Current Advice on Managing Resale Prices in Franchising

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A franchisor can agree with its franchisees to set resale prices, subject to the rule of reason. This principle has remained consistent since the Supreme Court, in its 2007 decision *Leegin Creative Leather Products. v. PSKS, Inc.*, 551 U.S. 877 (2007), overruled almost 100 years of precedent by holding that it would determine the legality of resale price maintenance ("RPM") agreements under the rule of reason rather than a *per se* standard. In the years that followed *Leegin*, legal scholars speculated how the decision would impact the use of RPM agreements by manufacturers, suppliers, distributors, and franchisors. Now, on the 14th anniversary of the Supreme Court's seminal decision, we revisit the Court's holding and its impact on cases involving franchises, provide advice on implementing RPM programs, and identify potential pitfalls of which franchisors and franchisees alike should be aware.

Leegin Creative Leather Products v. PSKS, Inc.

Beginning with *Dr. Miles Medical Company v. John D. Park & Sons Company*, 220 U.S. 373 (1911), the Supreme Court traditionally viewed agreements that allowed manufacturers or suppliers to set the minimum resale prices that their distributors could charge as *per se* illegal under Section 1 of the Sherman Act. In *Leegin*, however, the Court reversed course and held that the rule of reason should instead apply when analyzing vertical price restraints.

Leegin was a manufacturer of leather goods and accessories that retailers then resold under a specific brand name. *Leegin*, 551 U.S. at 882. In order to compete against well-known suppliers, Leegin instituted a retail pricing policy that required retailers to sell Leegin's products at suggested resale prices and refused to sell to retailers that discounted Leegin's goods below those prices. *Id.* at 883. Leegin claimed that its minimum resale price policy provided retailers with margins that could provide customers with certain levels of service and prevented discounts from harming the brand's image and reputation. *Id.* However, PSKS, Inc., which operated a store selling Leegin's goods, refused to stop discounting the goods. *Id.* at 884. After Leegin stopped selling to the store, PSKS sued Leegin, alleging that agreements with retailers to charge prices set by Leegin violated antitrust laws. *Id.* Leegin appealed to the Supreme Court after the Fifth Circuit rejected Leegin's argument that the rule of reason should have applied to its vertical price-fixing agreements with its retailers. *Id.* at 884–85.

In overruling *Dr. Miles* and finding that the rule of reason should apply to minimum resale price agreements, the Court gave significant weight to the procompetitive justifications for vertical price restraints. Importantly, the Court held "[m]inimum resale price maintenance can stimulate interbrand competition . . . by reducing intrabrand competition among retailers selling the same brand. The promotion of interbrand competition is important because 'the primary purpose of the antitrust laws is to protect [this type of] competition.'" *Id.* at 890 (quoting in part *State Oil v. Khan*, 522 U.S. 3, 15 (1997)). Moreover, the Court concluded that though minimum resale price agreements may have anticompetitive effects, especially if they result in cartels, "it cannot be stated with any degree of confidence that resale price maintenance always or almost always tends to restrict competition and decrease output." *Id.* at 894 (internal quotations omitted).

Though *Leegin* did not involve a franchise, its holding impacts such relationships because franchisors may employ methods such as volume incentive programs, minimum advertised price ("MAP") policies, and suggested retail pricing to influence their franchisees' resale prices.

The Rule of Reason

Under the rule of reason, the fact-finder must "weigh[] all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition." *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977). Courts use a

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three-step framework to determine whether a restraint violates the rule of reason:

> [T]he plaintiff has the initial burden to prove that the challenged restraint has a substantial anticompetitive effect that harms consumers in the relevant market. If the plaintiff carries its burden, then the burden shifts to the defendant to show a procompetitive rationale for the restraint. If the defendant makes this showing, then the burden shifts back to the plaintiff to demonstrate that the procompetitive efficiencies could be reasonably achieved through less anticompetitive means.

Ohio v. Am. Express Co., 138 S. Ct. 2274, 2284 (2018) (internal citations omitted).

The rule of reason requires antitrust plaintiffs to demonstrate that the challenged agreement harms competition, which makes it difficult to succeed on the claim. In the 14 years since *Leegin* was decided, very few federal courts have analyzed minimum resale price agreements in the franchise context. However, the few federal courts to do so have dismissed antitrust claims at the pleadings stage based on plaintiffs' failures to meet the minimum pleading requirements—namely, defining a relevant product and geographic market and pleading harm to competition. *See, e.g., Jacobs v. Tempur-Pedic Int'l, Inc.*, 626 F.3d 1327, 1331 (11th Cir. 2010).

Given the paucity of applicable case law, franchisors must instead rely on decisions analyzing minimum resale price agreements in similar contexts, such as those involving distributors or dealers, to discern potential antitrust risks arising from pricing policies. When considering a pricing policy, franchisors should analyze and identify the pro-competitive benefits of such a policy before implementing it, in the event that a third party challenges their policy.

Current Advice to Franchisors and Franchisees

Below is some practical advice to franchisors considering whether and to what extent they should influence their franchisees' resale prices and to franchisees whose resale prices may be affected by their franchisors.

