may have illegally tied the parts to the repair services market in which Kodak competed) *with* Intergraph Corp. v. Intel Corp., 195 F.3d 1346, 1357 (Fed. Cir. 1999) (Intel's refusal to continue supplying chips to a customer upheld where such chips were for use in a market where Intel did not compete).

[30] For example, a number of states prohibit or appear to prohibit beer suppliers from interfering with the prices charged by their wholesalers. *E.g.*, ALA. CODE § 28-8-3; ARK. CODE § 3-5-1107; TEX. ALCO. BEV. § 102.75.

[31] Accompanying this article for reference is a simplified policy example labeled "Feathery Golf Company Launch Control Golf Ball Distribution Policy."

[32] Adequate advance notice is usually a good idea so that resellers can make appropriate adjustments to their businesses, particularly due to lead times in advertising and catalog production.

[33] Although POS data is historically more readily available for consumer products due to the prevalence of checkout scanners, industrial suppliers are increasingly encouraging or requiring the everyday provision of such data by their resellers.

[34] *See supra* note 16.

[35] See the next section for a detailed discussion of the role of the policy administrator.

[36] A "mystery shop" or "mystery call" is when a supplier or reseller sends a person to visit or call a reseller to determine the price at which a product is offered or sold or other aspects of the way business is conducted. While suppliers may employ this technique as part of enforcing a resale price policy program or otherwise, resellers frequently use it on themselves for quality control purposes or on competitors for comparison.

[37] According to the *Chavez* court, "Just as the announcement of a resale price policy and refusal to deal with dealers who do not comply is permissible, measures to monitor compliance that do not interfere with the dealers' freedom of choice are permissible. To hold otherwise would render the manufacturer's announced policy ineffective and undermine rights protected by the *Colgate* doctrine, and could also result in the mistaken and arbitrary termination of dealers. By monitoring the dealers' compliance without forcing compliance or seeking or receiving communication of their compliance, a manufacturer permissibly exercises its right to select with whom to do business and on what terms." 113 Cal. Rptr. 2d at 182–83.

[38] By the same token, we know of a situation where a large reseller responded to a resale price policy by denying any responsibility for the sales conduct of its employees. The supplier tactfully rejected this attempt to dodge the policy.

[39] Note that some states have statutes containing language so broad that they could be read to require that mystery shops be conducted only by licensed private detectives. *See* CAL. BUS. & PROF. CODE § 7521; TEX. OCC. § 1702.104.

[40] Some sales people, particularly those whose compensation is based at least in part on reseller purchases, seem to be susceptible to "Stockholm Syndrome," in which they come to identify strongly with their reseller customers. Controlling what sales people say and their willingness to avoid interfering with the operation of the policy are critically important. Moreover, in some cases, the compensation program may have to be modified.

[41] Sometimes resellers persist in making this claim even after they talk with their counsel.

Legal Tools that Support Value Pricing

by Eugene F. Zelek, Jr., Partner, Marketing Law Group

A FREEBORN & PETERS CONTEMPORARY LEGAL ISSUES WHITE PAPER

ABOUT THIS WHITE PAPER:

"Price is what you pay. Value is what you get." - Warren Buffett

Value pricing can be a successful means to maximize profit by pricing products and services based on their value to end users. Using this approach necessarily means that customers are segmented, with some receiving better prices than others. However, many companies mistakenly believe that U.S. law requires that all customers receive the same price or a "fair and equitable" price, an unrealistically high standard that is a self-imposed roadblock to value-based differentiation.

Not only is the law supportive of segmentation and the economic discrimination that goes with it, but, where resellers are involved, the law also permits value pricing to be facilitated and preserved through the use of non-price vertical restrictions and resale price setting. In addition, price signaling can be a lawful way to avoid sending the wrong messages to the marketplace that jeopardize value pricing strategies.

Consistent with an unparalleled amount of pricing freedom under current law in the United States, there are four powerful and lawful tools that can help achieve and maintain prices based on value. The first is economic discrimination, which is useful in recognizing relative value, while the other three assist in facilitating segmentation or preserving value—non-price vertical restrictions, resale price setting and price signaling.[1] The last two often scare the daylights out of businesspeople and their lawyers who are not familiar with this area.

Value Pricing

For purposes of this paper, value pricing will be defined as pricing services or products based on their value to end users. By looking at things from the end user's perspective, pricing opportunities can be readily identified, and a marketplace reality check is built into the process, as end users are willing to pay only so much. Of course, this focus does not mean that other factors should not be taken into account in determining prices, such as (1) the supplier's financial and other goals, (2) the competitive landscape, (3) regulatory parameters, (4) trade relations and end user relations issues and (5) the sales path. The last consideration has significant implications for value pricing.

The Sales Path

To view value pricing in context, it is important to understand the relevant sales path. Services are typically provided directly by the supplier to end users. So, for example, Verizon is a supplier of cellular phone services, while Southwest Airlines provides air travel services. Sales and follow-on service may be furnished directly or through agents, such as Best Buy acting as an agent for Verizon. Agents usually work on a commission that is a percentage of the selling price, with the price generally determined by the supplier.

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[1] For convenience, this White Paper is written primarily from the perspective of the service supplier or the manufacturer, but much of it is relevant to resellers that wish to engage in value pricing or wish to encourage manufacturers to do so. In addition, this paper focuses on the parameters under the antitrust laws of the United States at the federal level. State law tends to be essentially the same, with some exceptions. *See, e.g.,* notes 9 and 32 *infra*. The laws of other countries vary, with those of Canada perhaps the closest to those in the United States. While competition law in the European Union has evolved to embrace certain standards conceptually similar to those of the United States, it remains different in key respects, such as regarding resale price setting. *See, e.g.*, Lothar Determann and Bill Batchelor, *Revised Competition Rules for Online and Offline Distribution in European Union*, 99 Antitrust & Trade Reg. Rep. (BNA) 478 (No. 2471, Oct. 10, 2010).

Like services, products may be sold and serviced directly by manufacturers to end users or through agents. But more importantly, products often are sold and serviced through resellers that take ownership to the products and resell them for their own accounts. Rather than a commission, resellers are compensated for the functions they perform on the difference between their buy price and the street price paid by the end user.[2] Depending on the industry, such resellers may be referred to as wholesalers, distributors, dealers, value-added resellers (VARs) or retailers. For example, Deere & Company sells agricultural equipment through dealers, while Kellogg sells food products to retailers and to foodservice distributors for resale, as well as providing industrial food products directly to other food processors.[3]

To apply value pricing analysis, the value to the end user (*i.e.*, in the examples just mentioned, the farmer, consumer, foodservice operator or industrial user) must be ascertained, usually by asking, either directly or through formal marketing research. Then, the trick is to deliver the value, something that typically is easier in direct sales or through agents due to the degree of control inherent in the relationship.[4] The fact that resellers have more independence makes it somewhat more complicated to deliver value through them.

