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THE FRANCHISE LAWYER

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Leegin: All Bark, No Bite?

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Three years ago this summer, the U.S. Supreme Court abandoned the 100 year-old *Dr. Miles* doctrine that established a rule of *per se* illegality for minimum resale price maintenance (RPM) agreements in favor of the more lenient "rule of reason" test. *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007). Under the rule of reason standard, courts are forced to consider the pro-competitive effects of vertical price restraints, only striking down such restrictions where the anti-competitive effects outweigh the competitive advantages. The *Leegin* decision—heralded by those favoring economic analysis of vertical price restraints—bookends an earlier opinion, *State Oil v. Khan*, where the Court declared that maximum RPM agreements should be reviewed under the rule of reason standard. *State Oil v. Khan*, 522 U.S. 3 (1997).

Many assumed, and perhaps even hoped, that the radical shift in law promulgated by *Leegin* would alter the landscape of antitrust jurisprudence. Nowhere was this more true than the franchise community. But to the surprise of many, and contrary to the effect of *Khan*, the high court's ruling has not been interpreted as a green light to engage in minimum RPM arrangements. Indeed, rather than embrace new policies and practices that employ the flexibility afforded by *Leegin*, many businesses (including franchise companies) have adopted a wait-and-see mentality. How is it that this opinion, once thought revolutionary in scope, has resulted in such a relatively small practical impact? The simple answer lies in the uncertain future of the rule of reason.

Leegin and the Franchise Community

The franchise community received *Leegin* with anticipation and expectation. At first glance, the more flexible rule of reason test provided an opportunity to control downstream pricing, which would address the persistent problem of free-riders as well as a franchise company's disadvantage competing in the market with competitors that own the entire chain of distribution. Many believed an increase in RPM agreements would stimulate interbrand competition by encouraging franchisees to provide services and promotional efforts on behalf of the franchisor's products, giving consumers greater choices. At the same time, others feared that franchisors would use RPM agreements to obtain monopoly profits or facilitate cartels at the supplier level. Some franchisees worried that *Leegin* marked an end to their independent development of pricing schemes reflective of local markets and customer needs. Still others worried that franchisors would use RPM agreements to force prices so high that they could not sustain business.

As the years have passed, franchisors and franchisees alike have waited for the proverbial ball to drop. But

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anecdotal evidence suggests that relatively few franchisors have embraced the freedoms allowed by *Leegin*. This result provides a stark contrast to the reaction following *Leegin*'s sister opinion, *Khan*. In the wake of the *Khan* decision, many franchisors raced to mandate maximum price restrictions. This was particularly true in the fast-food business where franchisees saw a flurry of maximum price setting, particularly with the advent of the "dollar menu." With *Leegin* however, we have not seen a similar revolution of the relationship between franchisees and franchisors with respect to price determinations, especially in industries that would be affected by the decision, including luxury markets.

Reasons Franchisors Refuse to Embrace *Leegin*

The easiest explanation offered for *Leegin*'s limited impact in the franchise community is that many franchisors are contractually bound by older franchise agreements expressly limiting their right to set minimum prices. But as each year passes, such reasoning contains less and less force. New agreements are executed; old agreements are renegotiated. And yet, the flood of minimum RPM agreements once expected to dominate the majority of franchise relationships have failed to materialize. We propose that franchisors' continued reluctance to implement RPM agreements lies primarily in the continued uncertainty surrounding the interpretation, enforcement, and utility of such agreements.

Lack of Judicial Guidance

One of the first questions franchisors and franchisees asked in the wake of *Leegin* was "how will the rule of reason be applied?" Three years later, that answer remains unclear. The Supreme Court left the question of how the rule of reason should be interpreted to the lower courts. The majority specifically suggested that lower courts should "establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market to provide more guidance to business." Despite this call to action, there have been relatively few opinions analyzing the application of the rule of reason under *Leegin*.

As a preliminary matter, the dearth of opinions likely results from potential litigants' reluctance to bring a case in the first instance. Antitrust cases are notoriously expensive. The time, cost, and risk associated with these cases increased when courts moved from the bright-line *per se* rule to the fact-intensive rule of reason. Success requires experienced attorneys and economic experts knowledgeable not only about the challenged RPM arrangement, but also the market as a whole and the pro-competitive and anti-competitive effects of the restriction. The rule of reason standard also increases the risks to a defendant by limiting the possibility of a successful motion to dismiss or summary judgment. Indeed, if a plaintiff forces a RPM agreement to court, chances are its legality will be decided by a jury. These factors militate in favor of settlement, and accordingly decrease the number of cases that ever make it before a judge.