- **Market power.** Ascertain market power in the relevant interbrand markets to determine whether any potential or proposed agreement is likely to have any anticompetitive effects. As a general rule of thumb, courts require a market share of more than 55 percent to establish prima facie market power, and a market share between 75–80 percent of sales is enough to establish a prima facie case of market power. *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 187 (3d Cir. 2005).
- **Procompetitive benefits.** Identify the procompetitive benefits of any RPM agreement. Examples of procompetitive benefits include: (i) preventing free-riding; and (ii) increasing interbrand competition, *e.g.*, making Burger King hamburgers more competitive with McDonald's.
- **Avoid inadvertent horizontal conspiracies.** Ensure that any RPM agreement is completely vertical. *Leegin*'s holding is limited to vertical price-fixing agreements. Horizontal price-fixing agreements remain *per se* illegal and present significant civil and criminal liability risk to organizations and individuals that enter into them. Accordingly, franchisors should be careful not to inadvertently enter into a horizontal conspiracy with franchisees. Take, for example, the scenario of a group of franchisees who express concern to the franchisor (through a Franchise Advisory Council or otherwise) that another franchisee has failed to comply with suggested retail pricing. To address the concerns, the franchisor then pressures the rogue franchisee's compliance. The franchisor's actions raise potential antitrust concerns because its conduct may be considered part of a horizontal conspiracy with the group of franchisees that it sought to appease. The better course for the franchisor is to monitor and enforce its MAP and pricing policies independently. Similarly, if the impetus for an RPM program comes from franchisees, then the RPM is more likely to be problematic.

  Franchisees should be vigilant not to enter into agreements with their fellow franchisees on resale prices and should be mindful that joining with other franchisees to demand a franchisor punish another franchisee for failing to follow suggested resale prices could create a *per se* illegal horizontal conspiracy.
- **Competitive pricing practices.** Franchisors should independently determine whether

or not to implement an RPM program and document how they came to the decision to implement the program. If competitors have similar types of programs or agreements, then there may be the risk that a court could view the agreement/program as facilitating a cartel.

- **Inconsistent state laws.** Franchisors with a national or large regional marketing area should be aware that several states' antitrust laws diverge from federal law and consider RPM agreements to be either illegal or unenforceable even after *Leegin*. Thus, franchisors should identify states where their RPM agreements are in force and make sure the applicable state laws permit those agreements. Likewise, franchisees should make sure the antitrust laws of the states where they do business do not make vertical resale price maintenance programs illegal. Below are several state laws that diverge from federal law:

  Maryland. In 2009, in direct response to *Leegin*, Maryland passed a law declaring any minimum RPM agreement *per se* illegal. *See* Md. Code Ann., Com. Law § 11-204(b) ("[A]ny contract, combination, or conspiracy that establishes a minimum price below which a retailer, wholesaler, or distributor may not sell a commodity or service is an unreasonable restraint of trade."). The Maryland Attorney General has filed complaints based on violations of Section 11-204(b). *See, e.g., State of Md. v. Johnson & Johnson Vision Care, Inc.*, Case No. 03C16002271 (Cir. Ct. (Balt. Cty.) Feb. 29, 2016).

  New York. New York does not make RPM agreements *per se* illegal. Rather, under a New York statute, minimum RPM agreements are unenforceable and not actionable at law. *See People v. Tempur-Pedic Intl., Inc.*, 95 A.D.3d 539, 944 N.Y.S. 2d 518 (N.Y. App. Div. 2012). Like Maryland, New York law distinguishes between minimum and maximum RPMs, making the latter unenforceable. N.Y. Gen. Bus. Law § 369-a. ("Any contract provision that purports to restrain a vendee of a commodity from reselling such commodity at less than the price stipulated by the vendor or producer shall not be enforceable or actionable at law."). Though the New York Court of Appeals has not decided whether New York courts evaluating vertical RPM claims will follow *Leegin* and apply the rule of reason, a federal court in New York has held that the rule of reason applies to such claims. *See, e.g., WorldHomeCenter.Com, Inc. v. Franke Consumer Prods.*, No. 10-cv-3205, 2011 U.S. Dist. LEXIS 67798 (S.D.N.Y. June 22, 2011) (rejecting the theory "that pleading a violation of § 369-a provides a means to establish per se liability under the Donnelly Act").