The Stakes

For the sale of services and the direct sale of goods, the value is simply the street price or what the end user is willing to pay. The illustration appearing below shows sales made directly by a supplier of a single service or product. If all sales were made at list price, total revenue to the supplier would be $90 million. However, because the street price is less, revenue is $63 million, representing the aggregate value.[5]

The Stakes: Sale of Services and Direct Sale of Goods

[2] Both the buy price and the street price are net prices, *i.e.*, after all discounts, allowances, rebates, free goods, credits and the like. For consumer products and services, the street price is the retail price, but the term "street price" will be used throughout this paper.

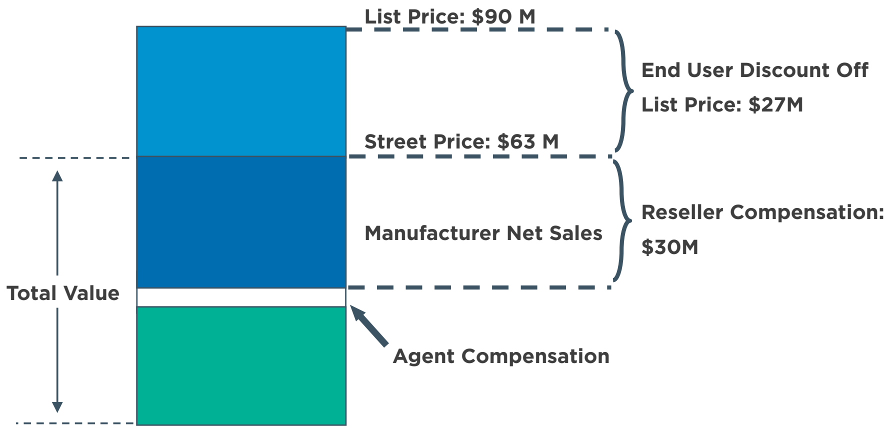
[3] Of course, it is possible for a manufacturer to sell directly or through agents to some end users, while simultaneously using either agents or resellers or both to reach others. Alternatively or in addition, the manufacturer may use multiple layers of intermediaries before some or all end users are reached. This White Paper assumes that there is either a direct manufacturer/end user relationship or a path that only uses one reselling intermediary between the manufacturer and the end user. However, the approach described here also can be applied to different or more complex sales paths.

[4] Among other things, the supplier's employees and agents for legal purposes are considered to be part or an extension of the supplier. So, sales made by such employees and agents are deemed to be made by the supplier.

It obviously is in the best interest of the supplier to increase the street price, as this result puts more money in its pocket. If an agent—like an independent sales representative or broker—is used, its commission or other compensation does not affect street price, but is paid by the supplier from its revenue.

When products are sold through resellers, the picture changes. In the illustration below, the list price and street price are the same as the previous example. However, this time the manufacturer splits the value or street price with its resellers to compensate the latter for what they do, so the $63 million in value is divided between that received by the manufacturer ($33 million) and what the resellers get ($30 million).[6] If the manufacturer uses agents, their commissions still come off the manufacturer's share.

The Stakes: Sale of Products Through Resellers



Often, manufacturers see their resellers as their customers and stop the analysis there. However, the real focus should be on the end users, because they ultimately determine the street price and value. Just as important, the price paid by each reseller allocates revenue and profit between the manufacturer and the reseller. Moving the reseller's buy price up or down changes the way the value pie is cut.

It also is possible to increase the aggregate street price (or the size of the pie) through value pricing, whether achieved by the manufacturer, the reseller or both. All other things being equal, if the manufacturer sees the reseller as its customer and isn't paying attention to the street price, any increase in the street price is retained by the reseller. Any decrease in street price—perhaps due to real or imagined competitive pressure—often results in the reseller asking for price concessions from the manufacturer to maintain the reseller's

[5] This example is based on a real-life situation. Note that this analysis could be done for different products, particular markets, competitive suppliers, the industry as a whole or any combination. In many industries, manufacturers negotiate prices directly with end users or end user buying groups, effectively selling directly, even if one or more resellers handle the logistics. *See* note 38 *infra*.

[6] In the event an intermediary (such as a wholesaler) sells to another reseller (like a retailer), the value is further divided.

margin. By ignoring the street price, the manufacturer cedes management of it to the resellers, and smart resellers take advantage of this position, as they should.

At a minimum, the smart manufacturer should monitor the street price and periodically adjust the reseller's buy price, if necessary, to maintain a split that provides the reseller with an appropriate margin to the cover the costs of what it is expected to do and its profit.[7] However, it is even better for the manufacturer to engage in value pricing by taking a direct role in managing both the street price and the split. Just as value pricing recognizes the different relative values that end users ascribe to the product, the manufacturer can reflect in its pricing to resellers the relative values they bring to the table that support end user value. In other words, recognizing and rewarding the value provided by the reseller can be used to help achieve value pricing to the end user.

Recognizing Value

Depending on how the supplier sells, optimizing street price necessarily involves value-based segmentation of end users, resellers or both. As a result, there will be discrimination in price, as not all customers will pay the same. A common myth among U.S. businesspeople is that the law requires all customers to receive the identical price, with maybe a bit of leeway for higher-volume purchasers, something that is implicit in the common use of the term "fair and equitable" as a pricing parameter. The reality is far different under the federal law addressing economic discrimination, known as the "Robinson-Patman Act."[8]

First, this statute does not apply to the sale of services, just goods.[9] Moreover, only goods sold on a business-to-business (B2B) basis are relevant.[10] So, for example, price discrimination among users of cellular phone services or air travel is not covered, nor are the different prices consumers pay for the identical vehicle at the same auto dealer.[11]

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7 If there is too much margin, the reseller frequently lowers the street price, something that puts the value-based price at risk. This behavior occurs because, once resellers are making a profit acceptable to them, they typically wish to gain ground on competitive resellers. At the same time, if the reseller does not have sufficient margin, it will cut back on what it provides (such as depth and breadth of inventory and support), which may be the very things that the manufacturer wishes the reseller to offer in order to differentiate the manufacturer's products and provide the value the end user expects. See John B. Henderson, Pricing Strategy: How to Design and Implement Effective Channel Pricing, Frank Lynn & Associates, Inc. Workshop (December 8, 2011). For a description of this approach, see http://www.franklynn.com/resources/?t=2540&st=3875&sst=452.

