

Free riding and Resale Price Maintenance, a love and hate relationship¹

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ABSTRACT

Is free riding bad for competition in the markets? Is it good and necessary to promote competition in the markets? Does free riding (being good or bad) depend on a market structure issue?

A new pro-competitive justification arose since Leegin overturned Dr. MILES COURT decision giving the business operators a rule of reason in order to determine antitrust harm by a resale price maintenance (RPM) conduct. American courts have dealt with free riding as a pro-competitive justification basing the analysis of this decision on the defendant's rule of reason. Should American Courts reevaluate their holdings on minimum RPMs, or should they keep tolerating manufacturer and retailers "free riding" on their leniency for anticompetitive effects?

Key words: Free riding, Minimum Resale Price Maintenance (RPM), precompetitive justifications, rule of reason, *per se* treatment, Multichannel shopping, Courts vs. Regulation.

"FREE RINDING" EN LA FIJACIÓN DE PRECIOS DE REVENTA

RESUMEN

¿Es el *free riding* negativo para la competencia en los mercados? ¿Es bueno y necesario para promover la competencia en los mercados? ¿El hecho de que el *free riding* sea bueno o malo, depende de una cuestión de la estructura de mercado?

Una nueva justificación pro competitiva surgió con la revocación a la decisión del Tribunal del Dr. MILES por parte de Leegin, donde se les dio a los operadores comerciales una regla de razonabilidad con el fin de determinar el daño ocasionado a la libre competencia por una conducta relacionada con el precio mínimo de reventa. Los tribunales estadounidenses han manejado el tema del *free riding* como una justificación pro competitiva utilizando la regla de razonabilidad en el análisis de sus decisiones. ¿Deberían las cortes estadounidenses reevaluar sus participaciones relacionadas con el precio mínimo de reventa, o deben seguir tolerando el *free riding* de fabricantes y minoristas y su indul-

gencia para los efectos contrarios a la libre competencia?

Palabras clave: *Free riding*, Precio mínimo de reventa, regla de razonabilidad, libre competencia, Tribunales vs. Regulación.

Free riding and Antitrust, a love and hate relationship³. A new pro-competitive justification arose since Leegin⁴ overturned Dr. MILES⁵ decision giving the business operators a rule of reason in order to determine antitrust harm by a resale price maintenance (RPM) conduct. American courts have dealt with free riding as a pro-competitive justification basing this decision on the defendant's rule of reason. Is Free riding bad for competition in the markets? Is it good and necessary to promote competition in the markets? Does free riding being good, or bad, depend on a market structure issue?

The basics of free riding describe it as "when one benefits at no cost from what another has paid for"⁶. This definition, on a simple analysis and reading, makes it sound as a perverse action, almost like a felony. So, should I as a consumer pay more for something that is less costly in another facility? This question does not sound as a rational question under the economics doctrine. From a consumer point of view is more likely to happen that the demand for a good is going to increase wherever prices are lower.

From a businessman point of view and from the antitrust point of view, free riding occurs when "a firm is able to capture the benefits of investments that another firm has made without paying for them" (HOVENKAMP, 1995). So, should I as a businessman increment the cost of my operation

by investing on items that are most likely not going to be necessary to increase my efficiency? Once again, this question does not sound as a rational question under the economics doctrine.

So far by the statements cleared above, free riding is not an enforcement concern as there is no antitrust provision that proscribes it. Then, is free riding an efficiency tool for consumers and manufacturers? It seems most likely to be one. The uncertainty of the aforementioned statement is not the resemblance of an un-attentive, un-detailed analysis. This is the resemblance of American antitrust case law about free riding.

In order to understand the free riding problem, one must understand that it is not a prohibited conduct by antitrust. "Free riding" is an expression use to define the conduct of an agent in the market. Free riding happens at a consumer level, at a retailer level and at a manufacturer level. In order for free riding to exist at the manufacturer and retailer level there should be firms on a same geographic market competing with each other for a product or service. For consumers "free riding" just obeys to normal consumer economic rationale behavior.

The term comes alive as one of the antitrust phenomena⁷, for the manufacturers and retailers who try to justify their conducts under the free riding pro-competitive effects justification. The conduct under concern here is Resale Price Maintenance –RPM–, which occurs when manufacturers set for their retailers a price for the commercialization of the goods they produce. The price line could be set as a maximum price to resell the goods by retailers above which the goods could not be sold, or, as a minimum price under which the goods may not be sold. Maximum RPM's are treated in

the United States under the rule of reason analysis and are not a mayor concern for the courts. It is minimum RPM's courts and business operators care for. The sole idea of a manufacturer setting a minimum price for the resale of its products from the consumer's point of view is not very attractive. Consumer's always enjoy competition and benefit from the low prices consequence of it. The fact that the manufacturer decides to set a price for its products lets the retailers competing only on two other fields: quality and service.

Perhaps the Court description in *Hovenkamp* could set an example for a better understanding of the framework given by the interaction between consumer's, manufacturers and retailers.

