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Resale price maintenance: A managerial perspective

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Managers can improve firm profits by selecting the appropriate pricing strategy. In this article, we show how managers can use one particular controversial pricing strategy—resale price maintenance (RPM)—to enhance firm profits. We first discuss the antitrust treatment of RPM, both in the United States and internationally. Then we examine the economic effects of implementing RPM in several key contexts: product promotion, quality certification, prestige goods, and online retail. We also discuss the effects of RPM on entry of new firms.

1 | INTRODUCTION

There are many pricing strategies that a manager could pursue in an effort to enhance the firm's profits. In this article, we examine a controversial pricing strategy known as resale price maintenance (RPM). When a manager sells the firm's product to a distributor on the condition that the distributor's resale price not fall below a specified minimum, he or she is imposing RPM on the distributor. Thus, RPM is a vertical pricing restraint that limits a reseller's ability to reduce the retail price. This seems like an odd restraint because the manufacturer would sell a larger quantity if the retail price were reduced. At first blush, it is not entirely obvious how RPM improves profits; which is what makes RPM interesting from a managerial perspective.

Until recently, RPM was a *per se* violation of the antitrust laws. Now, however, RPM is subject to rule of reason treatment in the United States, which means that the strategy is permissible unless its consequences are anticompetitive. In Section 2, we provide a brief overview of the US antitrust treatment of RPM and that of most other countries. In Section 3, we show that RPM improves the manufacturer's profits by inducing the distributor to promote the product. In Section 4, our attention centers on the use of RPM to signal product quality. In Section 5, we explain how RPM is especially beneficial for manufacturers of prestige goods. In Section 6, we discuss how RPM can facilitate the entry of new firms and product lines. In Section 7, we examine RPM given the rise of online discount retailers. We close with some concluding remarks in Section 8.

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2 | LEGAL STATUS OF RPM

In the early 1900s, the Dr. Miles Medical Company[1] sold its nonprescription medicines to its authorized wholesalers and retailers on the condition that they should not resell the products below specified minimum prices. John D. Park & Sons refused to agree to this limitation on their pricing freedom, but still wanted to distribute Dr. Miles's products. When John D. Park & Sons induced some authorized dealers to breach their contracts with Dr. Miles by selling its products to John D. Park & Sons, which was not an authorized dealer, Dr. Miles filed a breach of contract suit against John D. Park & Sons. By the time the case reached the Supreme Court, the original breach of contract suit had turned into an antitrust case. The Supreme Court objected to RPM contracts as they interfered with the freedom of traders. In addition, the Court likened Dr. Miles's vertical price agreement to a horizontal agreement among its distributors. Because such horizontal agreements were unlawful, the Court found Dr. Miles's RPM agreements to be similarly unlawful. The Supreme Court's opinion in *Dr. Miles* was understood to condemn RPM agreements as per se unlawful under §1 of the Sherman Act. The Supreme Court continued to protect the freedom of traders to deal with whomever they wish under their own terms. Apparently, the fundamental concern in *Dr. Miles* was the agreement between Dr. Miles and its distributors. The Court's focus on *agreement* was sharpened in the Court's *Colgate*[2] decision in 1919. Under *Colgate*, a manufacturer may announce a policy of refusing to deal with discounters. As long as the resellers did not affirmatively *agree* to abide by the policy, but simply respected the policy, the manufacturer was safe. Therefore, under *Dr. Miles* and *Colgate*, RPM programs that were the product of vertical agreements were illegal per se, whereas those that were imposed unilaterally were lawful. Importantly, neither the *Dr. Miles* opinion nor the *Colgate* opinion provided an economic analysis of RPM that identified the adverse economic consequences of the practice. Following *Dr. Miles*

and *Colgate*, the emphasis was on proof of agreement rather than economic effects. The mere existence of an RPM *agreement* was sufficient to prove that §1 of the Sherman Act had been violated.

Subsequent RPM cases shed no light on the competitive concerns. Because RPM agreements were per se illegal, adverse competitive effects were presumed to be present.[3] Following *Dr. Miles*, the outcome of legal challenges to RPM programs turned on the mere existence of the practice. Economically, equivalent practices often passed antitrust muster. For example, consignment sales agreements control downstream prices just as effectively as RPM agreements, but were approved in the Court's *General Electric* decision.[4] In a consignment sale, the manufacturer retains ownership of the good until it is sold to the consumer. In an RPM agreement, the manufacturer sells its product to the distributor, but retains control over the resale price. Thus, there is a legal distinction without much (if any) economic difference.

Much later, the Supreme Court confronted an unusual allegation in *Business Electronics*.[5] When Sharp sold its calculators to distributors, it did not forbid all discounting. Sharp did, however, supply its calculators on the condition that they could not be deeply discounted. A rival of *Business Electronics* complained that *Business Electronics* was reselling Sharp's products at excessive discounts. The rival threatened to discontinue selling Sharp's products if *Business Electronics* continued as a Sharp distributor. Sharp investigated these complaints and confirmed that its calculators were being deeply discounted. When Sharp terminated *Business Electronics*, the latter filed an antitrust suit alleging an RPM agreement. There were two issues to be resolved. First, did Sharp's conditioning amount to RPM in fact? Second, did the sequence of events provide the evidentiary foundation for an inference of an agreement? Because the Supreme Court found that the conditioning was too vague to support a cartel, it found that Sharp's conditioning did not constitute RPM.

A similar search for proof of an agreement was the central focus of the *Spray Rite* case.[6] There, the question was whether the existence of an agreement could be inferred from circumstantial evidence. In *Spray Rite*, the court found an agreement and applied the per se rule.

