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Leather Shop Strikes Out in Bid to Tag Its Distributor

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The latest chapter in a six-year-old antitrust case, a decision dismissing the complaint in *PSKS, Inc. v. Leegin Creative Leather Products, Inc.*, No. 03-cv- 107(TJW), 2009 WL 938561 (E.D. Tex. April 6, 2009), offers further guidance on how the courts will examine vertical agreements — agreements on prices between distributors and their retailers and between franchisors and franchisees. Once again, the law favors the distributor and the franchisor, although legal perils still remain.

Two years ago, in Leegin *Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007), the Supreme Court abandoned a 90-year-old rule that an agreement between a manufacturer and a distributor to set minimum resale prices was per se illegal under the Sherman Act, deciding instead that the legality of such vertical agreements on price would be evaluated under the rule of reason. The distinction between per se condemnation of an agreement and analysis of the agreement under the rule of reason is crucial for determining what a plaintiff must show to prevail in a case under Section 1 of the Sherman Act, 15 U.S.C. § 1.

To survive a motion to dismiss a claim that defendants committed a per se violation of the Sherman Act, such as an agreement among competitors on the price they will charge their customers, a plaintiff need allege only that such an agreement plausibly existed. But if the allegedly illegal agreement is one that courts evaluate under the rule of reason, the agreement is illegal only if the anticompetitive effects of the defendants' agreement outweigh its procompetitive benefits. Thus, in a rule-of-reason case, the plaintiff must allege, among other things, that the agreement existed, that the defendants had the power to affect the relevant market adversely, and that the agreement in fact had an anticompetitive effect on the market.

In *Leegin*, the Supreme Court reviewed a jury verdict that had found that Leegin, a manufacturer of high-end women's accessories, had violated the Sherman Act when it entered into agreements with its retailers to set the minimum resale price of its Brighton brand of women's accessories. The jury awarded plaintiff PSKS $1.2 million and, pursuant to the Sherman Act, the court trebled the damages award and added the plaintiff's attorneys' fees and costs. Following *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911), the trial court considered Leegin's vertical minimum resale price maintenance agreement to be per se illegal under the Sherman Act and did not require that the plaintiff show that Leegin had market power in any relevant market or that the agreement had an anticompetitive effect. The Court of Appeals agreed. But the Supreme Court reversed, continuing a trend started 30 years ago in *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977), that treats vertical agreements more leniently than it treats horizontal agreements — agreements among competitors.

The reason for this different treatment is that a vertical agreement might have procompetitive benefits: an agreement between a manufacturer and its retailers limiting each retailer to a certain geographic area or certain type of customer (as was the case in *Continental T.V.*) might encourage retailers to make certain investments in customer service or advertising that would strengthen interbrand competition even if it limited intrabrand competition. The Supreme Court overruled *Dr. Miles*, reversed the Fifth Circuit, and remanded. The Court of Appeals in turn remanded the case to the Eastern District of Texas. *PSKS, Inc. v. Leegin Creative Leather Products, Inc.*, 498 F.3d 486 (5th Cir. 2007).

On remand, to proceed to another jury trial, plaintiff PSKS had to allege not only that there was an agreement among Leegin and its retailers, but also that Leegin had market power in a relevant, properly defined market and that the agreement had an anticompetitive effect. The court permitted PSKS to amend its complaint. In PSKS's second amended complaint, PSKS alleged that Leegin's agreement with its retailers adversely affected competition in two relevant product markets, the "retail market for Brighton's women's accessories" and the "wholesale sale of brand-name women's accessories to independent retailers." PSKS also added allegations of a per se horizontal agreement among Leegin and its retailers. Leegin moved to dismiss the complaint.