8 15 U.S.C. § 13. Section 2(a) deals with price discrimination, while Sections 2(d) and 2(e) address promotional discrimination. Id. §§ 13(a), (d)-(e). In 1936, the Robinson-Patman Act amended the anti-discrimination provisions of the Clayton Act, and this area of the law has come to be referred to by the name of the amendment. "Fair and equitable" does not appear in the statute or, to the knowledge of the author, in any case. It seems to have evolved as shorthand for the obligations under law, but vastly overstates them. For a more detailed discussion of the operation of the Robinson Patman Act, see Eugene F. Zelek, Jr., *The Legal Framework for Pricing, in* Thomas T. Nagle, John E. Hogan and Joseph Zale, The Strategy and Tactics of Pricing 315-20 (5th ed. 2010) and William C. Holmes and Melissa H. Mangiaracina, Antitrust Law Handbook 543-625 (2010-11 ed. 2010). Although often overlooked, the Robinson-Patman Act also applies to sales by resellers made in interstate commerce.

9 *Metro Communications Co. v. Ameritech Mobile Communications, Inc.*, 984 F.2d 739, 745 (6th Cir. 1993). Actually, the term used in the statute is "commodities." 15 U.S.C. § 13(a). However, it should be noted that various states have enacted anti-discrimination laws that apply to services, although they are rarely enforced. *See, e.g.*, Cal. Bus. & Prof. Code § 17045.

10 *Volvo Trucks N. Am. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164, 169 (2006) (to support Robinson-Patman claim, plaintiff had to prove that the allegedly favored and disfavored customers were both businesses "contemporaneously competing to resell to the same retail customer"). For further discussion of the B2B nature of Robinson-Patman, see note 17 *infra*.

11 When there is a mixed offering, such as an industrial process control computer bundled with a software maintenance agreement, Robinson-Patman applies only if the "dominant nature"

Second, when sales of products in the B2B context occur and Robinson-Patman applies, the law states that only competing customers need to be treated the same, unless there is a good reason to do otherwise.[12] In other words, customers that don't chase the same purchaser don't compete.[13] This lack of overlap may be naturally occurring, such as having one customer in New York and another in California that each resells only in its respective geographic area.

Alternatively, the divisions may be contractually imposed, using something called "non-price vertical restrictions," where the manufacturer lawfully tells the reseller to whom it may sell, where it may sell or what it may sell to control the degree of overlap and the channel conflict that goes with it.[14] The use of such restrictions can be an effective tool for establishing value-based segmentation by controlling who competes with whom to preserve such segmentation.[15]

Robinson-Patman prohibits certain forms of two types of economic discrimination—price discrimination and promotional discrimination—with somewhat different legal standards for each. The former is always associated with the initial sale (the left oval in the illustration below) and includes things like volume discounts and extended payment terms. In contrast, promotional discrimination (right oval) is associated with resale activities only, such as the supplier's provision to the reseller of demonstrators, free display racks or financial incentives based on reseller sales loyalty.[16]

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12 *Eastern Auto Distributors, Inc. v. Peugeot Motors of Am., Inc.*, 795 F.2d 329, 335 (4th Cir. 1986).

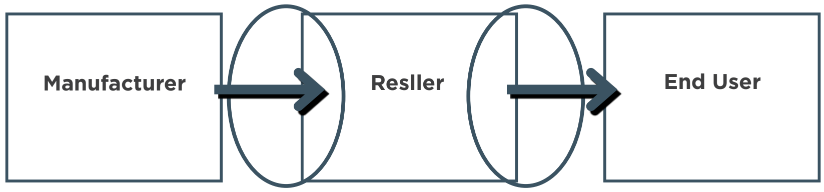
13 *Volvo Trucks*, 546 U.S. at 178-79. When a manufacturer sells to resellers, two or more of the latter compete if they pursue the same consumer or business end user. Where sales are made by a manufacturer directly to business end users, the question becomes whether the end users compete. For example, in the industrial context, end users often use or consume the product sold to them in the manufacturing process (such as cutting tools or work gloves) or they (sometimes referred to as "OEMs" or "original equipment manufacturers") incorporate the product into their own, so that the purchased good loses its separate identity. As an example of the latter, if a fastener manufacturer sells the same bolt assembly directly to Ford and Toyota for use in full-size pick-up trucks sold in the United States, such bolt assembly sales are to competitive customers and economic discrimination standards apply.

14 *See Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 51-52 (1977). Non-price vertical restrictions are governed by a manufacturer-favorable standard known as the "rule of reason," where they are presumed to be lawful, unless they can be shown on balance to be unreasonably anticompetitive. Moreover, the Supreme Court has stated that the primary concern of the antitrust laws is *interbrand competition* (one manufacturer's brand versus that of another), so *intrabrand competition* (that occurring between two resellers of the same brand) can be restricted if interbrand competition is fostered. *See id.* at 52 n.19.

15 While common in B2B markets and consumer durables, non-price vertical restrictions generally are not used for consumer packaged goods, particularly where manufacturers seek intensive, rather than selective, distribution. In contrast, suppliers of luxury packaged goods often prefer selective distribution, making non-price vertical restrictions attractive.

16 As a result, manufacturers selling directly to business end users are subject to the rules regarding price discrimination, while those selling to resellers have to comply with price discrimination and promotional discrimination standards.

Buying vs. Selling



Price Discrimination

Under price discrimination rules, competing customers must receive essentially the same prices, unless at least one defense is available.[17] The first defense is availability. If the same price realistically is made available to competing customers, but not all of them choose to take advantage of it, there is no discrimination and the legal analysis ends, even though a price difference results.[18] A good example is a prompt-payment discount that is offered to all competing customers. Those that pay within terms receive a better price than those that don't.

The second defense is cost justification, where a disparity in price is permitted based on legitimate cost-to-serve differences. Some or all of the cost savings can be passed on, but not a penny more.[19] For example, a typical way to justify the lower price for a private label product that is identical to the branded version is where the latter bears substantially more marketing and sales expenses.[20]

Functional discounts are the third defense, applying when a customer performs added services, such as warehousing, stocking or delivery, that functionally distinguish it from other customers. So, for example, a price reduction to one reseller over another may be justified as a reasonable reimbursement to the former for the added value that it has provided to the supplier or end user.[21]

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[17] More specifically, the presence of each of five elements is required for a violation: (1) discrimination (i.e., charging different prices to different customers), (2) on reasonably contemporaneous sales to two or more purchasers, (3) of goods, (4) of like grade and quality, (5) where there is a reasonable probability of competitive injury. 15 U.S.C. § 13 (a)-(b). The courts have interpreted the fifth element, among other things, to require that only competing customers be treated alike. *Infusion Res., Inc. v. Minimid, Inc.*, 351 F.3d 688, 692 (5th Cir. 2003), *cert. denied*, 542 U.S. 920 (2004) (plaintiff must prove that "as the disfavored purchaser, it was engaged in actual competition with the favored purchaser as of the time of the price differential"). This standard applies to "secondary line" discrimination—the most frequently litigated type—where a disfavored reseller may pursue the manufacturer for the discrimination against it.