In both *Spray Rite* and *Business Electronics*, a key issue was whether there was, in fact, an agreement. The focus was not on the economic effects because RPM was presumed to be anticompetitive. Interestingly, economists had been generally aware of the fact that there were sound business reasons for employing RPM agreements. For example, Breit (1991) has made a convincing argument that economists were generally aware that RPM was used to induce distributors to provide promotional services that manufacturers could not efficiently provide for themselves. The critical economic role of RPM was discovered by Yamey (1954) and by Telser (1960). Bowman Jr. (1955) also offers an early and useful analysis of RPM.

Telser (1960) explained that a manufacturer faces a significant problem when it tries to induce its distributors to provide costly point-of-contact promotional services. Some opportunistic distributors may reduce their costs by not providing the services, cut prices below that of full-service distributors, and thereby expand their sales and profits. Put differently, these opportunistic distributors would free ride on the efforts of the full-service distributors. This free riding would make these promotional efforts unprofitable. Consequently, the promotional efforts would disappear eventually to the manufacturer's detriment. Thus, RPM could be used to enhance promotional efforts by distributors, and thereby serve a procompetitive purpose. Following Telser, a substantial literature on RPM was developed that further analyzed the economic rationales for RPM.[7] Because this literature undermined the sensibility of the *Dr. Miles* rule of per se illegality, there was mounting criticism of *Dr. Miles*. Ultimately, in 2007—nearly a century after *Dr. Miles*—the Supreme Court recognized that RPM is not invariably anticompetitive and, therefore, is unsuitable for per se condemnation. The facts in *Leegin* were unremarkable. Leegin Creative Leather Products manufactured a line of coordinated women's fashion accessories including belts, hand bags, and shoes. Its business strategy was to sell its Brighton line of products through boutique women's shops rather than through department stores and mass merchandisers. Leegin wanted its retail distributors to promote its Brighton line and saw the need to protect its retailers' margins by forbidding discounts. When PSKS, doing business as Kay's Kloset, refused to comply, it was terminated as a Brighton dealer. In response, it filed an antitrust suit alleging that Leegin's RPM program was a per se violation of §1 of the Sherman Act. The lower courts adhered to the *Dr. Miles* precedent and ruled in favor of PSKS. The Supreme Court, however, had other thoughts. Given this opportunity to reconsider *Dr. Miles*, it acknowledged the fact that RPM is not invariably anticompetitive. Accordingly, the Court reversed *Dr. Miles* and removed the per se label from RPM. Elzinga and Mills (2010) provide some useful insights into operation and effects of RPM in Leegin's business.[8,9]

Now, this pricing strategy must be evaluated under the rule of reason. In a rule of reason analysis, the plaintiff must offer proof that an RPM agreement is facially anticompetitive and, therefore, should be condemned as an unreasonable restraint of trade. The defendant then has the burden of disproving the existence of the program or proving that the RPM agreement is procompetitive or competitively neutral. If the defendant's effort is successful, the burden shifts back to the plaintiff to rebut the defendant's evidence or to offer a less restrictive alternative to RPM.

The fact that RPM is now subject to rule of reason treatment under the Sherman Act does not mean that RPM is per se lawful, but it does mean that adverse economic effects must be proven rather than presumed.

Manufacturers that find RPM to be promotional and on balance profitable may employ this pricing strategy without fear of per se condemnation in the United States. Nonetheless, these firms should proceed with caution. First, there is lingering hostility toward RPM, which may result in expensive legal challenges. Second, for multinational firms, the practice remains per se unlawful outside the United States.[10]

Initially, there were legislative efforts to repeal *Leegin* by amending §1 of the Sherman Act. Senate bill S. 75—the "Discount Pricing Consumer Protection Act"—was introduced in 2011 and sought to make RPM per se illegal.[11] Although the Senate bill was not passed, some states have legislation that makes RPM unlawful. For example, the Code of Maryland was amended to state: "a contract, combination, or conspiracy that establishes a minimum price … is an unreasonable restraint of trade or commerce."[12] This clearly makes RPM per se illegal

in Maryland. State law in California[13] also continues to make any vertical price-fixing agreements, including RPM, illegal per se despite *Leegin*.[14,15]

Some states have done the opposite and established a rule of reason approach to RPM. In Kansas, the state Supreme Court ruled that RPM was per se illegal under existing state law. However, the Kansas legislature passed an amendment that nullified the ruling and established a rule of reason approach.[16]

In *People v. Tempur-Pedic International, Inc.*,[17] the New York Attorney General tried to argue that Tempur-Pedic, a producer of premium mattresses, had engaged in RPM. The court rejected this argument because the relevant state statute[18] does not explicitly prohibit RPM agreements, although it does state that such contracts are unenforceable. Furthermore, the court found that Tempur-Pedic had not entered into an explicit RPM agreement with its retailers. Although Tempur-Pedic prohibited retailers from advertising prices lower than Tempur-Pedic's chosen minimum, these retailers were free to sell the product at any price. However, retailers could be unilaterally terminated at any time. In short, Tempur-Pedic had combined the *Colgate* shield with a minimum advertised price (MAP) program to avoid litigation while still maintaining high minimum prices at its retailers.

2.1 | International attitudes toward RPM

RPM limits a reseller's freedom to reduce the price that it charges to its customers. Assuming that the manufacturer's designated price floor is a binding constraint, the price that the consumer pays is higher than the price in the absence of RPM. This higher price would seem to reduce consumer welfare and, therefore, be objectionable. As we will see in subsequent sections, this is not necessarily the case, but this feature of RPM agreements has resulted in hostility toward RPM agreements around the world. In this subsection, we illustrate this contention by examining the antitrust treatment of RPM in Canada, China, the European Union, France, Germany, Japan, Korea, and the United Kingdom.[19]

2.2 | Canada

Until 2009, RPM was a criminal violation of Canada's Competition Act. Canada softened its attitudes toward RPM and moved closer to the views in the United States. Nonetheless, there is a lingering suspicion that RPM is anticompetitive. Currently, RPM is unlawful in Canada provided that (a) RPM prevents price reductions that would otherwise occur, (b) the manufacturer refuses to supply its product to resellers that resell the product at discount prices, and (c) the RPM program has an adverse effect on competition in the market for the good(s) in question.

