

SESSION- 8

**Economics of Vertical Restraints**

CASE STUDY

**EVOLVING ECONOMICS - THE ROLE OF VERTICAL AGREEMENTS IN  
MODERN RETAIL**

**1. INTRODUCTION**

In the dynamic retail landscape, a compelling tug-of-war between consumer welfare and manufacturers' interest is based on vertical price agreements. These agreements shape competition and pricing strategies, making it crucial to explore their impact on innovation and market fairness.

As economic landscapes shift, unravelling the complexities of these agreements becomes crucial for striking the delicate balance between fostering innovation, preserving consumer choice, and ensuring fairness in the marketplace. What are the hidden ramifications of these pricing strategies, and how might they redefine our shopping experiences? The answers lie at the intersection of strategy, competition, and the future of retail.

**2. CASE FACTS**

The situation pertains to an oligopolistic market scenario. Leegin, a manufacturer specializing in leather apparel, recognized that its strategic interests would be better served by avoiding a detrimental price war, which often leads to unsustainable pricing practices. Instead, the company decided to prioritize quality and enhance its brand image by implementing a policy that generally prohibits retailers from discounting its products below the recommended retail price. This approach was intended to maintain the integrity of Leegin's brand and ensure a consistent market positioning. However, five years after instituting this policy, Leegin discovered that Kay's Kloset (**'Kay'**) was violating it by marking down Leegin products by 20%. When Kay refused to adhere to the pricing policy, Leegin terminated its business relationship with the retailer.

In response, PSKS, the parent company of Kay, initiated legal action against Leegin, alleging violations of antitrust laws based on claims that Leegin had entered into agreements with retailers to enforce fixed pricing. The case hinged on the contention that Leegin's pricing policy constituted an unlawful restraint of trade. When the district court declined to allow testimony regarding the procompetitive effects of Leegin's pricing strategy, the company appealed the decision, seeking to have the precedent set by *Dr. Miles* overruled. (*Dr. Miles principle established that 'Vertical restraints are per se illegal'*).

### 3. ANALYSIS OF BUSINESS CONDUCT

Following the appeal application, the United States Supreme Court ('SC') examined both economic and legal applications of the issues with vertical restraints. The SC initially analysed the *implications of vertical agreements that establish minimum resale prices*, focusing on whether these should be treated as automatically illegal (per se rule) or analysed based on their actual effects (rule of reason).

There are several potential economic justifications for minimum resale price agreements. *For instance*, they can enhance competition between different brands (inter-brand competition) by reducing competition among retailers selling the same brand (intra-brand competition). This reduction in intra-brand competition can encourage retailers to invest more in customer service and marketing, as they can be assured they won't lose sales to discounters. However, despite these potential benefits, there are also risks associated with vertical price agreements. They can facilitate collusion among manufacturers or retailers, leading to higher prices for consumers. Moreover, powerful companies might exploit these agreements to unfairly dominate the market, further raising concerns about their anticompetitive effects.

Furthermore, analysing it from the perspective of Section 1 violation of the Sherman Act, it was held by the Hon'ble SC that the accepted standard under the said provision is the 'Rule of Reason'. Hence, it was concluded that, *"Vertical retail-price agreements have either pro-competitive or anticompetitive effects, depending on the circumstances in which they were formed."*



### 4. REMEDY PROVIDED BY THE AUTHORITY

The Hon'ble apex court, overruling Dr. Miles case held that the doctrine of stare decisis does not necessitate adherence to the per se rule concerning resale price maintenance under the Sherman Act. As a common-law statute, its interpretation must adapt to evolving economic conditions. SC held that the agreement was *not anti-competitive* and hence, *no penalty* was levied on the enterprise.

### 5. RELEVANT PROVISIONS

### **5.1 Section 1 – Sherman Antitrust Act, 1890: -**

“Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. Every person who shall make any such contract or engage in any such combination or conspiracy, shall be deemed guilty of a misdemeanour, and, on conviction thereof, shall be punished by fine not exceeding five thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, at the discretion of the court.”

### **5.2 Dr. Miles Principle – Dr. Miles Medical Co. v. John D. Park & Sons Co., 1911**

It established that vertical restraints are *per se illegal*.

## **6. QUESTIONS FOR DISCUSSION**

**The group will be divided into two sub-groups.**

### **Questions for the first subgroup**

- 6.1** How do minimum resale price agreements limit consumers' choices? Under what conditions can such agreements be justified?
- 6.2** What could be the possible solutions to maintain a balance between a variety for consumers and manufacturer's liberty on putting resale pricing policies?

### **Questions for the second subgroup**

- 6.3** Whether the implementation of resale price maintenance strategies has significant anti-competitive or pro-competitive effects on the market ecosystem, particularly in relation to upstream and downstream channels?
- 6.4** Whether smaller manufacturers, where they have small size and market power of little importance, can justify similar pricing strategies without risking anti-competitive behaviour?

## **7. RELEVANT READINGS**

- 7.1** Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877, 2007 (Can be accessed here: [Judgement Copy](#))
- 7.2** Vertical Restraints – an economic perspective, Fiscalia Nacional Economica (Can be accessed here: [Research Paper](#))