The law also recognizes "primary line" discrimination, which permits a manufacturer to sue a discriminating competitive manufacturer, but only if a rather high threshold is met: (1) the discriminatory price must be below the offending manufacturer's cost and (2) the market structure must be such that the offending manufacturer's losses can be recouped later. *Brooke Group v. Brown & Williamson Tobacco Corp*., 509 U.S. 209, 222-24 (1993). "Tertiary line" discrimination cases, although rare, have been brought, where competitive customers of the favored and disfavored purchasers pursue the manufacturer. *See Texaco Inc. v. Hasbrouck*, 496 U.S. 543, 565-66 (1990).

The common denominator is the requirement of competition. It is because of this element that Robinson-Patman is a B2B statute, since consumers do not compete against each other. *See generally Feeney v. Chamberlin Mfg. Corp.*, 831 F.2d 93, 96 (5th Cir. 1987) (commissioned salesperson was not a competitor, so standing to sue for price discrimination was lacking).

[18] *Shreve Equip., Inc. v. Clay Equip. Corp*., 650 F.2d 101, 105-06 (6th Cir.), *cert. denied*, 454 U.S. 897 (1981).

[19] *Empire Rayon Yarn Co. v. Am. Viscose Corp*., 160 F. Supp. 334, 337 (S.D.N.Y. 1958).

[20] However, an end user preference for a branded product over a physically identical private label offering does not itself justify a price difference. *FTC v. Borden Co*., 383 U.S. 637, 639-41 (1966) (branded and private label evaporated milk).

Another defense is meeting competition. Under the law, discrimination is permissible if it is based on a good faith belief that a discriminatory price is necessary to meet that of a competitor or to maintain a price difference. All competing customers do not have to be offered or receive the special price.[22]

The final defense to price discrimination is called "changing conditions." Where the supplier has perishable goods which are about to go out of date or seasonal, obsolete or distress merchandise, it may lawfully drop the price to clear them, even if, before doing so, the supplier sold to some competitive purchasers at full price.[23]

Promotional Discrimination

In many industries, the trend has been away from things like volume discounts, which focus on how a customer buys, to performance-based incentives that look at how the reseller sells and the value that it delivers. The latter is where promotional discrimination comes in. In some respects, its rules are more flexible than those for price discrimination.

Under Robinson-Patman promotional discrimination standards, discounts, allowances and services must be functionally available on proportionally equal terms to competing customers, unless a variation is necessary to meet competition.[24] Because proportional equality is required (rather than the arithmetic equality implicit in the rules regarding price discrimination), flexibility for variation by competing customer is permitted.

Indeed, there are three ways to proportionalize benefits—based on (1) purchases, (2) cost and (3) value.[25] Under the first method, those that buy more receive more promotional goodies (*e.g.*, a rebate of $5 per case purchased in exchange for displaying the product). The second approach, cost to the reseller, allows more to be paid if the cost of performance is higher (*e.g.*, the price of a full-page ad in a national magazine likely is greater than a full page in a local publication). Finally, the law allows proportionalization based on the value to the manufacturer, allowing it to place a price tag on particular performance. So, for example, a plumbing fixture manufacturer may determine that end users value seeing its products displayed in a showroom, so it provides a two-percent rebate on purchases of the covered products to each of its dealers suitably displaying such products. This amount is not based on the dealer's showroom costs, but on the value to the manufacturer to encourage something that in turn is valued by the end user.

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21 *See Texaco*, 496 U.S. at 562. Unlike the precision required for an allowance dependent on the cost justification defense, a functional discount need only bear a reasonable relationship to the services provided. *See id.* at 561.

22 *Falls City Indus. v. Vanco Beverage, Inc.*, 460 U.S. 428, 445 (1983).

23 *See, e.g., Comcoa Inc. v. NEC Tel., Inc.*, 931 F.2d 655, 659 (10th Cir. 1991) (obsolete products); *A.A. Poultry Farms v. Rose Acre Farms*, 683 F. Supp. 680, 691 (S.D. Ind. 1988), *aff'd on other grounds*, 881 F.2d 1396 (7th Cir. 1989) (perishable fresh food, *i.e.,* eggs).

24 *Comcoa*, 931 F.2d at 664-65. Promotional services include things like the provision of product demonstrations for the benefit of a reseller's customers.

25 The first two proportionalization methods are discussed in the *Guides for Advertising Allowances and Other Merchandising Payments and Services*, 16 C.F.R. § 240, a helpful, but non-binding, discussion from the perspective of the Federal Trade Commission (FTC). *Id.* § 240.9. Support for the third is found in *Colonial Stores Inc. v. FTC*, 450 F.2d 733, 743-44 (5th Cir. 1971) and *In re Lever Bros. Co.,* 50 F.T.C. 494, 512 (1953). *See also FTC v. Simplicity Pattern Co.,* 360 U.S. 55, 61 n.4 (1959) (acknowledging *Lever Bros.* without specifically embracing or questioning it). In the last revision of the FTC Guides more than 20 years ago, the agency considered including value as a valid means of proportionalization, but stopped short due to what it said was the possibility of abuse and the role of the Guides to encourage compliance. 53 Fed. Reg. 43,233 (Oct. 26, 1988). Today, value is widely used to proportionalize.

By the way, a frequently overlooked mechanism to insure that price concessions or promotional benefits are passed on to end users by resellers is mandatory pass-through, a practice that is subject to the rule of reason and generally lawful.[26]

Preserving Value

While U.S. law is supportive of recognizing value through economic discrimination, it also permits preserving value-based prices by allowing the manufacturer to set resale prices and to engage in price signaling.[27]

Lawfully Setting or Encouraging Resale Prices

If a supplier is selling directly or through an agent to the end user, the supplier determines the street price. However, where resellers take title and resell, they set the street price, which is, of course, the same as the resale price. Regardless whether manufacturers are engaged in value pricing, they often wish to control or influence the street price. Historically, this could be done with varying degrees of success by the manufacturer simply adjusting the reseller's buy price or selecting resellers carefully and ending relationships with those that don't operate in a manner consistent with the manufacturer's goals. However, the U.S. Supreme Court has made it clear that the manufacturer can go beyond these steps to dictate resale prices, sometimes referred to as "resale price maintenance" or "vertical price fixing."