2.3 | China

Following the introduction of capitalism, China's economy exploded. At this point, it is the largest economy in the world. As it grew, China saw the desirability of a formal competition policy. In August 2009, China enacted its Antimonopoly law (AML). Under the AML, RPM is prohibited. It is deemed to be a vertical anticompetitive practice. Article 10 of the AML indicates that RPM might be exempted from prosecution under certain conditions, which are spelled out in Article 15.

In the cases that have found RPM to be a violation of the AML, fairly substantial fines have been imposed. Johnson & Johnson, for example, was fined about $82.5 million. Two liquor producers were fined about $70 million for setting minimum resale prices. Several producers of infant formula were fined about $100 million for establishing and enforcing an RPM program.

2.4 | European Union

Article 101 of the Treaty for the Function of the European Union (TFEU) ordinarily focuses on collusive conduct among ostensible competitors. RPM, however, involves agreements between a producer and its distributor(s), that is, a vertical agreement. Nonetheless, it is suspect under Article 101 because it is presumed to be anticompetitive. This presumption is driven by the fact that resale prices are higher than they would be in the absence of the RPM agreement. Interestingly, proof of market power is unnecessary to establish a violation of the TFEU.

Some traditional efficiency defenses are recognized in principle but they have not saved an RPM agreement from condemnation. Those found guilty of unlawful RPM have faced heavy fines in the past.

2.5 | France

As a member of the EU, France is bound to respect the TFEU. It does, however, have its own competitive law under the French Competition Authority, RPM may be challenged as an anticompetitive agreement or as an abuse of dominance.

2.6 | Germany

In Germany, RPM may be challenged as an anticompetitive vertical agreement or an abuse of dominance. German courts have found RPM agreements to be hard core restraints on competition because such agreements prevent intrabrand competition through discounting.

Suppliers that actively impose RPM restraints on their distributors may be guilty of a violation even if they are relatively small, that is, are not dominant.

2.7 | Japan

Under the JAA, RPM is an unfair trade practice. The economic rationale for condemning RPM appears to be a concern that RPM facilitates monopolistic pricing in oligopolistic markets. Although RPM does not seem to be common in Japan, it results in fines where it is found.

2.8 | Korea

Chapter 7 of the Monopoly Regulation and Fair Trade Act addresses RPM in Korea. This provision categorically prohibits RPM. In both the KFTC Guidelines under the KFTC decisions, it is clear that RPM is unlawful per se.

There are some circumstances that may warrant an exception to the per se rule. If these conditions are met, the KFTC may grant an exception. These conditions are (a) the quality of the good must be uniform and easily indentifiable, which suggests that the good must be an inspection good; (b) the good is used on a daily basis by most consumers; and (c) there is fierce competition in the sale of the good in question. Satisfying all these conditions narrows the scope of this provision for exceptions.

2.9 | United Kingdom

In the United Kingdom, RPM is considered to be a hard core violation of the TFEU. If RPM is employed without any evidence of horizontal collusion, the office of Fair Trade does not usually impose any fines. Instead, it is satisfied with a commitment from the firm to refrain from engaging in such practices in the future. In contrast, if RPM is accompanied by horizontal collusion, the overall scheme will be dealt with harshly.

In principle, RPM may be permitted if the supplier can provide a convincing efficiency justification for its use. So far, no one has been successful in justifying RPM.[20]

3 | RPM AND PRODUCT PROMOTION

In some circumstances, a manufacturer's distributors can provide point-of-contact promotional services far more efficiently than could the manufacturer. Unfortunately, the distributors may be unable to recover the costs of providing these promotional services and, therefore, will not supply them. In this section, we explain thoroughly how a manufacturer can use RPM to induce its distributors to promote the product. We focus on the costs and benefits to managers at the manufacturing stage and the distribution stage. In addition to the graphical analysis, we provide a numerical example.

3.1.1. | Economic results without promotion

Consider a two-tier distribution system in which a manufacturer with market power sells its output to a competitively structured retail sector. The retailers resell the product to final consumers. For simplicity, assume that the retailers do not transform the product. Instead, they simply provide retailing services such as display, set up, delivery, and the like.

Initially, we assume that the retailers do not provide any additional point-of-contact promotional services. The economic results can be illustrated in Figure 1.

The retail demand by consumers is represented by D_1 and the marginal and average cost of performing the retail function is denoted by mc_1. This cost of retailing does not include the wholesale price of the product. Instead, it merely captures the costs of providing the retail transaction—labor costs, display, inventory, set up, and delivery costs.

The manufacturer does not face the consumer demand (D_1). Instead, it faces the wholesale demand on the part of the retailers. Because the retailers only want to buy the product so they can resell it, the wholesale demand is derived from the consumer demand. For any given quantity, the maximum price that the manufacturer can charge is the difference between the price consumers are willing to pay and the marginal cost of retailing. Thus, the derived demand will be expressed as

