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What Baby Products Can Teach Us About Successful Distribution Strategies for the Current Legal and Economic Climate

In current market conditions, having the right distribution strategy is more crucial than ever. "Vertical" price restraints have long been a useful tool for product distribution strategies. For a manufacturer, vertical price restraints—particularly manufacturers' minimum suggested resale price (MSRP) arrangements—can put a manufacturer's product on the shelves of more outlets, protect and promote the value of its brands, encourage dealers to inform consumers better about its brand, and compete more vigorously against rivals in other ways. A retailer may benefit from an MSRP arrangement because the seller can prevent or discourage free riding on the services the retailer provides, guarantee favorable margins, and help the retailer compete on a variety of factors as opposed to exclusively on price.

Despite recent Supreme Court precedent in the area, however, the legal landscape for vertical price restraints is still not well mapped. Manufacturers and dealers can better position themselves if they are aware of the latest relevant legal developments in this area. Similarly, current market conditions may make it critical for companies to evaluate regularly or adjust their distribution strategies. The objective of this overview of the latest legal developments concerning MSRP arrangements is to help both manufacturers and dealers understand the legal issues involved by a discussion of the current antitrust class action against Babies "R" Us. A few pricing and marketing ideas for distribution strategies in times like the present are also presented.

Babies "R" Us Antitrust Class Action

Despite two 2007 Supreme Court decisions that make it more difficult to sue a party under federal antitrust laws for vertical price restraints, on July 15, 2009, a federal judge in Philadelphia granted class certification to a complaint alleging that Babies "R" Us (BRU) had coerced manufacturers of high-end baby products into preventing Internet dealers from discounting their products. *McDonough et al. v. Toys "R" Us Inc. et al.*, No. 06-0242, 2009 WL 2055168 (E.D. Pa. July 15, 2009).

The plaintiffs are consumers who had allegedly paid inflated prices at BRU for certain baby products. In 2002, the plaintiffs filed their original complaint, which alleges violations of § 1 of the Sherman Antitrust Act, which prohibits unreasonable restraints of trade. This section requires proof that the defendant was a party to a contract, combination, or conspiracy, and that this conspiracy unreasonably restrained trade. Several Internet retailers selling baby products made similar allegations against BRU in a companion case that survived a motion to dismiss. *See BabyAge.com v. Toys "R" Us, et al.*, No. 05-6792 (E.D. Pa. May 19, 2008).

BRU, which started in 1996 with a small number of stores, currently has more than 260 stores across the country. As BRU grew, however, the number of small retailers specializing in baby products shrunk and retailers dwindled from 2,700 in 1996 to 600 in 2002. BRU thus became the dominant retailer of baby products, and its stiffest competition now comes from Internet retailers that have lower operating costs and can therefore offer deep discounts.

More specifically, the plaintiffs allege that BRU demanded protection from Internet discounting and threatened not to carry certain manufacturers' products unless the manufacturer agreed to prevent Internet retailers from discounting the items. Manufacturers allegedly had been forced to acquiesce, because BRU was their largest and most important customer. To prevent Internet discounting, manufacturers applied various tools, including MSRP policies prohibiting retailers who want to continue to sell the manufacturer's product from selling below the MSRP. Another tool was a dealer selection policy banning retailers who sold only via the Internet from selling the manufacturer's products altogether. The plaintiffs' evidence includes a statement of the founder of Regal Lager, the distributor of popular BabyBjörn products, about BRU: "It's hard to say no when they have over 50% of our business!" The conspiracy between BRU and manufacturers of baby products unreasonably restrained trade, plaintiffs alleged, because BRU was able to, and did, charge higher prices because other retailers were prevented from discounting.

BRU's unsuccessful motion to dismiss the case failed and the plaintiffs' successful motion for class certification are significant, because they prove that two 2007 Supreme Court precedents will permit appropriate, if fewer, vertical price restraint claims to move forward.