The court rejected both of the product markets that PSKS proposed. The first market, the court held, was an alleged market for a single brand of goods. It is well established that absent exceptional circumstances, a single brand in a market of competing brands cannot constitute a relevant product market for analysis under the Sherman Act. *See, e.g., Green Country Food Market, Inc. v. Bottling Group, LLC*, 371 F.3d 1275 (10th Cir. 2004); *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480 (5th Cir. 1984). PSKS argued that it was entitled to special treatment because it had identified a unique "submarket" that should be treated distinctly for antitrust purposes. But these are not the sort of special circumstances that might allow a court to conclude there was a separate market for a particular brand. For example, a plaintiff might arguably have been locked into a particular brand because of an earlier decision to enter into a business servicing a particular brand of equipment that requires investments in training, spare parts and diagnostic software, *see Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451 (1992). Perhaps a franchisee invests in a particular franchise, and subsequent to the investment the manufacturer of the equipment or the franchisor materially changes the terms of the business relationship. In those cases, there might be an argument that the service company or franchisee was locked into a market for a single brand. But no such circumstances existed here. PSKS instead argued only that the market for Brighton goods was a cognizable submarket. Because Leegin's Brighton brand accessories competed with accessories of other brands from other manufacturers, the court concluded that the alleged market for Brighton brand goods alone could not be a relevant product market for antitrust analysis.

PSKS's second product market was the market for the "wholesale sale of brandname women's accessories to independent retailers." The court rejected this market as well because it did not describe a plausible market. The most important test of whether products are in one market or another is whether a particular product is readily interchangeable with another. PSKS did not show why the limitation of the market to independent retailers made sense when consumers could purchase substitute goods from other types of retailers. A market of "women's accessories" was too broad and too vague to define a relevant market. PSKS failed to show that a brand name was relevant to the substitutability of products. And the court found that limiting the market to wholesale sales was not relevant when the relevant question was the impact on the retail market.

Once the court found that neither of PSKS's alleged product markets was a relevant product market for antitrust analysis, PSKS's claims were doomed to fail. Market power and anticompetitive effects cannot be analyzed if there is no relevant product market.

The court rejected PSKS's claims of horizontal restraints for two reasons. First, PSKS had abandoned any such claims because it did not allege any horizontal agreement in its original complaint. Although the Supreme Court's decision in *Leegin* did indeed change well established precedent, which might entitle a party to revive a claim not pursued in an original proceeding, the rule that the Supreme Court changed related to vertical restraints, not horizontal ones. Moreover, that court held that the alleged horizontal restraint relied on Leegin's position as a dual distributor, both a wholesale distributor and a retail distributor. Such dual distribution systems are analyzed as vertical arrangements and therefore fall under the rule of reason. Any rule-of-reason claim will fail because, as discussed above, PSKS had failed to allege a cognizable product market.

The PSKS remand illustrates just how difficult it can be to survive a motion to dismiss where plaintiffs seek to establish that a vertical restraint, even a vertical agreement on prices, violated the Sherman Act. To be viable, a complaint must allege a plausible relevant product market. But distributors and franchisors should be aware that they should not engage in vertical pricing agreements without considering whether their particular proposed agreements might violate the antitrust laws. First, there are situations where distributors do indeed have sufficiently high market shares for their vertical agreements to have anticompetitive effects. Second, there are situations where the lock-in rule of *Kodak* arguably applies, something that franchisors who are contemplating significant changes to their relationships with franchisees on retail pricing of the brand's goods or services should consider. Third, most states have their own antitrust laws. Although many states interpret those laws consistently with the federal courts' interpretations of the Sherman Act, some, particularly those that are not bound by statute to follow federal antitrust precedents, have not adopted the Supreme Court's rule in *Leegin* with respect to vertical price maintenance agreements within particular states. In fact, some states have made clear that they will continue to treat minimum resale price maintenance arrangements as illegal *per se*, as they did when, after the Supreme Court's decision in *Leegin*, they objected to any modification of an earlier FTC order prohibiting a resale price maintenance scheme. *See, e.g.*, In the Matter of Nine West Group Inc., Docket No. C-3937 (FTC). Finally, Congress is considering legislation to reverse the rule in *Leegin*. The Discount Pricing Consumer Protection Act, S.148, 111th Cong. (2009), would amend Section 1 of the Sherman Act to condemn as illegal "[a]ny contract, combination, conspiracy or agreement setting a minimum price below which a product or service cannot be sold by a retailer, wholesaler, or distributor..." Therefore, although the tide has moved noticeably in favor of distributors and franchisors over the last several decades, distributors and franchisees are not immune from the antitrust laws.