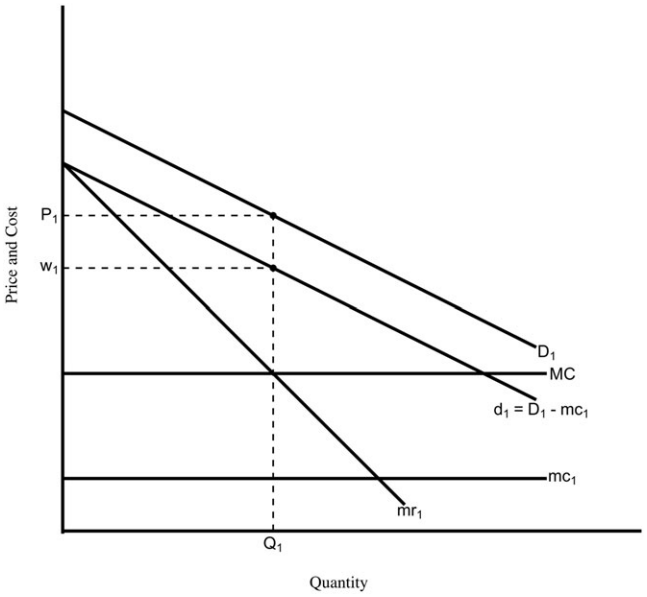

FIGURE 1 Economic results without promotion. MC = marginal cost

$$w_1 = P_1 - mc_1,$$

where w_1 is the wholesale price, P_1 is the retail price, and mc_1 is the marginal cost of retailing. For Figure 1, the derived demand is represented by $d_1 = D_1 - mc_1$. The associated marginal revenue curve is denoted by mr_1.

The manufacturer will elect to produce the output where its marginal cost of production (MC) equals marginal revenue (mr_1). Thus, the manufacturer will produce Q_1 and charge a wholesale price of w_1. Its profits will be equal to

$$\pi = (w_1 - MC)Q_1.$$

For the retailers, the sum of w_1 and mc_1 is just equal to P_1, which corresponds to Q_1 on the retail demand. Thus, the retailers earn no economic profit:

$$\pi = (P_1 - w_1 - mc_1)Q_1 = 0,$$

but they do realize a competitive return on their investment in this venture.

3.1.2. | Economic effects of point-of-contact promotion

In addition to the usual kinds of advertising and promotion, there may be point-of-contact, or product-specific, promotional services that can be provided far more efficiently by the retailer than by the manufacturer. Automobile dealers provide test drives and stock substantial inventories of different models in different colors with different options. They also supply warranty service. Consumer electronics dealers have well-trained sales people who can demonstrate and explain various features. Sophisticated sales personnel in boutique women's shops can provide fashion advice that promotes a coordinated and stylish appearance. These sorts of promotional services are

difficult for the manufacturers to supply themselves because the contact is between the consumer and the retailer. These services increase the value of the product in question to the consumers and thereby lead to an increase in consumer demand, which benefits the manufacturer because the derived demand shifts as well. The economic consequences can be seen in Figure 2.

Suppose that point-of-contact promotional services would increase the marginal cost of retailing to mc_2. These services enhance the value of the product to the consumers, which is reflected in the shift in the retail demand from D_1 to D_2. In this example, the vertical shift in the marginal cost of retailing is smaller than the shift in the retail demand. Put differently, we assume that the value of the enhanced promotional services to the consumer exceeds the cost of supplying these services.[21]

Because the derived demand is the difference between the retail demand and the marginal cost of retailing, the derived demand increases from d_1 to d_2, where

$$d_2 = D_2 - mc_2,$$

and the associated marginal revenue shifts to mr_2.

Profit maximization will lead the manufacturer to increase its output to Q_2 where mr_2 equals MC. The corresponding wholesale price will be w_2. The retail price that corresponds to Q_2 is P_2. The manufacturer's profits will increase to

$$\pi_2 = (w_2 - MC)Q_2,$$

whereas the distributor's profits remain equal to zero.

In order to experience these elevated profits, the manufacturers will specify a minimum resale price of P_2 while charging a wholesale price of w_2. Initially, the retailer margin will be equal to $P_2 - w_2 - mc_1$, which is positive. The retailers will compete among themselves for increased sales. They cannot compete on price due to the RPM agreement. Consequently, they compete on nonprice grounds by offering enhanced point-of-contact promotions. As they compete, they incur the costs of expanding their inventories, hiring more informed sales people, and generally investing in promotional efforts. When their costs rise to mc_2, they will not increase their efforts beyond that point.[22]

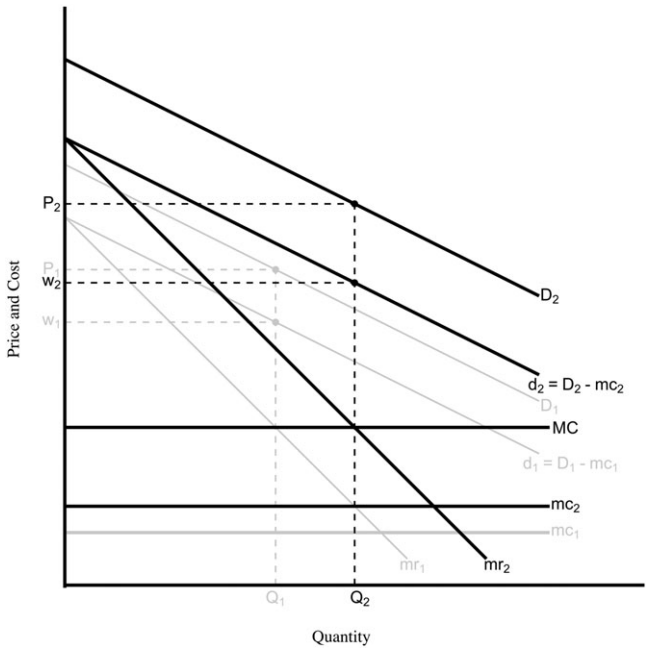

FIGURE 2 Economic effects of point-of-contact promotion. MC = marginal cost

In the absence of RPM, some clever retailers would figure out that they could stop providing point-of-contact promotional services and thereby reduce their costs. Although rival retailers provide the services, the clever retailers cut price a bit below P_2 and take business away from the full service retailers. With RPM, however, they cannot do this because they will be terminated.

If discounting becomes widespread, the full service retailers would not be able to provide the promotional services as they would be incurring costs but not making sales. Thus, the services would not continue, retail demand would fall from D_2 to D_1, and the manufacturer's profits would fall from π_2 to π_1.

