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STATE OIL CO. V. KHAN: A REVERSAL ON MAXIMUM RESALE PRICE MAINTENANCE

by

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INTRODUCTION

On November 4, 1997, the Supreme Court in a unanimous decision ruled that a manufacturer or supplier does not necessarily violate federal antitrust law by placing a ceiling on the retail price a dealer can charge for its products. In State Oil Co. v Khan[1], the Court reversed nearly thirty years of legal precedent set by the decision in Albrecht v. The Herald Co.[2], altering the standard from one of a *per se* violation to one governed by the Rule of Reason.

Rationale for Resale Price Maintenance

Resale Price Maintenance (RPM) is controlled by Section 1 of the Sherman Act[3] which states "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 declared to be illegal." Most RPM agreements require the setting of minimum rather than maximum resale prices. Empirical studies show that , except in rare cases, these RPM agreements result in higher retail prices and, therefore, lower sales for the manufacturer.[4] It is somewhat surprising that manufacturers would ever want to set minimum resale prices: once a manufacturer sets the product's wholesale price, it would normally be in the manufacturer's best interest to increase sales by having the product sold at the lowest possible retail price. If RPM generally does not benefit manufacturers, why has it been so commonly used? There are four major arguments that explain the adoption of RPM.

First, RPM may be the result of "retailer cartel", i.e. collusion among retailers, to keep prices high. According to this argument, the most important reason for RPMs popularity has been the desire of small retailers to compete with large discount stores.

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Historically, small retailers put pressure on Congress, and Congress responded by legalizing RPM with the passage of the Miller-Tydings Act in 1937.[5]

Second, it is suggested that RPM might make tacit collusion among manufacturers easier to maintain, but little empirical evidence supports this theory.[6] According to this theory, if retail prices are fixed, a retailer will have little incentive to cheat on the agreement and reduce prices. Because the price reductions cannot be passed on to customers, the cuts are likely to have a limited effect on the cheater's market share.[7]

Third, RPM might prevent retailers from selling high-quality products at low prices or as "loss leaders". According to this theory, if a high-quality product is consistently sold at a low price, consumers will begin to think of the product as a low quality product, and this will hurt the manufacturer in the long run. Both Levi jeans and Izod alligator shirts may have been victims of this phenomenon when they moved away from RPM.[8] Levi-Strauss was persuaded by the FTC to abandon RPM in 1977. Initially Levi's sales increased, but during the early 1980s it lost significant market share to designer jeans such as Gloria Vanderbilt, Ralph Lauren and Calvin Klein. Similarly, Izod's image and appeal declined as the shirts became more widely available.

Finally, RPM has been justified by the argument that some products require high quality pre-sale service from retailers, and only RPM or vertical integration can ensure the provision of such services. For example, by imposing RPM on their retailers, manufacturers could ensure that the dealers do not compete on price, but instead, would compete by attempting to provide better service. In the absence of RPM, some retailers, for example, computer dealers would provide good, but costly, service and charge high prices while other dealers would provide little or no service and charge low prices. Consumers could then shop around at the high priced, good service dealers, but ultimately purchase their computers at the low priced dealers. The low priced dealers would then obtain a "free ride" on the services provided by the high priced, good service dealers who might then be eliminated from the market. The prevention of a significant free rider problem is the most convincing economic justification for RPM. However, this argument may make sense only for a small number of items such as automobiles, computers, audio and video equipment, and bicycles, for which in-store pre-sale services are important.

The Rule of Reason

The first major interpretation of this statute came with the decision in Standard Oil Company of New Jersey v. United States[9]. In his opinion, Chief Justice Edward White said,

> It is obvious that judgment must in every case be called into play in order to determine whether a particular act is embraced within the statutory classes, and whether, if the act is within such classes, its nature or effect causes it to be a restraint of trade within the intendment of the act. If the criterion by which it is determined in all cases whether every contract, combination, etc., is a restraint of

> trade within the intendment of the law, is the direct or indirect effect of the acts involved, then of course the rule of reason becomes the guide[10]...

In his dissent to the decision[11], Justice Harlan maintained a Rule of Reason Approach had been rejected in the earlier case of United States v. Trans-Missouri Freight Assn.[12]. In that decision, Justice Peckham, speaking for the majority said,

> What is the meaning of the language as used in the statute, that '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?'. Is it confined to a contract or combination which is only in unreasonable restraint of trade or commerce, or does it include what the3 language of the act plainly and in terms covers, all contracts of that nature?...The arguments which have been addressed to us against the inclusion of all contracts in restraint of trade, as provided for by the language of the act, have been based upon the alleged presumption that Congress, notwithstanding the language of the act, could not have intended to embrace all contracts, but only such contracts as were in unreasonable restraint of trade...In other words, we are asked to read into the act by way of judicial legislation a exception that is not placed there by the law-making branch of the government, and this is done upon the theory that the impolicy of such legislation is so clear that it cannot be supposed Congress intended the natural import of the language it used. This we cannot and ought not to do.[13]