The first type of resale price in which manufacturers are interested is maximum prices, *i.e.*, placing an upper bound on what the reseller may charge. In the value pricing context, putting a ceiling on resale prices can prevent resellers from taking too much margin and throwing off the manufacturer's value price structure. It also can be used for promotional resale price uniformity in order to permit nationally or regionally promoted prices.

The second type—minimum or exact resale prices—is far more common.[28] Establishing a price floor or exact price can insure sufficient margin for resellers to furnish the things end users or the manufacturer value, such as convenient locations, on-site inventory and knowledgeable salespeople. Other common uses include protecting brand image, facilitating the introduction of new products and leveling the playing field to permit different types of resellers to compete.[29] In some cases, building in a margin for resellers allows a manufacturer to enhance its own.

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26 *See, e.g., Acquaire v. Canada Dry Bottling Co.*, 24 F.3d 401, 410 (2d Cir. 1994); Jack Walters & Sons Corp. v. Morton Building, Inc., 737 F.2d 698, 708 (7th Cir.), cert. denied, 469 U.S. 1018 (1984); Lewis Service Center, Inc. v. Mack Trucks, Inc., 714 F.2d 842, 846 (8th Cir. 1983), cert. denied, 467 U.S. 1226 (1984); AAA Liquors, Inc. v. Joseph E. Seagram & Sons, Inc., 705 F.2d 1203, 1206 (10th Cir. 1982), *cert. denied*, 461 U.S. 919 (1983).

27 As noted earlier, non-price vertical restrictions also may be useful in preserving value-based segmentation by controlling competitive overlap. *See* text accompanying notes 14-15 *supra*.

28 Relevant cases usually discuss minimum prices, but exact prices are analytically the same.

29 In many industries, there is considerable channel conflict between resellers with low costs (such as big-box retailers or those selling only over the Internet) and those with significantly higher costs (like traditional brick-and-mortar resellers). A manufacturer may wish to retain the higher-cost resellers to avoid becoming overly dependent on some resellers, serve market segments otherwise missed or make sure valued services are provided. Setting a minimum resale price can help maintain the viability of such resellers.

Until 1997, setting any type of resale price by agreement was illegal on its face. Then, the U.S. Supreme Court determined that agreeing on maximum resale prices is subject to the much more manufacturer-friendly rule of reason, the same standard that governs the rather common use of non-price vertical restrictions discussed earlier.[30] Ten years later, the Court extended this more lenient approach to minimum or exact resale price setting, so that, under current federal law, all agreements that establish a resale price are presumed to be lawful until they can be shown on balance to be unreasonably anticompetitive.[31] However, the decision to include minimum price agreements under the rule of reason umbrella was controversial, as various efforts have been made at the federal and state levels to go back to or enforce the previous standard, only some of which have been successful.[32]

However, there is another way to set resale prices that is unaffected by these efforts. Section 1 of the Sherman Act, which is the principal U.S. antitrust statute in this area, requires that a "contract, combination…or conspiracy" be present for a violation, which means that there must be some sort of agreement.[33] Because of this requirement, the Supreme Court in 1919 ruled that a manufacturer could unilaterally announce a minimum resale price by policy (*i.e.*, without an agreement) and simply refuse to supply any reseller that didn't follow it.[34] Moreover, if a reseller adheres to the price in the policy, there is still no agreement.

After a long dormant period, use of minimum resale price policies blossomed with the rise of discount retailing in 1980s, then spread to B2B products and became even more prevalent for both consumer and business products due to the challenges brought by the growth of Internet sales and the expansion

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30 *State Oil Co. v. Khan*, 522 U.S. 3, 17-18 (1997). The rule of reason is addressed in note 14 *supra*, and non-price vertical restrictions are discussed in the text accompanying that footnote and the following one.

31 *Leegin Creative Leather Prods., Inc. v. PSKS*, 551 U.S. 877, 886-87 (2007). Canada, through legislation, adopted a similar rule for resale price programs in 2009, repealing its criminal prohibitions on setting or influencing resale prices. Competition Act, R.S.C., ch. C 34 (1985), § 76.

32 Bills have been introduced in the last several sessions of Congress to overturn the *Leegin* decision, but none has passed. *See, e.g.*, S. 75, 112th Con. (2011); H.R. 3406, 112th Con. (2011); S.148, 111th Con. (2009); H.R. 3190, 111th Con. (2009); S. 2261, 110th Con. (2007). In 2009, Maryland enacted its own statute to make setting minimum prices by agreement illegal. Md. Commercial Law Code Ann. § 11-204(b) (2009). Later, the Kansas Supreme Court ruled that the law of that state prohibits minimum resale price agreements. *O'Brien v. Leegin Creative Leather Prods., Inc.*, No. 101,000, 2012 Kan. LEXIS 246, at *62 (Sup. Ct. Kan. May 4, 2012). However, due to constitutional issues, these state laws likely apply only to sales wholly within each state's borders. *See* Leiv Blad and Bryan Killian, *A Civil Conflict: Can the States Overturn Leegin?*, *The CPI Antitrust Journal* 3-6 (January 2010 (2)). Other jurisdictions have claimed that their respective laws do not allow minimum resale price agreements. For example, California obtained a consent order from a cosmetics supplier to stop the latter's resale price efforts, but that state's view has yet to be tested in the courts post-*Leegin*. *See California v. Bioelements, Inc.*, Cal. Super. Ct., Riverside Cty., No. 10011659 (Jan. 11, 2011). New York brought a case against mattress supplier Tempur-Pedic that alleged illegal price setting under that state's law, but lost when the court determined that the statute upon which the state relied makes minimum resale price agreements unenforceable, but not unlawful. *People v. Tempur-Pedic Intl., Inc.*, 916 N.Y.S.2d 900, 909 (N.Y. 2011), *aff'd*, 2012 NY Slip Op 3557 (N.Y. App. Div. 1st Dep't. May 8, 2012). *Accord Worldhomecenter.com, Inc. v. Franke Consumer Prods., Inc.*, No. 10 Civ. 3205 (BSJ), 2011 U.S. Dist. LEXIS 67798, at **13-16 (S.D.N.Y. June 22, 2011) (under state law in New York, contracts that set resale prices are unenforceable and the *Leegin* rule of reason standard applies to determine legality). *See also Worldhomecenter.com, Inc. v. KWC Am., Inc.*, No. 10 Civ. 7781, 2011 U.S. Dist. LEXIS, at *10 (S.D.N.Y. Sept. 15, 2011).