  California. The California Supreme Court interprets California's Cartwright Act, Cal. Bus. & Prof. Code § 16700 *et seq.*, as making both vertical and horizontal price-fixing agreements *per se* illegal. Cal. Bus. & Prof. Code § 16720; *Mailand v. Burckle*, 572 P. 2d 1142, 1147 (Cal. 1978). While California courts look to federal law for guidance in construing the Cartwright Act, the California Supreme Court has not had occasion to rule on a price-fixing case since the Supreme Court's *Leegin* decision to clarify whether California will follow that decision. Lower courts have observed that vertical price-fixing is still a *per se* violation of the Cartwright Act. *Alsheikh v. Superior Court*, No. B249822, 2013 Cal. App. Unpub. LEXIS 7187, at *10 (Cal. Ct. App. Oct. 7, 2013); *see also Alan Darush MD APC v. Revision LP*, 2013 U.S. Dist. LEXIS 60084 (C.D. Cal. Apr. 10, 2013) ("Under current California Supreme Court precedent, vertical price restraints are per se unlawful under the Cartwright Act . . . [t]here is no indication that precedent is changing."). Further, since *Leegin* was decided, the California Attorney General's office has stated that "[i]n California, prices must be set independently—and competitively—by distributors and retailers," and has brought enforcement actions and entered into settlements with businesses that allegedly entered into vertical pricing agreements. Press Release, Cal. Att'y General Halts Online Cosmetics Price-Fixing Scheme (Jan. 14, 2011), available at http://oag.ca.gov/news/press-releases/attorney-general-halts-online-cosmetics-price-fixing-scheme.

Alternative Pricing Approaches

Wary of the implications of implementing bilateral price-fixing agreements inappropriately, some franchisors choose to avoid entering into pricing agreements altogether in favor of unilateral pricing policies consistent with *United States v. Colgate & Co.*, 250 U.S. 300 (1919). Under a unilateral

pricing policy, the franchisor announces a minimum resale price, without any agreement from the reseller franchisee, and refuses to make further sales to any reseller franchisee that sells below the announced price.

In addition, some franchisors implement consignment and agency arrangements. For example, a franchisor may supply products to consumers by "consigning" such products to its franchisees. Under a consignment model, the franchisee only pays the franchisor when such products are resold by the franchisee. This approach allows the franchisor to unilaterally determine the resale price, without an agreement on price that could form the basis of price-fixing liability. However, franchisors should be mindful that requiring the franchisees to pay delivery or fulfillment fees could violate potentially applicable state franchise relationship laws, such as those requiring fair and reasonable prices.

Similarly, agency relationships do not raise Section 1 concerns because a principal and agent are considered to be a single entity—the agent merely carries out the decisions of the principal—and, therefore, incapable of concerted action or conspiring in violation of the antitrust laws. *In re Aluminum Warehousing Antitrust Litigation*, 95 F. Supp. 3d 419, 445 (S.D.N.Y. 2013). If a plaintiff, however, is able to prove that an agency relationship or a consignment arrangement is a sham, then a court may find the existence of an agreement for antitrust purposes.

Consignment and agency relationships, however, have their shortcomings. For one, they demand more dependency than most franchise arrangements. Franchisors exercise much more control over the franchisees' business, possibly increasing vicarious liability risk. Franchisees lose their ability to operate their businesses as they see fit and to derive higher profit margins from operating a more efficient business.

Looking Ahead

Overall, there has been a fairly static legal regime in the wake of *Leegin*, which has to this point provided businesses with certainty and clarity that resale price-fixing agreements will be evaluated under the rule of reason and not considered *per se* illegal. Looking forward, however, political forces seem eager to change this dynamic. In trying to curb the power of big tech, some politicians are pushing to enact laws favoring *per se* illegality and rejecting an inquiry into the procompetitive benefits of certain pricing restraints. This represents a shift away from the Chicago school of thought, which underpins the Supreme Court's analysis in *Leegin*, and closer to the Harvard school of thinking, which generally considers the conduct of large firms in concentrated industries to be anticompetitive. *See, e.g.*, Andy Kessler, *Unfortunately, 'Big Is Bad' Is Back*, WSJ, June 6, 2021, available at https://www.wsj.com/articles/unfortunately-big-is-bad-is-back 1622995107?reflink=desktopwebshare_permalink.

In that regard, a bipartisan group of lawmakers in the House of Representatives recently introduced a series of legislation aimed at reducing the competitive dominance of big tech companies like Google, Facebook, Amazon, and Apple in digital markets by prohibiting the companies "from acquiring competitive threats, preferencing their own services, and using their control of multiple business lines to disadvantage competitors." *See* Matthew Perlman, *House Lawmakers Float Bipartisan Big Tech Bills*, Law360, June 11, 2021, available at https://www.law360.com/articles/1393416/house-lawmakers-float-bipartisan-big-tech-bills. Notably, regulation of these companies is based on their size measured in sales and market capitalization, not their market dominance as measured by traditional economic analysis or conduct. With an administration that seems supportive of this line of thought and likely to appoint judges with similar views, future judicial decisions may start to question the theoretical underpinnings of *Leegin* and, as a result, the ability of franchisors and franchisees to agree on resale prices.

Conclusion

Businesses that distribute goods and services through vertical arrangements have benefitted from the clarity provided by the Supreme Court's 2007 decision in *Leegin*. That clarity should last in the near term, but academia and politicians, alarmed by the dominance of big tech, are demanding changes to existing antitrust laws that could impact the way in which courts and federal and state enforcement bodies analyze resale price maintenance agreements in the future. Franchisors and franchisees should remain watchful of these trends to ensure continued compliance with the legal landscape surrounding resale price-fixing arrangements. ■