Henceforth, most antitrust claims are handled under the Rule of Reason under which the court reviews a number of relevant factors, however, some types of restraints on trade have such predictable and pernicious anti-competitive effect, and such limited potential for pro-competitive benefit, that they are deemed unlawful *per se*[14]. According to one scholar,

> Antitrust reflects the never-ending conflict between the desire for certainty and the desire for flexibility that is as old as the processes of the law itself. Whereas a *per se* rule immediately brands the operative facts embraced by it as unreasonable, the Rule of Reason opens the way to reliance upon a broad range discretion in weighing the evidence of defenses of justification compatible with the purposes of the antitrust statutes. The Rule of Reason operates through a process of inclusion and exclusion in a case-by-case consideration of all the facts. The *per se* illegality doctrine operates by converting predetermined single-fact categories into fixed rules of law.[15]

To be *per se* unreasonable, a practice must be inherently harmful to competition and should be readily recognized as unreasonable and, hence, illegal without further economic inquiry.[16] An inquiry into the relevant economic product market and geographic market as well as the defendant's economic power within those markets would be pertinent and necessary.[17]

The *Albrecht* Case

The case of Albrecht v. The Herald Company[18] was decided by the Supreme Court in 1968. Albrecht was an exclusive distributor for *The Herald* in a portion of the city of St. Louis. When Albrecht began selling newspapers at a price above *The Herald's* suggested retail price, the newspaper ceased selling to him. Albrecht brought a lawsuit alleging a *per se* violation of the Sherman Act[19]. This case was unusual in that the alleged violation was not the setting of a minimum price but rather a maximum price at which the distributor could effectively sell the product without losing his distributorship. The courts had long recognized setting of a minimum price as a *per se* violation[20]. However, the issue of maximum price setting had not arisen until the case of Kiefer-Stewert Company v. Joseph E. Seagram & Sons, Inc., et al[21] in 1951. In Kiefer, the Court held "agreements, no less than those to fix minimum prices, cripple the freedom of traders and thereby restrain their ability to sell in accordance with their own judgment"[22]. Therefore, such agreements were ruled to be *per se* violations of the Sherman Act.

The positions of the parties in Albrecht indicate the different goals of the parties to the contract. The distributor was interested in maximizing his profits per unit sold while the newspaper was interested in keeping the prices low in order to sell a greater volume of papers. A greater volume of papers sold at lower prices might not maximize sales profits but would support higher advertising rates. In the opinion for the majority, Justice Byron White wrote, "Schemes to fix maximum prices by substituting the perhaps erroneous judgment of a seller for the forces of the competitive market, may severely intrude upon the ability of buyers to compete and survive in that market"[23]. The Court held the setting of maximum prices to be a *per se* violation of the Sherman Act. In a dissenting opinion, Justice Harlan argued for the application of a Rule of Reason.

In the present case the Court uses again the fallacious argument that price ceilings and price floors must be equally unreasonable because both cripple the freedom of traders and thereby restrain their liberty to sell in accordance with their own judgment ...It has long been recognized that one of the objectives of the Sherman Act was to preserve, for social rather than economic reasons, a high degree of independence, multiplicity, and variety in the economic system. Recognition of this objective does not, however, require this Court to hold that every commercial act that fetters the freedom of some trader is a proper subject for a *per se* rule in not whether the dictation of maximum prices is ever illegal, but whether it is always illegal.[24]

It would be nearly thirty years before Justice Harlan's words would become prophetic.

The *Khan* Case

In State Oil Company v. Khan[25], Khan leased a gas station and a convenience store from supplier State Oil Company. Under the lease, State Oil sold its gasoline to Khan at State Oil's suggested retail price, less a margin of 3.25 cents per gallon, representing Khan's profit margin on the sale of the gasoline. While Khan could charge any retail price he wanted, if the price were above State Oil's retail price, any excess would be rebated to State Oil. This arrangement effectively set a ceiling on Khan's retail price of gasoline. Khan's business did not prosper and when State Oil sought to evict him, Khan filed a complaint alleging in part that, by preventing him from raising or lowering retail gasoline prices, State Oil had violated the antitrust laws.

At the Federal District Court level, the court ruled that Khan had failed to make out a case for a *per se* violation of Section 1 of the Sherman Act because he had shown no "manifestly anti-competitive implications or pernicious effect on competition" that would justify *per se* prohibition of State Oil Company's conduct.[26] On appeal, the Circuit Court of Appeals reversed.[27] In the Seventh Circuit's opinion, Judge Posner cited the Albrecht case[28] as "unsound when decided" and "inconsistent with later decisions" of the Supreme Court but determined that the Seventh Circuit was bound to follow the stare decisis of Albrecht case and find a *per se* violation of the Sherman Act. State Oil appealed and oral argument was had before the Supreme Court on October 7, 1997.

As an interesting aside, the Justice Department and the Federal Trade Commission joined in an amicus curiae brief in favor of a reversal of the Albrecht decision. Acting Assistant Attorney General Joel I. Klein argued that the ruling in Albrecht had done "considerably more harm than good" and that the ceilings on prices are "likely to be pro-competitive"[29]. On the retailers' side, organizations of automobile and gasoline dealers as well as the Attorney Generals of thirty-three states filed briefs urging the Court to uphold Albrecht.