33 *See* 15 U.S.C. § 1.

34 *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919). For a comprehensive discussion of the use of minimum resale price policies, see Brian R. Henry and Eugene F. Zelek, Jr., *Establishing and Maintaining an Effective Minimum Resale Price Policy: A Colgate How-To*, 17 *Antitrust 8* (Summer 2003) (written before *Leegin*, but still a useful guide).

into other new distribution channels.[35] Such policies are used for luxury goods, consumer durables (particularly appliances, electronics and sporting goods) and various industrial products (like foodservice equipment, premium tools and test equipment).[36] They can be broad or narrow, covering some or all products or geographic areas. A policy violation can result in the loss of a single product, a product family or all products. Finally, because a policy is unilateral, a reseller that violates it can be reinstated by the manufacturer anytime, as long as the latter is careful to avoid probation or any form of agreement on compliance.

Apart from using agreements or policies, another way to dictate a resale price is for the manufacturer to jump over the reseller and agree with the end user on the latter's buy price, something that can be referred to as "direct dealing." As long as there is no contractual or other legal impediment, one way to do this is for the manufacturer to make the end user a direct customer.[37] However, when the involvement of intermediaries is necessary for logistical or other reasons, the manufacturer can determine the resale price by offering one or more resellers the opportunity to resell to the end user at the price agreed between the manufacturer and the end user. If the reseller declines, the manufacturer finds someone else to serve the end user, but there otherwise is no penalty. If the reseller accepts, there is no agreement on resale price or, at most, an agreement subject to the rule of reason.[38]

Although not as potent as dictating a resale price, it is possible to encourage one through the use of financial or promotional incentives. Because reseller participation is voluntary, such incentive programs are judged under the rule of reason.[39] One example is a minimum advertised price (MAP) program, where the reseller receives a payment (such as a co-op advertising allowance) in return for adhering to a specified minimum price in the ads or Internet listings for which the allowance is paid.[40] However, if the reseller uses only its

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[35] Two Supreme Court cases in the 1980s helped by providing support for the use of minimum resale price policies. *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988); *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752 (1984). Adding new channels increases the risk of channel conflict and corrosive price competition, particularly if the new channels have different cost structures than the incumbent ones.

[36] Although the movement of consumer food products into mass merchandisers like Wal-Mart and Target set the stage for conflict with traditional grocery chains and others, as is the case with vertical non-price restrictions, minimum resale price setting typically is not employed for consumer packaged goods (including food), except in the luxury segment.

[37] A manufacturer allocating an end user to itself is a customer restraint subject to the rule of reason as a non-price vertical restriction, a result that doesn't change even if the manufacturer, by taking an account directly, competes with the reseller, something called "dual distribution." *See Smalley & Co. v. Emerson & Cuming, Inc.*, 13 F.3d 366, 368 (10th Cir. 1993). At the same time, some state statutes may get in the way of selling directly. For example, as a legacy of Prohibition, producers in the alcoholic beverage industry generally cannot sell to retailers or consumers and must sell to wholesalers, which, in turn, sell to retailers. *See, e.g.*, Liquor Control Act of 1934, 235 ILCS 5/5-1, 5/6-4 (Illinois). In addition, some reseller protection laws of general or industry-specific applicability may inhibit a manufacturer from taking away a reseller's customer and going direct. *See, e.g.*, Wisconsin Fair Dealership Law, Wisc. Stat. § 135.03-.04 (prohibition in general applicability statute on substantially changing the reseller's "competitive circumstances" without good cause and an opportunity for cure).

[38] *Metro Ford Truck Sales, Inc. v. Ford Motor Co.*, 145 F.3d 320, 325 (5th Cir. 1998), *cert. denied*, 525 U.S. 1068 (1999) (special wholesale discount program was unilateral action); *Wisconsin Music Network, Inc. v. Muzak Ltd. P'ship.*, 5 F.3d 218, 222 (7th Cir. 1993) (national account program subject to rule of reason); *Ohio-Sealy Mattress Mfg. Co. v. Sealy, Inc.*, 585 F.2d 821, 836-38 (7th Cir. 1978), *cert. denied*, 440 U.S. 930 (1979) (rule of reason treatment for national account program). Direct dealing is common in some industries (particularly when large end users or end user buying groups are involved) and generally takes one of two forms: (1) a manufacturer and an end user or buying group agree on the buy price, while the price for handling and delivery is separately negotiated between the reseller and the end user or buying group or (2) a delivered (or installed) price is agreed upon between a manufacturer and an end user or buying group.

[39] *See, e.g., Lake Hill Motors, Inc. v. Jim Bennett Yacht Sales, Inc.*, 246 F.3d 752, 757 (5th Cir. 2001) (rule of reason treatment under the Sherman Act); 6 Trade Rep. Rep. (CCH) ¶ 39,057 at 41,728

own funds, it can advertise at any price it wants, and, regardless whether it takes the manufacturer's money, it can always sell at any price it desires.[41]

Other examples of price encouragement include: (1) group or shared-price advertising—only those resellers that wish to participate are identified in ads that offer a special price; (2) target price rebates—based on point-of-sale (POS) data, resellers receive payments based on how close their actual selling prices are to the target prices; and (3) floating price allowances—resellers are offered a promotional allowance to reduce their shelf, catalog or Internet prices by a specified percentage during a designated promotional period.

Lawful Price Signaling

Another way to preserve value-based prices is to use price signaling to avoid competitive misinterpretation of pricing actions. While this term is rather pejorative, the fact is that every company signals all the time, as each intentional or unintentional act or failure to act sends a message or signal to the market.

For example, a company that repeatedly refuses to price below a certain level communicates that it will not take business at any cost. This suggests to competitors that it will not undercut them, something that may lead to more price stability in the market. Similarly, the decision to follow or not to follow the lead of another may be intentional or inadvertent, but it too sends a message to the market.