3.2 | Numerical example

A numerical example may be useful to make these economic results more tangible. We begin with the retail demand, which we can write as

$$P = 80 - Q/2,$$

where P is the retail price and Q is the quantity demanded. The marginal cost of performing the retail function is constant and equal to 10.

$$mc_1 = 10$$

Consequently, the derived demand for the manufacturer's product is

$$w = P - mc_1 = 70 - Q/2,$$

which was found by subtracting the marginal cost of retailing from the retail demand. The marginal revenue curve associated with the derived demand is

$$mr_1 = 70 - Q.$$

The manufacturer's marginal cost of producing the good is

$$MC = 30.$$

Profit maximization by the manufacturer requires producing the output where the marginal revenue equals the marginal cost of production.

$$70 - Q = 30.$$

Solving for the profit maximizing quantity yields $Q = 40$. The wholesale price is found by substituting this value into the wholesale demand.

$$w = 70 - \frac{40}{2} = 50.$$

Competition among the retailers leads them to sell Q at retail price of 60.

For the manufacturer, profit is

$$\begin{aligned}\pi &= (w - MC) \times Q \\ &= (50 - 30) \times 40 \\ &= 800.\end{aligned}$$

Now let us see if RPM improves matters. Suppose that an increase in the marginal cost of retailing from 10 to 20 will lead to a shift in retail demand to

$$P = 120 - Q_2/2.$$

This, in turn, results in a shift in the derived demand to

$$w = 100 - Q_2/2,$$

with a corresponding shift in the marginal revenue to

$$mr_2 = 100 - Q_2.$$

With no change in the marginal cost of production, profit maximization requires production where

$$mr_2 = MC,$$

$$100 - Q_2 = 30,$$

$$Q_2 = 70.$$

The profit maximizing wholesale price is then

$$w_2 = 100 - \frac{70}{2} = 65.$$

The retail price that corresponds to this quantity is

$$P_2 = 120 - \frac{70}{2} = 85.$$

The manufacturer's profit is now

$$\begin{aligned}\pi_2 &= (w_2 - MC) \times Q_2 \\ &= (65 - 30) \times 70 \\ &= 2,450,\end{aligned}$$

which is larger than the profit without the added cost of retailing.

RPM is used to induce the added expenditure on retailing. The manufacturer sets a minimum resale price equal to 85. At marginal retailing costs of mc_1, there is a positive profit margin from the retailers. This induces them to compete for additional sales. Because they cannot compete by lowering price below P_2, they must compete on nonprice terms. Thus, mc_1 rises to mc_2, which wipes out all distributor profit.

4 | RPM AND QUALITY CERTIFICATION

Product *quality* is a general term that acquires meaning in specific contexts. As a general proposition, consumers prefer higher quality goods and services to lower quality versions at equal prices. Most consumers prefer uniform quality—no surprises good or bad. Consequently, consistency of quality is also important to consumers as it reduces uncertainty. Once a manufacturer has established its profit maximizing reputation, it will want to maintain that reputation and may do so in some cases by using RPM. In this section, we examine the use of RPM in certifying quality and preserving the quality image of prestige goods.

At any given price, consumers prefer higher quality goods to lower quality goods. In some cases, quality is an inspection characteristic. Fit and finish, color, style, and the like can be observed before purchasing and consuming the product. In contrast, durability, color fastness, taste, and reliability are experience characteristics that cannot be assessed before consuming the product. This is an information problem for the manufacturer as consumers will be willing to buy more at higher prices if they can be reliably informed about a product's quality.[23] This is where quality certification can be beneficial.

Retail distributors have established reputations in the minds of consumers regarding the overall quality of their offerings. Neiman Marcus and Nordstrom's have reputations for high quality merchandise. One expects to find nothing but stylish and well-made goods at these prestigious stores.

Consumers also expect to pay high prices at these stores and are willing to do so because the product quality has been assured. In contrast, Sears and JCPenney's have a different quality image. They depend on durable, reliable merchandise at "reasonable" prices for their success. Again, consumers know what to expect when they shop at these outlets.

Whether it be Neiman Marcus or Sears, the store's brand, or reputation, carries over to the merchandise that it stocks. A Neiman Marcus customer can be confident that a purse by Michael Kors will be stylish, the materials will be first-rate, and the workmanship will be excellent. The source of this confidence is the fact that the product is being sold by Neiman Marcus. In essence, Neiman Marcus certifies the quality for Michael Kors purses. This certification of quality is valuable to the manufacturer because it permits higher prices than could be charged without the consumer's confidence in the high quality.

For its part, Neiman Marcus must preserve its reputation and, therefore, will invest resources in determining the quality of alternative products before it decides to stock a certain product. Obviously, it hopes to recover these costs through sales of the superior product. There are other retailers that do not invest any resources in quality determination. Instead, they can simply observe the offerings at Neiman Marcus and copy its selections.[24] These retailers essentially "free ride" on the efforts of Neiman Marcus. If this undermines the profitability of that item, Neiman Marcus may discontinue the line. Because the product will no longer be sold by Neiman Marcus, the quality certification is lost. As a result, the demand will shift to the left and the manufacturer's profits will fall.

There are several ways in which the manufacturer may respond. First, it may simply refuse to deal with retail outlets that sell at "affordable" prices. This may limit the manufacturer's sales, however, as there is a limited number of prestige stores. Consequently, highly selective distribution may not be a profitable option. Second, the manufacturer could sell to Neiman Marcus at prices below those charged to the less prestigious stores. This would allow Neiman

Marcus to maintain its margins and the less prestigious stores could not profitably cut their prices below those of Neiman Marcus. The problem with this strategy is that it may violate the Robinson-Patman Act's prohibition of price discrimination.[25] If those retailers that are disadvantaged competitively by paying higher wholesale prices succeed at trial, they will be entitled to receive treble damages plus attorney's fees.[26] Third, the manufacturer could use RPM to protect its quality certifying retailer from free riding by so-called affordable outlets.

