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SHEPPARD MULLIN
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What a Babies "R" Us' Class Action Lawsuit Can Teach Us About Successful Distribution Strategies for the Current Legal and Economic Climate

Despite two 2007 Supreme Court decisions that make it more difficult to sue 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") 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 Babies "R" Us Lawsuit

In BRU, plaintiff consumers filed a complaint in 2002 claiming that they had paid inflated prices at BRU for certain baby products pursuant to an alleged violation of Section 1 of the Sherman Act. Section 1 requires proof that the defendant was a party to a contract, combination or conspiracy, and that this conspiracy unreasonably restrained trade. Several Internet baby product retailers 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).

Starting in 1996 with a small number of stores, BRU currently has more than 260 stores across the country. As BRU grew, however, the number of small specialty baby products retailers shrunk. Between 1996 and 2002, the number of smaller baby product retailers dwindled from 2,700 to 600. BRU thus became the dominant retailer of baby products. BRU's stiffest competition comes from Internet retailers who, with lower operating costs, can offer deep discounts.

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 them. Manufacturers allegedly were forced to acquiesce because BRU was their largest and most important customer. To prevent Internet discounting, manufacturers applied various tools. These included 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 Internet-only retailers from selling the manufacturers' products altogether. Plaintiff's evidence included 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!" According to plaintiffs, the alleged conspiracy between BRU and baby product

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manufacturers unreasonably restrained trade because BRU was able to and did charge higher prices because other retailers were prevented from discounting.

BRU's unsuccessful motion to dismiss and plaintiffs' successful motion for class certification are significant because they demonstrate that two 2007 Supreme Court precedents still leave room for some 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. That statement must have enough "heft" to show a pleader is entitled to relief. 127 S. Ct. 1955 at 1966, 1964 (2007). Second, in Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S.Ct. 2705 (2007), the Court held that minimum resale price maintenance agreements ("RPM") are no longer *per se* or presumptively illegal under federal law, but rather should be evaluated under the rule of reason, a standard that requires proof the agreement has unreasonably restrained competition. (See author's prior blog articles about the Supreme Court decision and the decision on the renewed case against Leegin). Determining the reasonableness of a restraint generally entails a detailed evaluation of the its history, nature and effect, 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 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, Judge Brody of the United States District Court for the Eastern District of Pennsylvania held the BRU plaintiffs' allegations and evidence were hefty enough to meet Twombly's stricter pleading standards. As to Leegin's hurdles, Judge Brody found that BRU's alleged conduct preventing Internet discounting, taken as true, would support a finding that BRU unreasonably restrained competition. She noted that the Supreme Court in Leegin did *not* hold that RPM agreements are *per se* lawful. Rather, the Court held that RPM agreements should be evaluated on a case by case basis under the rule of reason. One example where RPM may have anticompetitive effects, the Court noted, is when RPM is abused by a dominant retailer. Elaborating, the Court explained that a dominant retailer might request RPM to forestall innovation in distribution and a manufacturer might consider it has little choice but to accommodate the retailer's demands. 127 S.Ct. 2705 at 2717. The Court noted as well that if there is evidence 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 noted that the Court 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 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 the Court cited to 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, coerced toy manufacturers into implementing vertical restraints to hinder competition from

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warehouse clubs like Costco, BJ's and Sam's Club.

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 include:

- Dominant retailer pressure on manufacturers regarding resale price and dealer selection. A dominant retailer who threatens to stop carrying a manufacturer's products unless the manufacturer agrees to prevent discounting may expose itself to antitrust challenges. Typically, 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 urges a manufacturer to adopt an MSRP policy, it may be argued that it is for an anticompetitive purpose.

- Options other than price cuts. In the current economic climate, many retailers are trying to capture sales by lowering their prices, 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:

    - Convince consumers to invest in quality over quantity. Retailers in the United States may consider promoting among consumers the mind-set that with fewer dollars to spend, consumers should be investing in quality, practical, durable, "timeless" or "classic" pieces, rather than spend their dollars on less expensive products of inferior quality. Manufacturers can lead the way and offer cooperative marketing funding and other trade fund programs.

    - Pursue symbiotic, cross-promotional offers. An example of this is Lucky Brands' recent "Buy Two Tank Tops, Get a Week of Complimentary Yoga Classes" promotion. 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, having become familiar with the studio and "hooked" on yoga, will purchase additional classes.

    - Look North to Increase Sales. Last winter, the Canadian government implemented more lenient rules for vertical price restraints, among other amendments to the country's competition laws. Experts have said that Canada is weathering the financial crisis better than the United States, and the Bank of Canada declared late June that Canada's recession is over. It found that consumer spending increased in the second quarter of 2010, surpassing expectations, and that consumer confidence is high. With a surging exchange rate as well, manufacturers and retailers may benefit from focusing on increasing sales in Canada and other markets.

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- Manufacturers that have not issued MSRP policies before may wish to consider doing so now. If retailers discount too deeply, manufacturers may see the value of their brands, trademarks and images depreciate, and lose the return on their investment in 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 may still be feasible. A manufacturer can explain to dealers individually that an MSRP policy will help more retailers survive as their competition will be subject to the same terms and conditions. This will allow retailers to compete on non-price features such as service, selection, convenience, ambience, and innovative advertising and marketing programs.

- Requirement of Concerted Action. In BRU, 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 v. Federal Law. Individual states have their own antitrust laws. Most states follow federal antitrust law developments, but not all. Leegin did not change state laws prohibiting RPM. Thirty-seven states submitted a joint amicus brief in Leegin. California did not, but its enforcement officials may nevertheless believe that RPM remains *per se* illegal under California law, despite Leegin. New York's officials take the position that New York laws prohibits RPM. Further, 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 RPM. There are two congressional proposals to reverse Leegin. One of these is the Johnson-Conyers bill, H.R. 3190. On July 30, 2009, the House Judiciary Committee's Courts and Competition Policy Subcommittee approved H.R. 3190. Senator Herb Kohl (D-Wis.), just months after Leegin was decided, introduced a bill to restore the *per se* rule of illegality for RPM. S. 2261. He introduced a subsequent bill to preserve the initiative, S. 148. The House and Senate have held subcommittee hearings on these initiatives, but it is not yet known whether or when this legislation will move forward.

- Disparate pricing and other preferential treatment. 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. The RPA prohibits price discrimination (meaning any difference in price) where certain circumstances are met, as well as discriminatory promotional allowances and services.

Authored by:
Heather M. Cooper
(213) 617-5457
HCooper@sheppardmullin.com