Even if these steps were aimed at sending a signal, few would find them particularly risky, as the essence of competition is unilaterally deciding to lead, follow or sit on the sidelines. Indeed, U.S. law supports this point, as it is clear that the practice of independently imitating or following competitors—known as "conscious parallelism"—is entirely lawful.[42]

When information flow is imperfect, customers and competitors plan their own moves through trying to read the market by looking at the signs, signals, tracks and tea leaves to discern what others intend or are likely to do or why others did what they did. Indeed, price wars have been ignited when one

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(FTC May 21, 1987) (FTC announcement that advertising price restrictions in promotional programs are subject to the rule of reason). While the FTC has no authority under the Sherman Act, application of the Federal Trade Commission Act, 15 U.S.C. § 45, to resale pricing uses the same Sherman Act analysis. *In re Russell Stover Candies, Inc.*, 100 F.T.C. 1, 1982 WL 608313, at *27 (FTC. Jul. 1, 1982), *rev'd on other grounds, Russell Stover Candies, Inc. v. FTC*, 718 F.2d 256 (8th Cir. 1983). The *Leegin* decision implicitly endorses the rule of reason for agreements that encourage resale price behavior, because, if it is lawful to *set* resale prices by agreement (unless such an agreement is unreasonably anticompetitive), the same must be true of the less restrictive *encouragement* of them by agreement. Alternatively, prices may be encouraged by unilateral policy, thereby avoiding the rule of reason and the risk, however modest, that goes with it. Keep in mind that the provision of financial or promotional incentives subjects such programs or policies to the requirements of the Robinson-Patman Act.

[40] Somewhat confusing is the fact that sometimes any program dealing with resale pricing—including a policy that sets resale prices, rather than just advertised prices—is erroneously referred to as a "MAP program." *See, e.g.*, Joseph Pereira, *Group Hits Manufacturers' Minimum Pricing*, Wall St. J., Dec. 4, 2008.

[41] To further complicate matters, some companies (like certain foodservice equipment manufacturers) make the penalty for a MAP violation the loss of the offending reseller's ability buy the affected product in the future, a result more typical of a resale price policy. This approach likely evolved because the amount of co-op advertising or similar allowances at risk simply is not large enough to dissuade advertised price behavior that the manufacturer finds undesirable.

[42] *See, e.g., Blomkest Fertilizer, Inc. v. Potash Corp. of Sask., Inc.*, 203 F.3d 1028, 1032-1033 (8th Cir.) (en banc), *cert. denied sub nom., Hahnaman Albrecht, Inc. v. Potash Corp. of Sask., Inc.*, 531 U.S. 815 (2000) ("Evidence that a business consciously met the pricing of its competitors does not prove a violation of the antitrust laws."); *In re Citric Acid Litig.*, 191 F.3d 1090, 1102 (9th Cir. 1999) ("A section 1 violation cannot...be inferred from parallel pricing alone,...nor from an industry's follow-the-leader pricing strategy."); *Wallace v. Bank of Bartlett*, 55 F.3d 1166 (6th Cir. 1995) ("Parallel pricing, without more, does not itself establish a violation of the Sherman Act.").

company wrongly interprets another's actions and overreacts to the real situation.[43] For example, an equipment manufacturer may drop all of its U.S. prices on a particular product in reaction to a price reduction by a competitor, unless it understands that the reduction was both limited and temporary in an effort to clear some excess inventory.

A concept that may be referred to as "strategic price management" seeks to formalize and manage the flow of information within a company along both offensive dimensions (outgoing signals) and defensive dimensions (responses to incoming messages) with the goals of consistency and clarity. At the same time, clarity may not be desired for all pricing moves, as a company may wish certain actions or inactions and their rationale to be clear, while others to remain murky.

Signaling is a subset of strategic price management. As such, it is the overt communication or explanation of future, contemporaneous or previous pricing actions (or other things of competitive significance) with an intent that competitors receive such communication. Signaling contrasts with the more subtle forms of communicating with the market—such as merely turning down certain business—and makes it easier for others to figure out what is going on.[44]

Adding price transparency could be one of these more subtle forms or could constitute price signaling. One real-life example of the latter is an elevator manufacturer creating a hypothetical "standard" product in an environment where each product is custom configured, then publishing both a description and a price for it. The standard product was then used as a vehicle to communicate changes in price for the custom products, where pricing is necessarily opaque.[45] In another situation, a seller added transparency to its contract pricing to blunt the fact that powerful buyers were playing the few sellers off each other because each price was separately negotiated and effectively invisible.

Sometimes signaling goes farther. Faced with some recurrent issues, a prominent company in a cyclical industry announced that, unlike its prior practice, the company would not add capacity during the then-current boom period, as such capacity was a drag on its financial performance during slow times. It also communicated a price increase. Within a short time, its two primary competitors independently made similar announcements. The effect was to improve industry pricing.[46]

From a legal point of view, the danger implicit in price signaling is that it may constitute or provide evidence of price fixing among competitors, sometimes referred to as "horizontal price fixing." This form of cartel action is almost always illegal on its face in the United States, and often is prosecuted criminally under the Sherman Act.[47] However, as is the case with vertical price fixing discussed earlier, the Sherman Act requires that an agreement

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[43] Walter L. Baker, Michael V. Marn and Craig C. Zawada, The Price Advantage 136-41 (2d ed. 2010).

[44] Influencing industry pricing in this fashion is part of one of the three levels of price management. Michael V. Marn, Eric V. Roegner and Craig C. Zawada, The Price Advantage 80-89 (2004). The other two are at the transaction and the product/market strategy levels. *Id.* at 13-73.

[45] *Id.* at 81.

[46] The author worked with the signaling company in this example and in the previous one to structure and implement the approach used. There were no adverse legal consequences.

be present in order for there to be a violation.[48] The problem from an enforcement perspective is that explicit price fixing language in a written contract or otherwise between or among competitors is rare.

As a result, the law has established a two-pronged test that allows an illegal agreement to be inferred when there is no smoking gun. The first element is proof of parallel business behavior or conscious parallelism. But, as was noted previously, this element alone is not illegal, as it is the essence of competition. So, conscious parallelism must be coupled with the second element—the presence of one or more "plus factors" that subject the circumstances under scrutiny to a smell test.

One of these factors is whether the parallel behavior is unlikely to have occurred absent an agreement, while a variant of this concept is whether the behavior is against individual self-interest, but is consistent with a conspiracy.[49] Another plus factor is evidence of meetings or other direct communications among competitors, particularly if pricing was discussed by persons in a position to make pricing decisions. Incriminating statements made in documents, e-mail or otherwise can also be a plus factor, as can a history of horizontal price fixing.