"The full service computer dealer may have, among other things, an expensive showroom, trained personnel demonstrating computers and assembling optimal packages, seminars for prospective purchasers. The free riding dealer down the street has a cheap ware house, untrained minimum wage personnel, and stacks of Computers in boxes. Costumers will go to the full service dealer and obtain the information they need to make a wise choice; then they will go to the free rider to make their purchase at a lower price" (*HOVENKAMP, Op. cit.*).

The reasons for manufacturers not liking free riding retailers could seem obvious: lower margins, brand destruction. A manufacturer spends a lot of resources designing strategies to improve the ways to promote its goods. Such efforts in the mind of the manufacturer should be compensated with good margins. Concerns could also arise regarding the return manufacturers expect after positioning their goods in a market. "Branding", as it is known to marketing ex-

perts, takes a lot of resources from the firms. The fact of having free riding retailers selling their goods at very low prices could destroy their major efforts in placing their goods and brands in the desired market. Manufacturers take very seriously the markets at which they want their products to be distributed. They pay special attention to the channels through which they intent their distribution to be made. The fact of having firms commercializing their products at different channels and at prices that could conflict with the market they target could diminish their "branding" efforts, Or as many marketing experts name it "destroy brand".

Alleging the abovementioned reasons manufacturers and retailers came up with minimum RPM's. The objective of minimum RPM's is to inhibit horizontal competition at the retailers level. Such restriction in the competition game produces retailers who compete in other fields different to price. Such fields are; quality of their goods and better service in their goods. Manufacturers' concern might be that "discounting retailers can free-ride on retailers who furnish services and then capture some of the increased demand those services generate"⁸, leaving them with a lack of control over the market targeted and the marketing channel of their goods. Apparently, the problematic acts described above are a disincentive to the dealer who invests in the promotion of the goods. The dissent question, "how often the 'free-riding' problem is serious enough to significantly deter dealer investment."⁹, could also be seen as the justification for a rule of reason analysis of the courts in the minimum RPM's issue. In a very simple explanation, Courts allege to care about free ridding because it deters dealer investments,

which downstream would benefit consumers' wealth fare.

In other words, this is the reason why "The primary accepted pro-competitive efficiency rationale for resale price maintenance is the prevention of retailer free-riding" (KLEIN, 2009).

So far the manufacturer has a "logic" explanation for imposing minimum RPM's, but let's not forget that this strategy has the effect of an unlawful Sherman Act Section 1 prohibited agreement. Setting prices on a minimum price line could be a smooth way to smuggle a price agreement amongst competing dealers. Manufactures margins could be manipulated by blocking the price variable at a minimum price at which consumers will have to buy. Further more, what would happen to the most efficient manufacturer that tries to enter the market? Are RPM's exclusionary devices for the incoming manufacturer? (BLAIR, 2008)¹⁰.

With minimum RPM's a manufacturer could deter the entrance to the market to more efficient firms because by setting the margins at the desired (right) level, he could ensure retailers margins to be so high that they will not shop for other manufacturer. Passing over margins from the manufacturer to the distributor could have the effect of a vertical merger between the manufacturer and the distribution network. Margins could be split between the upstream and downstream incumbents with the sole purpose of manipulating the commercial network in a fashion that blocks the more efficient manufacturer entrance. The commercial network would probably find no interest in selling the new incumbent goods.

Regarding the free riding pro-competitive justification alleged before the courts for minimum RPM's, the Courts have seen that

"discounting retailers can free-ride on retailers who furnish services and then capture some of the increased demand those services generate"¹¹. On this given framework, the retailers will find their interests in providing services diminished by free riding. "The standard analysis concludes that the reduction in retailer-supplied services in response to free-riding, therefore, ultimately leads to both consumers and the manufacturer being worse off, consumers are worse off because they do not receive retailer services that they desire and the manufacturer is worse off because the demand for its products is reduced" (KLEIN, Op. cit.). "Justifications for RPM based on free riding are empirically dependent on whether and to what extent consumers value the promotional efforts of channel members that RPM induces" (GUDLACH, CANNON & MANNING, 2010: 416).

So why did the Courts decided to give the free riding issue a treatment of an exclusion from responsibility for a conduct that before was treated as *per se*?¹² Apparently, the rule of reason analysis gives the courts the possibility (powers) to determine how "bad" is free riding in order to determine if the minimum RPM is justifiable¹³. Apparently, the courts have a scale to determine how "bad" free riding is¹⁴; "There is consensus in the literature that "free riding" takes place.... The question is how often the "free riding" problem is serious enough significantly to deter dealer investment....All this is to say that the ultimate question is not whether, but how much, "free riding" of this sort takes place"¹⁵. The courts then analyze the free riding justification on every market, on every different case, to see if the incoming retailer could be seriously discouraged by the figures adverse effect¹⁶.

So, in order to determine how much of free riding is bad common sense will redirect the reader's thoughts to the market, to the consumer's psyches.