In *Bell Atlantic v. Twombly*, the Court heightened the legal standards for pleading a conspiracy, requiring that a plaintiff make a statement that offers enough factual matter to suggest a right to relief. According to the Court, the statement must have enough "heft" to show that a pleader is entitled to relief. 127 S. Ct. 1955, 1966 (2007). In addition, in *Leegin Creative Leather Products Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007), the Court held that minimum resale price maintenance agreements (RPMs) are no longer per se or presumptively illegal under federal law but should be evaluated under the rule of reason—a standard that requires proof that a trade restraint has unreasonably restrained competition. Determining the reasonableness of a restraint generally entails a detailed evaluation of the history, nature, and effect of the restraint; who instigated it; whether the businesses involved have market power; and whether there are any procompetitive business justifications for the restraint. Such an evaluation typically requires substantial resources. Thus, some legal practitioners and commentators believed that *Leegin* and *Twombly* could effectively quell a large number of federal vertical price restraint claims.

BRU demonstrates, however, that some vertical price restraint claims may still go all the way to judgment on the merits. On a motion to dismiss the case, Judge Brody of the U.S. District Court for the Eastern District of Pennsylvania held that the plaintiffs' allegations and evidence in *BRU* were hefty enough to meet the stricter pleading standards established in *Twombly*. As to the hurdles resulting from the *Leegin* ruling, Judge Brody found that BRU's alleged conduct preventing Internet discounting, taken as true, would support a finding that BRU had unreasonably restrained competition. The judge noted that in *Leegin*, the Supreme Court did *not* hold that RPMs are per se lawful but that they should be evaluated under the rule of reason on a case-by-case basis. One example of the possible anticompetitive effects of RPMs, the Court noted, is when a dominant retailer abuses an RPM. Elaborating this opinion, the Court explained that a dominant retailer might request an RPM in order to "forestall innovation in distribution [and a] manufacturer might consider it has little choice but to accommodate the retailer's demands." 127 S. Ct. at 2717. The Court also noted that, if there is evidence that retailers were the impetus for a vertical price restraint, there is a greater likelihood that the restraint facilitates a retailer cartel or supports a dominant, inefficient retailer. If the dominant retailer has market power, the Court warned, the anticompetitive concerns may be serious.

Judge Brody applied these points in her decision in *BRU*, noting that the Court's ruling in *Leegin* directs lower courts to "be diligent in eliminating [RPM agreements'] anticompetitive uses from the market." Quoting from *Leegin*, Judge Brody found that, when a manufacturer is coerced into using an RPM, "the manufacturer does not establish the practice to stimulate services or to promote its brand" but, instead, "supports a dominant, inefficient retailer." *Id.* at 2719. The support that the Court cited in making this point, Judge Brody noted, was none other than *Toys "R" Us Inc. v. FTC*, 221 F.3d 928 (7th Cir. 2000). In that instance, the Seventh Circuit upheld findings that Toys "R" Us Inc., BRU's parent company, had coerced toy manufacturers into implementing vertical restraints as a way to hinder competition from warehouse clubs like Costco, BJ's, and Sam's Club. If the allegations and evidence against BRU are to be believed, Toys "R" Us may have failed its corporate child by allowing it to commit the same costly mistakes Toys "R" Us had committed years ago.

Vertical Price Restraints in the Current Legal and Economic Climate

BRU raises some important points about vertical price restraints and distribution strategies. Relating these to current economic and legal conditions, these points include the following:

- Dominant retailers should not pressure manufacturers on matters involving resale prices and dealer selection. A dominant retailer that threatens to stop carrying a manufacturer's products unless the manufacturer agrees to prevent discounting exposes itself to serious antitrust risk. An MSRP restraint should be adopted by a manufacturer unilaterally in the exercise of its independent discretion. If a dominant retailer or one or more competing manufacturers urge a manufacturer to adopt an MSRP policy, it is likely that they are doing so for an anticompetitive purpose.
- Retailers have other options besides price cuts. In the current economic climate, many retailers are trying to capture sales by lowering their prices, thereby decreasing their profit margins. In many product categories, only the most efficient retailers with the lowest operating costs and those with the most innovative marketing strategies may survive. A few alternatives to competing solely on price include the following:
  - » convincing consumers to invest in quality rather than quantity—When it comes to apparel, the French are well known for buying fewer products of better quality and making these their wardrobe staples. Retailers in the United States can promote the mind-set that, because consumers have fewer dollars to spend, they should be investing in a few quality pieces that are practical, durable, "timeless," or "classic." Instead of spending their money on products that are less expensive products but of inferior quality. Manufacturers can lead the way and offer cooperative marketing funding and other trade fund programs.