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Moreover, those cases that do make it in front of a judge are often disposed of on procedural grounds. This is especially true in light of the heightened pleading requirements in *Bell Atlantic v. Twombley*, which requires plaintiffs to allege facts that plausibly suggest that an RPM agreement exists and that it is unreasonable. *See Spahr v. Leegin Creative Leather Products, Inc.*, 2008 WL 3914461 (E.D. Tenn. 2008); *Jacobs v. Tempur-Pedric, Int'l, Inc.*, 2007 WL 437980 (N.D. Ga. Dec. 11, 2007) (rejecting Plaintiff's implausible market definition and granting dismissal under *Leegin* and *Twombly*). More problematic for franchisors, those few courts or governmental agencies that have substantively interpreted the rule of reason under *Leegin* imply that some RPM agreements may be "inherently suspect." *See, e.g.*, *In re Nine West*, FTC Docket No. C-3937, at 10, 12 (May 6, 2009), *available at* http://www.ftc.gov/os/caselist/9810386/080506.order.pdf; *Baybyage.com, Inc. v. Toys "R" Us, Inc.*, 558 F. Supp. 2d 1011 (E.D. Wis. 2007).

Faced with this dearth of judicial guidance on the application of the rule of reason, franchisors have been—and will continue to be—hesitant to test the waters by implementing a vertical price restraint that might be challenged in court, unless otherwise mandated by the company's business model.

Congress and the States on the Offensive

In addition to the lack of judicial guidance, franchisors must face the uncertain future enforcement of minimum RPM agreements in light of the aggressive campaign against the rule of reason in the federal and state governments. In the past few years, members of Congress have led an offensive attack against *Leegin*,

seeking to legislatively overturn the Supreme Court's 2007 opinion. That effort seems to be picking up steam. On March 18, 2010, a Senate panel voted to approve a bill (S.R. 148) that would make it illegal for manufacturers to set a minimum resale price for their products. The House Judiciary Committee approved a similar bill (H.R. 3190) in January 2010. Recent appointments to the FTC and the DOJ have lobbied Congress for such legislative action, and presumably will continue to do so.

Likewise, the majority of state governments have advocated for a legislative solution to *Leegin*. In November 2009, forty-one state attorneys general sent Congress a letter urging the passage of *Leegin*-repealer legislation. The attorneys general urged that "Congress, not the Court, is better positioned to evaluate the detrimental impact of resale price fixing on consumers and the underlying public policy of the nation's antitrust laws." But in many cases, state governments are not waiting on Congress to legislate a *per se* rule. Several states, like California, already have state laws that may prohibit RPM agreements. Other states, in reaction to *Leegin*, are passing legislation restoring the *per se* rule under state law. For example, Maryland expressly rejected the *Leegin* decision by statute. In many states, attorneys general have expressed willingness to prosecute RPM agreements under their existing antitrust laws despite the fact that litigation in state forums will create inconsistent results as between federal courts and state courts.

Until Congress and state governments settle on a legislative reaction to *Leegin*, uncertainty will surround the potential enforcement of any RPM agreement and thus, discourage franchisors from entering into such agreements where they may otherwise be inclined. For this reason, the elections of 2010 and the subsequent make-up of Congress and state governments will prove to be particularly important to franchisors and franchisees alike.

Economic Uncertainty

A final uncertainty that plagues many franchisors is the potential usefulness of RPM agreements in a robust economic market. One year after the *Leegin* decision, the economy crashed. In this climate, few franchisors are inclined to require that franchisees charge their customers higher prices, especially in luxury markets. Accordingly, though *Leegin* was decided three years ago, franchisors do not have the benefit of experience with respect to vertical price setting. Once the economy improves, we can expect some franchisors to test the utility of minimum RPM agreements for the first time, and as the collective experience with these agreements grows, we will likely witness an increase in the overall impact of *Leegin* on the franchise community.

The Uncertain Future of *Leegin*

Amidst all the uncertainty, one thing is clear: the boundaries and future enforceability of minimum RPM agreements have yet to be determined under the rule of reason. Until the courts adequately define the application of the rule of reason and governments decide their legislative strategy, we can expect continued reluctance from franchisors. They will likely continue to accomplish minimum RPM in the same indirect ways they utilized before *Leegin*, including limiting free goods, minimum advertising policies (MAPS), and an exercise of the *Colgate* doctrine, which permits manufacturers to impose minimum RPM by announcing and enforcing policy to terminate any retailer that sells below the manufacturer-set price. In the end, *Leegin* is undoubtedly a revolutionary legal opinion. As for its practical impact in the franchise community, however, we must continue to wait and see.

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