The manufacturer could set a minimum resale price that would permit a prestige store to maintain a margin that makes selling the manufacturer's product profitable. Less prestigious stores cannot discount below the Neiman Marcus price without risking loss of the line. Unable to charge affordable prices, these retailers may abandon efforts to sell the prestigious goods. If so, the quality certifying outlets will not be under attack, but the manufacturer is bound to lose some sales. Those outlets that ordinarily charge affordable prices may continue to stock the prestige item to convince their customers that the prestige good is worth the high (undiscounted) price that is charged.

5 | RPM AND PRESTIGE GOODS

In the previous section, we discussed the benefits of RPM for preserving the reputation of a manufacturer's products by dealing with prestigious retailers. The manufacturer can use RPM to protect these prestigious retailers from free riding by discount retailers who do not signal the quality of the product. Now, we turn to the prestige of the product itself.

Some products, particularly luxury goods, are *prestige goods*. These are goods that are more desirable to consumers because of their high prices. Unlike regular goods, if these products are discounted then demand will *decrease* rather than increase. For instance, a price decrease could be followed by a decrease in demand if consumers perceive the price as a signal for quality. According to Ackert (1995), "Just because a customer associates a product's higher cost with higher quality does not make that product a prestige good … The defining characteristics of a prestige good are high price, visibility, image-enhancement, and giving customer service."[27] Indeed, a product is not a prestige good unless its high price is an intrinsic part of the consumption value of the product. For prestige goods, a high price should be considered an attribute of the product.

Consumers may derive value from a higher price for several reasons. Veblen (1899) popularized the term "conspicuous consumption" to describe how consumers often derive social status from purchasing luxury goods. According to Veblen (1899), consumers would derive less value from a discounted prestige good because it no longer signals their wealth to others.[28] A higher price also imparts exclusivity to the consumers of the product. Discounting a prestige good dilutes this exclusivity.

A wide array of luxury goods fit this description, from Rolex watches to Ferrari sports cars. For example, a genuine Rolex watch and a cheap replica Rolex watch will have widely different prices but perform the same function. These are products that are very close substitutes in a functional sense, yet consumers continue to pay much higher prices for genuine Rolex watches. This occurs because consumers value the prestige and exclusivity of owning a genuine Rolex. If they were only concerned with the time-telling features, they would choose a well-made replica or a similarly styled watch from a different brand.

In short, the high price of a prestige good is itself part of the consumption value of the product. Implementing a high minimum resale price on prestige goods will increase demand by preventing discounting from eroding the product's image. This results in more products sold at a higher retail price, making RPM an obviously profitable strategy for manufacturers of prestige goods. In addition, consumers seem to want these high prices, which suggests that consumers of prestige goods are better off when manufacturers use RPM.

6 | RPM, ENTRY, AND NEW PRODUCTS

For some types of products, entry of new brands is difficult because shelf space is limited. A new brand necessarily displaces competing brands completely or reduces their shelf space. Distributors must incur opportunity costs—the lost profits on current sales—when they add a new brand to their offerings. As a result, the would-be entrant will have to persuade distributors that enhanced profits will result from adding the new product.[29]

For already well-known producers such as Levi Strauss, Hewlett-Packard, Nike, and Coca-Cola, distributors may be favorably disposed to their new products. But lesser known or unknown manufacturers may have some difficulty in getting shelf space.

RPM commitments may facilitate the entry of new firms or new products. In that event, RPM would be procompetitive. This use of RPM is somewhat limited in its scope and effectiveness.

If RPM is used to gain a competitive advantage over one's rivals, any advantage will be temporary. The problem is that this strategy can easily be matched by rivals. For example, a few of the less popular athletic shoes—Converse, Keds—tried to gain some traction by protecting dealers from intrabrand competition through RPM agreements. It did not work as other less popular brand manufacturers matched this effort. Similarly, when Alcon introduced its newest contact lenses pursuant to an RPM program, the other contact lens manufacturers followed suit, so any gain was short-lived.

7 | RPM AND ONLINE RETAILERS

Many manufacturers distribute their products through an assortment of distribution channels.[30] Apple, for example, sells its consumer electronics through its own brick-and-mortar stores.[31] It also distributes its products through third-party outlets such as Best Buy and Target. One can buy the same product online from Apple and from third-party online distributors. Given the consumer preferences and the nature of their wares, these alternative channels of distribution are both compatible and complementary. There are times, however, when the nature of online retailing conflicts with the manufacturer's business model. These situations involve products for

which point-of-contact promotional services are important and consumers make infrequent purchases.

Many online retailers use business models that are inconsistent with the goals of the manufacturers that supply them. Specifically, a number of online firms are using a deep discounting model, through which they offer brand name products at prices that are consistently and substantially lower than those offered by brick-and-mortar retailers. When a consumer visits an online retailer, he will find lists of product characteristics and a few pictures, but not much else. This experience cannot compare with the information consumers receive when seeing a product in a traditional store. The promotional aspect of displaying a product in a traditional retailing space influences the market demand for the product. The promotion allows online retailers to free ride on the efforts of the brick-and-mortar stores.

At a brick-and-mortar store, the consumer can touch and feel the product. The size, fit and finish, appearance, and quality of a Baby Bjorn, for example, can be evaluated far more accurately in a brick-and-mortar store than by looking at an online discounter's pictures. A knowledgeable salesperson can help compare the costs and benefits of various features. The more complicated the product, the more important the brick-and-mortar stores become to the manufacturer. To the extent that a manufacturer depends upon these stores for its success, it needs to be sure that the traditional stores find it profitable to stock the manufacturer's wares. Consequently, a manufacturer must beware of free riding by the online discounters.