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   » pursuing symbiotic, cross-promotional offers—one like Lucky Brands' recent "Buy Two Tank Tops, Get a Week of Complimentary Yoga Classes" promotion, for example. In this case, Window advertisements have lured new customers inside Lucky stores to purchase tank tops they will wear to yoga class as well as other items that may have caught their eye while inside the store. The yoga studio benefits because some students who exhaust their complimentary classes will pay for more classes at the studio after they have become familiar with them.
   » increasing sales by looking north—Last winter, among other amendments to its competition laws, the Canadian government implemented more lenient rules for vertical price restraints. Experts have said that Canada is weathering the financial crisis better than the United States is, and, in late June, the Bank of Canada declared that Canada's recession is over after finding that consumer spending had increased in the second quarter of 2009, surpassing expectations, and that consumer confidence was high. With a surging exchange rate as well, manufacturers and retailers may benefit from focusing on increasing sales in Canada, which, like most countries, has detailed rules for the packaging, labeling, and marketing of consumer goods. Licensed Canadian counsel should be contacted for guidance on ways to proceed.
- Manufacturers that have not issued MSRP policies before may want to consider doing so now. If retailers discount products too deeply, manufacturers may see the value of their brands, trademarks, and images depreciate and could lose the return on their investment into protecting their value. Even if, at first blush, it seems unreasonable to expect retailers to adhere to a policy that prevents discounting at a time when almost everyone has lowered prices, an MSRP arrangement may still be feasible. A manufacturer can individually explain to dealers that an MSRP policy will help more retailers survive, because their competition will be subject to the same terms and conditions. This situation will allow retailers to compete on features that are not related to the price of the product but on features such as service, selection, convenience, ambience, and innovative advertising and marketing programs.
- Retailers and manufacturers must be cognizant of the important distinction between concerted and unilateral conduct in antitrust law. In *BRU*, the plaintiffs alleged a conspiracy between a single, dominant retailer and certain manufacturers to prevent discounting by Internet dealers. When a manufacturer chose to suspend its MSRP policy, BRU cut orders for that manufacturer's products. When a manufacturer independently adopts a purely unilateral MSRP policy and enforces it unilaterally and evenly, without taking direction from or acquiescing to other retailers or manufacturers, a plaintiff may not satisfy the concerted action requirement. Thus, even though RPM agreements can be lawful under federal law, a purely unilateral and independently enforced MSRP policy is the safest approach to regulating minimum resale prices.
- State laws and federal laws may differ. Individual states have their own antitrust laws. Most states follow federal antitrust law developments, but not all states do. *Leegin* did not change state laws prohibiting RPMs. Whereas 37 states submitted a joint amicus brief in *Leegin*, California did not, even though its enforcement officials may nevertheless believe that retail price maintenance remains per se illegal under California law, despite the ruling in *Leegin*. New York's officials take the position that New York laws prohibits RPMs, and Maryland has enacted legislation expressly repealing *Leegin*. Other states may or may not follow suit.
- Congress could repeal *Leegin* and reinstate the per se rule against RPMs. Congress is considering two proposals to reverse *Leegin*. One of these is the Johnson-Conyers Bill (H.R. 3190), which the House Judiciary Committee's Subcommittee on Courts and Competition Policy approved on July 30, 2009. The other proposal in the bill introduced by Sen. Herb Kohl (D-Wis.) just months after *Leegin* was decided. S. 2269 would restore the per se rule of illegality for RPMs. Kohl introduced a subsequent bill—S. 148—to preserve the initiative. Both the House and Senate have held subcommittee hearings on these initiatives. On Jan. 13, 2010, the House Judiciary Committee approved H.R. 3190 by voice vote. Thus the movement to return to the per se rule may move forward.
- Disparate pricing and other preferential treatment may violate antitrust laws. Preferential treatment provided to some dealers, such as brick and mortar dealers, over others can violate other federal and state antitrust and unfair competition laws, including the federal Robinson-Patman Act, which prohibits price discrimination (meaning any difference in price) when certain circumstances are met as well as discriminatory promotional allowances and services. **TFL**

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