If both conscious parallelism and plus factors are present, there is a presumption of conspiracy that can be rebutted by various considerations.[50] For example, an oligopolistic industry or other market structure where pricing is interdependent can explain parallel behavior that may be suspect.[51] Other plausible, benign explanations for the conduct being examined also can undercut conspiracy arguments.[52]

In the leading case on price signaling, DuPont and other chemical manufacturers announced price increases well in advance of the notice periods in their supply agreements with industrial end users. The FTC determined that this practice was unlawful, as it facilitated price parallelism, but the appellate court disagreed, stating that consciously parallel pricing is not illegal unless it is collusive, predatory, coercive or exclusionary—none of which was present.[53] Moreover, the court noted that, while signaling raises the possibility of collusion, it can have legitimate business purposes too, such as aiding buyers in planning for the future.[54]

If the following elements are in place, it is generally irrelevant that competitors receive the information conveyed and unilaterally act on it:

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[47] Since 2004, criminal violation of the Sherman Act is a felony punishable by: (1) a $100 million fine if the perpetrator is a corporation or other entity and (2) a $1 million fine or 10 years in prison or both if the violator is an individual. 15 U.S.C. § 1. Under the Comprehensive Crime Control Act and the Criminal Fine Improvements Acts, 18 U.S.C. §§ 3571-3572, the fine may be increased to twice the gain from the illegal conduct or twice the loss to the victims, while the Federal Sentencing Guidelines can also impact the penalties imposed. *See* United States Sentencing Commission, 2010 Sentencing Guidelines.

[48] See text accompanying note 33 *supra*.

[49] *See, e.g., American Tobacco Co. v. United States*, 328 U.S. 781, 805 (1946) (price increases despite surpluses that should have resulted in lower prices); *Interstate Circuit, Inc. v. United States*, 306 U.S. 208, 222 (1939) (price increases, although individual self-interest to cut prices). The plus factors must tend to exclude the possibility of independent conduct. *In re Baby Food Antitrust Litig.*, 166 F.3d 112, 133 (3d Cir. 1999), citing *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 764 (1984).

[50] *Todorov v. DCH Healthcare Authority*, 921 F.2d 1438, 1456 n.30 (11th Cir. 1991).

[51] *See Baby Food*, 166 F.3d at 116, 121-22 (interdependent pricing of oligopoly defendants accounting for 98 percent of industry sales); *Reserve Supply Corp. v. Owens-Corning Fiberglas Corp.*, 971 F.2d 37, 39, 50-51 (7th Cir. 1992) (interdependent pricing in oligopolistic industry with defendants and third manufacturer collectively holding 85 to 90 percent market share). Ironically, it is in oligopolistic markets where price signaling can be the most effective.

(1) A legitimate interest to communicate with stakeholders

The communication from the company should be relevant to its stakeholders, which may include actual and potential end users (regardless whether sold directly), resellers or other intermediaries, employees, investors and investment analysts. In general, pricing-related matters meet this test due to the obvious effect on purchasing decisions and the supplier's earnings. Indeed, the fact that public companies are required to publically disclose relevant information in timely fashion is helpful.[55]

(2) Communication directed at stakeholders

The announcement or other communication should be directed at the stakeholders with an interest in it, rather than at competitors. It is preferable to do so out in the open, both to be up front about what is being conveyed and to make it easier for competitors to get the message.[56] Appropriate means to reach stakeholders include press releases, letters or other written or electronic communications, postings on the company's website, speeches, presentations, public filings and articles or interviews in the general or specialized press.

(3) An appropriate message

The signaling company should focus its comments on what it will do or has done, rather than referring to competitors or inviting them to follow.[57] While industry context may be relevant, it is the actions or inactions of the company that directly mesh with the interests of the stakeholders.

Without evidence of agreement, the signaling of pricing behavior, even if acted upon by competitors, is lawful. The key is focus on directing an appropriate message to stakeholders with a bona fide interest in it, while avoiding the plus factors (like direct communications with competitors

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[52] *See, e.g., Baby Food*, 166 F.3d at 121-38 (failure to produce evidence of other than independent action in spite of some parallel behavior and low-level sharing of some information among salespeople). While the validity of the purported reasons for engaging in the behavior in question is a consideration, even a pretext for doing so does not alone establish a conspiracy. *See also Blomkest*, 203 F.2d at 1034 (mere opportunity to conspire not necessarily probative of price fixing).

[53] *E. I. Du Pont de Nemours & Co. v. FTC*, 729 F.2d 128, 139-40 (2d Cir. 1984).

[54] *Id.* at 134. See Reserve Supply, 971 F.2d at 54 (advance notice of price increases). *See also Catalano, Inc. v. Target Sales*, 446 U.S. 643, 647 (1980) (according to dictum in the per curiam opinion, "advance price announcements are perfectly lawful").

[55] *See* Richard M. Steuer, John Roberti and Jodi A. Simala, *Perils in Disclosures: Making Disclosures and Reacting to Competitors' Disclosures*, 100 Antitrust & Trade Reg. Rep. (BNA) 566 (No. 2500, May 20, 2011).

[56] A good example of what not to do was a closed data collection and dissemination company jointly owned by eight airlines with a non-public computerized system that was used by each participant to communicate to the others fare changes and promotions in advance and permitted later modification or withdrawal of such announcements. Apparently taking the position that the airlines were effectively sitting in the same room and discussing prices, the Justice Department attacked this practice as horizontal price fixing. The defendants accepted consent decrees that ended it. *United States v. Airline Tariff Publishing Co.*, 1994-2 Trade Cas. (CCH) ¶ 70,686 (D.D.C. 1994) (all defendants, except United Air Lines, Inc. and USAir, Inc.); 836 F. Supp. 9 (D.D.C. 1993) (United and USAir).

[57] Even when no agreement is reached on price, the FTC has obtained consent orders from signaling companies where they invite one or more competitors to follow or state that their pricing action is contingent on competitors playing ball. In re U-Haul Int'l., Inc., 5 Trade Reg. Rep. (CCH) ¶ 16,461 (FTC July 20, 2010); *In re Valassis Communications, Inc.*, [2006-09 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 15,860 (FTC April 28, 2006).

Note that consent orders apply only to the accused parties that agree to them and do not otherwise carry the force of law. The FTC has attempted for some time to attack certain conduct where there is no conspiracy or agreement as "invitations to collude" or behavior that facilitates collusion (sometimes called "facilitating practices"). Although the agency has managed to obtain these and other consent orders against unilateral behavior, this theory has never been endorsed by any court. *See* Geraldine M. Alexis, *Invitations to Collude are the Federal Trade Commission's New Weapon to Police Unilateral Activity*, 14 *Antitrust* 68 (Spring 2000).

on price) that tend to support the presence of a conspiracy. As long as competitors unilaterally act on such message, signaling is a lawful means to help preserve value pricing.

Conclusion

For some time, U.S. law has been increasingly more flexible regarding pricing matters. As part of this trend, tools like economic discrimination, non-price vertical restrictions, resale price setting and price signaling help suppliers and resellers both achieve and maintain value pricing by: (1) recognizing the value of products and services from the end user's perspective, (2) establishing prices that vary with perceived value and (3) taking steps to preserve value-based prices. While the law is not black and white in the area of pricing (or in many others for that matter), there is considerable room to meet the challenges of enlightened pricing strategies.

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