In the extreme, nearly all consumers would visit traditional retailers to make product comparisons, see and feel the merchandise, and learn about the products, but not buy from those retailers. Instead, they would turn to the online discounters for their lower prices. The online discounters would be so successful that the traditional retailers would discontinue stocking some products. After all, retail floor or shelf space is a scarce resource, and a retailer will remove items that fail to generate profit. Because brick-and-mortar stores no longer stock the product, product-specific services would not be provided. This would reduce the demand for the manufacturer's sales and profits. Accordingly, a manufacturer will have an incentive to prevent deep discounting through its use of RPM or refusal to deal.

In principle, the manufacturer could refuse to deal with online retailers at all. Presumably, a manufacturer still has the right to deal or not with any potential customer. But online sales may appeal to some customers irrespective of discounts. Some consumers prefer the convenience of online shopping, and manufacturers want their business. But they do not want deep discounting to jeopardize their brick-and-mortar retailers.

Online retailers are often able to provide these deep discounts as a result of their lower operating costs. They are the ultimate no-frills retailers. They have no expensive space in shopping malls or other brick-and-mortar locations. They have people taking orders by phone or processing online orders, but they have no sales staff. They provide no promotional services and, therefore, incur no promotional costs. For consumers who have sampled a variety of products at traditional retail locations, some online discounters provide a measure of convenience. For example, for a still-undecided customer, shopping online may reduce search costs by making the final price and quality comparisons less time consuming. Consumers are able to access *Consumer Reports*, and many sites provide consumer feedback that assists the consumer in judging both the quality of the products and the value received.

The fact remains, however, that online discounters can undermine the profitability of a manufacturer's brand. The benefits of discounting presuppose that consumers can "test drive" the product in a traditional retail environment. If that is not possible because traditional retailers no longer carry the product, the manufacturer will suffer. Consequently, many manufacturers want to limit discounting so their products will continue to be profitable for the brick-and-mortar retailers. This may well require terminating online discounters that refuse to abide by the RPM conditions. This dramatic step should not be taken without great care for at least two reasons. First, online sales have been growing rapidly. It is the wave of the future. Second, terminating online discounters will arouse the antitrust authorities in many jurisdictions.

7.1 | E-commerce growth

E-commerce has grown considerably in the last 20 years. In 1998, the volume of online retail sales was approximately $4.984 (millions of dollars). By 2015, online sales had grown to an estimated $340.415 (millions of dollars).[32] As one can see, online sales are growing dramatically at an increasing rate. Even as a percentage of total retail sales, online retail sales have risen sharply. Figure 3 shows the rising share of online retail from Q4 1999 to Q1 2017.[33] It is increasingly difficult for a manufacturer to turn its back on this channel of distribution, especially given such a dramatic increase in sales. The trick is to find a way to enjoy the benefits of online sales without sabotaging the brick-and-mortar retailers. One way is to employ RPM. Examples include baby products (car seats, cribs), golf clubs, and mattresses. For the online distributor to succeed, it must alter its business model as it could no longer rely on simply undercutting the brick-and-mortar distributor's price.[34]

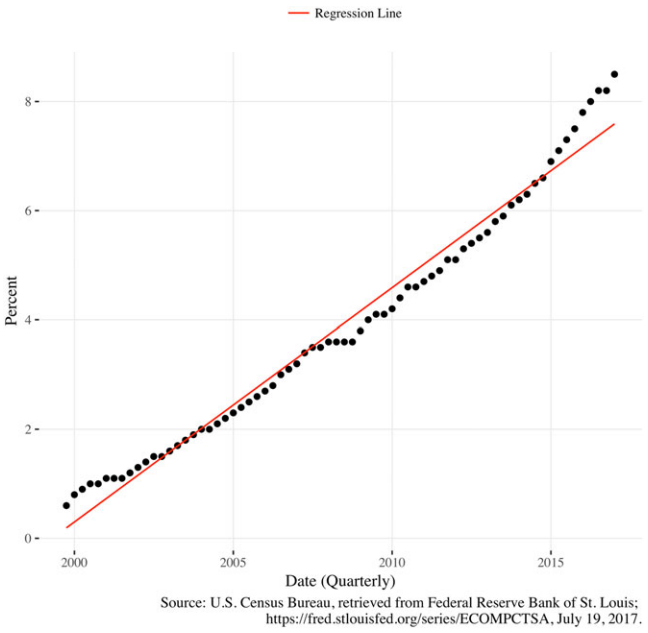

FIGURE 3 E-commerce sales as a percentage of total retail sales (quarterly) [Colour figure can be viewed at wileyonlinelibrary.com]

7.2 | Leegin and the Online Discounter

There is a major shift in the importance of retail channels. Increasingly, consumers are ordering merchandise of all kinds through their computers rather than visits to brick-and-mortar outlets. In many instances, online sellers offered at deep discounts relative to the prices at traditional outlets. For manufacturers that were concerned about this trend, *Leegin* appeared to offer the promise of stemming the tide toward the online discounters. Interestingly, the tide seems not to have been stemmed.

After *Leegin*, RPM is no longer presumptively unlawful, but the lingering hostility may result in legal disputes. Terminated dealers will still be furious at the loss of a profitable line. Some consumers may object to the withdrawal of discounts. Consequently, the gains that may follow for the induced promotion flowing from the RPM agreement must be weighed against the possible litigation costs. Even successful defendants in antitrust suits bear heavy litigation costs.