Today's consumer is reached easily through different platforms. Television, radio, magazines, newspaper, Internet, and mobile phones are platforms used by the market agents to reach the minds of consumers and ease them into consuming their goods. At the same time this instruments that could serve for the aforementioned purpose deliver immense amounts of information to consumers. A consumer will always be a consumer and will search for his well-being. Let consumers look for their well-fare and pursue their benefit from economic rationale be the constant. Now, take this consumer and stuff him with knowledge about the markets. It does not require fancy economic theory's to know that this consumer is going to act according to the information he is receiving and perform efficiently. The consumer will, and make no hesitation, free ride. So if the above statement is true why try to restrain free riding? Free riding is something that cannot be stopped as our variables will not stop in their evolution process. On the contrary, our constant will stay the same. Every day more and more, information is going to reach the consumer through the platforms cited above or through new ones complementing them. Why suppress price, (one of the instruments of competition) by allowing (unless disputed) minimum RPM's?¹⁷. Being "The antitrust concern where these circumstances and behaviors are present is that one or more retail members of one channel of distribution will free ride on the investments made by retail members of another channel of distribution to the detriment of consumer

welfare" (GUDLACH, CANNON & MANNING, 2010: 388). Perhaps, in this case, and being free riding an un-stoppable phenomena, manufacturers should not be allowed to impose market restrictions through minimum RPM's. The manufacturer should behave every day more according to the consumer's desire.

In past years consumers had been practically channeled into whatever manufacturers believe to be the most efficient channel for them to provide for consumers. Today consumers have developed what marketing experts call "Multi-channel shopping" "Today, research indicates that consumer behave increasingly as multichannel shoppers relying on more than one channel of distribution for their purchases. As the Internet has become a dominant force and other channels of distribution (e.g., catalog sales and television home shopping) have emerged and gained prominence overtime, consumers are reportedly using more than one channel for their purchases" (GUDLACH, CANNON & MANNING, 2010: 393). There is an increasing tendency for consumers to "research the product in one channel . . . , and then purchase it through another channel" (VERHOEF, NESLIN & VROOMEN, 2007). "A survey of 280 Dutch consumers found that across six product categories, on average, 76% engaged in research shopping. Further demonstrating this trend, a recent study by Deloitte reported that 56% of consumers shopped and purchased a product using multiple channels at least once in the previous year" (GUDLACH, CANNON & MANNING, Op. cit.). Marketing experts describe how the costumer behavior has changed with channel evolution:

"What makes shopping behavior new and profoundly challenging is that costumers today are no longer marching through

those five stages {awareness, consideration, preference, purchase, post-sale service} in the context of a single channel. Instead, they are using all the available channels, entering different ones to fulfill their needs at different stages" (NUNES & CESPEDES, 2003: 98).

Agents in the market have evolved with the consumer behavior. Managers nowadays have decided to design channels for today's informed consumers¹⁸. This phenomena is called "Multi-channel distribution", "the use of multiple channels of distribution is now becoming the rule rather than the exception" ((GUDLACH, CANNON & MANNING, Op. cit.: 396). Even better, a system named "channel synergy" is taking place in the most efficient manufacturers around the world. "Channel synergy" consists in manufacturers combining channels in order to operate more efficiently¹⁹. The dynamic manager interested in this adaptation should balance his efforts and resources in order to better understand his consumer's needs and capture better margins through increasing his sales and capturing more market share²⁰. This manager is not expecting to rely on State regulation in order to perform in the market. This manager evolved with the consumer needs, stopped thinking about ways around competition like minimum RPM's. Instead, he created ways to fulfill the markets needs and satisfy his business interests. This sounds very much like a gain-gain situation for the participants of the market²¹.

Should American Courts reevaluate their holdings on minimum RPM's, or should they keep tolerating manufacturer and retailers "free riding" on their leniency for anticompetitive effects? Perhaps, manufacturers and retailers do "free ride", but on the courts. If an agent in the market plays his cards right

(setting the right RPM's, enough to exclude without getting caught) he could end up setting some nice restrictions on his market that will allow him to gain higher profits by incrementing his margins and augmenting his market share on behalf of the courts tolerance for a horizontal restriction. Perhaps, what minimum RPM actors are doing is "low riding" on the courts at an anticompetitive and procompetitive measuring "scale" for effects. Maybe, the message that is being send from the courts to the agents of the market interested in setting minimum RPM agreements is something like the late 70's song "Low rider don't use no gas now", "free ride" on the courts. Perhaps, courts are implying "take a little trip and see" if you could get away with it. "Take a little trip with me" and you will probably exclude the entrant competitor. Then, this would be something very much like regulation on behalf of the courts and not on the Congress where this powers should rest. Are courts the means for arbitrage in this love and hate relationship between antitrust and "free riding"?

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 - 3 GOSH SHUBA, When Exclusionary Conduct Meets the Exclusive Rights of Intellectual Property: Morris v. PGA Tour and the Limits of Free Riding As an Antitrust Business Justification, Vol. 37. Loyola University Chicago Law Journal at P 37 "To say that a person requires legal protection because of free riding is a seductive argument. Claims that certain activity steals the fruit of someone's labor or is an illegal misappropriation of someone's gains, however disguise the question of entitlement and assumes that the creator is entitled to completely appropriate the value of what she has created."
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