In its ruling, the Supreme Court explicitly overruled Albrecht[30]. In a unanimous decision of the Court, Justice Sandra Day O'Connor stated in her opinion,

> ...guided by the general view that the antitrust laws' primary purpose is to protect inter-brand competition, and that condemnation of practices resulting in lower consumer prices is disfavored, this Court finds it difficult to maintain that vertically imposed maximum prices could harm consumers or competition to the extent necessary to justify their *per se* invalidation of *Albrecht's* theoretical justifications for its *per se* rule- that vertical maximum price fixing could interfere with dealer freedom, restrict dealers' ability to offer consumers essential or desired services, channel distribution through large or specially advantaged dealers, or disguise minimum price fixing schemes- have been abundantly criticized and can be appropriately recognized and punished under the Rule of Reason....In overruling *Albrecht*, the Court does not hold that all vertical maximum price fixing is *per se* lawful, but simply that it should be evaluated under the Rule of Reason, which can effectively identify those situations in which it amounts to anti-competitive conduct[31].

CONCLUSION

The authors concur in the reasoning of the Supreme Court in State Oil Company v. Khan[32]. In the past manufacturers have avoided direct legal confrontation with antitrust regulators by alternate mechanisms such as franchise fees, whereby a manufacturer requires retailers to pay a fixed fee for the right to sell the product, volume discounts disguised in the form of manufacturer rebates and minimum purchase requirements. The authors conclude that a great deal of existing RPM agreements have a positive or neutral effect on economic efficiency and welfare and each antitrust case over RPM should be analyzed in detail to determine whether there is a positive or negative effect on economic efficiency. The Supreme Court's decision to alter the standards of antitrust violation from *per se* to one governed by the Rule of Reason is a step in the right direction.

ENDNOTES

[1] __U.S.__, 1997 WL 679424 (Nov. 4, 1997)

[2] 390 U.S. 145 (1968)

[3] 15 USC Section 1

[4] S.C. Hollander, in B.S. Yamey(ed.), *Resale Price Maintenance* Chicago: Aldine, 1966) pp. 67-100: Marvin Frankel, "The Effects of Fair Trade: Fact and Fiction in Statistical Findings", *Journal of Business* (July 1955); and J.F. Pickering, "The Abolition of Resale Price Maintenance in Great Britain", *Oxford Economic Papers* (March, 1975).

[5] The Miller-Tydings Act amended the Sherman Act to permit states to pass laws to exempt "agreements prescribing minimum prices for the resale of a branded commodity which…is in free and open competition with commodities of the same general class produced or distributed by others". The Act also prevented the FTC from taking action against RPM as an "unfair method of competition". By 1941, forty-five of the forty-eight states had passed so-called fair trade laws permitting RPM. Only Texas, Missouri, Vermont and the District of Columbia stood as exceptions. The courts have generally been together on RPM than has Congress. In 1976, however, even Congress turned against RPM and repealed the remaining "fair trade laws" that permitted resale price maintenance.

[6] Waldman and Jensen, *Industrial Organization* (Reading, MA, Addison Wesley, 1998) p.422

[7] Thomas R. Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence* (Washington: FTC Bureau of Economics staff report, November 1983) pp. 13-19, 80, 140-4, 161-3; and Stanley I. Ornstein, "Resale Price Maintenance and Cartels", *Antitrust Bulletin* 30 (1985), 401-32.

[8] Robert L. Steiner, "Jeans: Vertical Restraints and Efficiency", in Larry L. Duetsch(ed.) *Industry Studies* (Englewood Cliffs, NJ: Prentice-Hall, 1993), pp. 182-205; and "Has Izod's Alligator Peaked?" *New York Times* (September 8, 1983): D1.

[9] 221 U.S. 1 (1911)

[10] Id

[11] Id

[12] 166 U.S. 290 (1896)

[13] Id

[14] *Northern Pacific Railroad Company v. United States*, 356 U.S. 1

[15] S.C. Oppenheim, "Federal Antitrust Legislation: Guideposts to a Revised National Antitrust Policy", *Michigan Law Review,* Vol. L (June, 1952), 1149

[16] *Carlson Machine Tools, Inc. v. American Tool, Inc.* (1982, C.A. 5 Tex), 678 F. 2d 1253

[17] *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447 (1993). *See also, Brooke Group Ltd. v. Brown and Williamson Tobacco Corp.* 509 U.S. 209

[18] 390 U.S. 145 (1968)

[19] Id

[20] *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911)

[21] 340 U.S. 211 (1951)

[22] Id

[23] See Supra note 11

[24] Id

[25] See Supra note 1

[26] Id

[27] 93 F. 3d 1358 (7th Cur. 1996)

[28] See Supra note 11

[29] Brief for the United States and the Federal Trade Commission's Amici Curiae Supporting Reversal

[30] See Supra note 1

[31] Id

[32] Id