7.3 | E-commerce and MAP programs

Retailers who operate online sell to a wide geographic market that often spans across states and may even extend internationally. Manufacturers who enter into RPM agreements with these online retailers may expose themselves to antitrust litigation if these sellers operate in areas where RPM is still unlawful. The manufacturer must comply with the strictest set of laws in the markets it reaches to avoid legal liability. For example, an online retailer that operates in all 50 states presumably has customers in Maryland. However, as we discussed in Section 2, RPM is per se illegal by Maryland state law. In the same section, we also described how Tempur-Pedic was able to avoid antitrust litigation in New York—where the legality of RPM was somewhat ambiguous at the time—by using a combination of the *Colgate* shield and a MAP program. This is instructive for manufacturers who seek to employ RPM but have distribution to online sellers.

Tempur-Pedic is not the first company to realize the usefulness of MAP in the absence of a true RPM program. In fact, MAP policies are so prevalent online that there are even third party services that offer to monitor retailers for violations.[35] Often, you can find these policies in effect when an online retailer has discounted an item but will not display the price until you "add the item to your cart." This is an example of a retailer bound by the manufacturer's MAP policy. The retailer can discount the price below the manufacturer's desired minimum but cannot advertise the price. This imposes a search cost on the consumer and thus may lower sales for discounters. In this way, MAP acts as a "soft RPM." The price floor is not rigid, but retailers who discount below it are effectively being penalized with lower sales.

7.4 | RPM programs proposed by distributors

There is a concern that a dominant retailer or a group of retailers could induce a manufacturer to implement an RPM program. The aim might well be to prevent online retailers or "big box" stores from sharply discounting the manufacturer's products [see Blair & Wang, 2017 for a brief discussion].

8 | CONCLUSION

In the right circumstances, RPM can be a profitable business strategy. As we have seen, RPM can be used to induce distributors to provide promotional services that lead to increased consumer demand and higher profits for the manufacturer. In a similar vein, RPM can protect the margins of prestigious retailers whose stocking decisions certify the quality of the manufacturer's product, which enables the manufacturer to charge more for its brand. RPM can also be used to prevent discounting that would undermine the prestige of certain brands. Finally, manufacturer profits may rise with the use of RPM in the presence of demand uncertainty. The gains in profits that RPM make possible must be weighed against potential legal challenges. Although RPM is no longer per se unlawful, disgruntled distributors and/or consumers may still file suit. If a manufacturer's use of RPM is challenged as an antitrust violation, there is not much upside. If the manufacturer loses, it will be subject to treble damages under §4 of the Clayton Act.[36] In addition, it will have to pay a reasonable attorney's fee to the plaintiff plus its own legal fee, which may or may not be reasonable. If it wins, it still has to pay its own legal fees. These potential costs must be weighed against any gain in profit attributable to the use of RPM arrangements.

ENDNOTES

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

[2] *United States v. Colgate*, 250 U.S. 300 (1919).

[3] Klein (2014) examines the evolution of the law regarding RPM following *Leegin*.

[4] *United States v. General Electric Co*., 272 U.S. 476 (1926). In *Simpson v. Union Oil Co. of California*, 377 U.S. 13 (1964), the Court reversed *General Electric* and condemned consignment sales.

[5] 485 U.S. 717 (1988).

[6] *Monsanto Co. v. Spray-Rite Service Corp*., 465 U.S. 752 (1984).

[7] See Marvel and McCafferty (1985) and Marvel (1994) for relevant economic analyses.

[8] Hovenkamp (1991) puts the *Dr. Miles* case in historical perspective by examining the presence of a widespread price fixing conspiracy among retailers.

[9] Elzinga and Mills (2010).

[10] For a compilation of international views, see Sokol, Crane, and Ezrachi (2014).

[11] "Discount Pricing Consumer Protection Act", S. 75, 112th Cong. (Introduced 01/25/2011).

[12] Md. Code, Com. Law § 11–204 (b).

[13] Cal. Bus. & Prof. Code §§ 16720(b) and (e).

[14] For an in-depth discussion of state RPM law, see Lindsay (2014).

[15] Hubbard (2014), for example, provides some guidance regarding challenges to RPM programs following *Leegin*.

[16] S.B. 124, 58th Leg., 2013 Reg. Sess. (Kan. 2013).

[17] *People v. Tempur-Pedic International, Inc*., 2012 NY Slip Op 3557 (2012).

[18] N.Y. Gen. Bus. Law § 369-a.

[19] The following summaries of the law in different jurisdictions is based on Sokol et al. (2014).

[20] Blair and Wang (2017).

[21] This means that the added promotional services are worth more to consumers than they cost. If this were not true, the manufacturer would not want them provided as its profits would fall.

[22] Stigler (1968) argues that the economic results of price and nonprice competition are equivalent.

[23] Akerlof (1970) explored this problem in the context of the used car market.

[24] The benefits of quality certification and the use of RPM was explored by Marvel and McCafferty (1984).

[25] 15.U.S.C. §13. Selling to a preferred customer at a lower price than is available to that customer's rivals is secondary-line price discrimination. The supposed evil is that the preferred customer will have a competitive advantage and, therefore, competition will be substantially lessened. For a compact treatment of price discrimination in the United States, see Blair and Kaserman (2009), Chapter 13.

[26] Section 4 of the Clayton Act provides that "[a]ny person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor … and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee." Damage calculation in Robinson-Patman cases are tricky; see Blair and Durrance (2015).

[27] Ackert (1995). See pg. 1205 for the relevant quote.

[28] Veblen (1899).

[29] For further analysis of the effects of RPM on entry of new products, see Hemphill and Wu (2013).

[30] For an extensive analysis of RPM in the presence of online retailers, see Blair and Haynes (2010).

[31] To this extent, Apple is vertically integrated into distribution.

[32] U.S. Bureau of the Census (2017a).

[33] U.S. Bureau of the Census (2017b).

[34] Akman and Sokol (2017).

[35] See http://www.amazowl.com/amazon-map-enforcement (accessed July 20, 2017) for one example.

[36] For a skeptical view of such claims, see Blair, Herndon, and Lopatka (2005).

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