A Developing Circuit Split Over Vertical Restraints?

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In Leegin Creative Leather Products Inc. v. PSKS Inc., 551 U.S. 877 (2007), the U.S. Supreme Court held that vertical resale price maintenance (RPM) agreements were not per se unlawful under the Sherman Act, but instead were to be evaluated under the rule of reason. Given the challenges of pleading and proving rule of reason cases, Leegin was heralded by some as the death knell for Sherman Act claims based on vertical restraints.

In United States of America v. Apple Inc., however, the Southern District of New York held, notwithstanding Leegin, that the per se rule applied to Apple's vertical agreements with electronic book publishers. This decision seems contrary to Leegin's holding and reasoning and could, if upheld by the Second Circuit, give rise to a circuit split.

Leegin Eliminates Last Category of Vertical Restraints Subject to Per Se Rule

In Leegin, the Supreme Court reversed the long-standing rule, established by Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911), that vertical RPM agreements are per se unlawful under the Sherman Act. Noting that the per se rule is reserved for restraints "that would always or almost always tend to restrict competition and decrease output," and acknowledging that RPM agreements potentially have both pro- and anti-competitive justifications, the Supreme Court concluded that the rule of reason should be applied to RPM agreements. Leegin thereby eliminated the last category of vertical restraints subject to the per se rule.

The Supreme Court emphasized in Leegin that lower courts would, over time, "establish the litigation structure to ensure the rule [of reason] operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses. Courts can, for example, devise rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones." And, in dicta, the Supreme Court specifically discussed several circumstances under which RPM agreements could violate the rule of reason, including where a vertical RPM agreement facilitates a horizontal cartel:

A horizontal cartel among competing manufacturers or competing retailers that decreases output or reduces competition in order to increase price is, and ought to be, per se unlawful. To the extent a vertical agreement

setting minimum resale prices is entered upon to facilitate either type of cartel, it, too, would need to be held unlawful under the rule of reason.

This formulation — that a vertical agreement facilitating a manufacturer or retailer cartel "would need to be held unlawful under the rule of reason" — is less than clear. It expressly assumes that the rule of reason should be applied, but the "would need to be held unlawful" language suggests liability would be automatic. And courts have since disagreed regarding the meaning of the phrase.

A Developing Split Among the Circuits Regarding Treatment of Vertical Restraints?

In Toledo Mack Sales & Service Inc. v. Mack Trucks Inc., the Third Circuit considered a Sherman Act case involving both a horizontal cartel among dealers of Mack trucks, and vertical agreements between Mack Trucks and its dealers. In evaluating the plaintiff's Sherman Act claim, the Third Circuit applied the per se standard to the horizontal claims between the Mack truck dealers, but applied the rule of reason to the vertical agreements between Mack Truck and the dealers.

Quoting the language from Leegin that vertical agreements facilitating horizontal cartels "would need to be held unlawful under the rule of reason," the court concluded that "[t]he rule of reason analysis applied even when, as in this case, the plaintiff alleges that the purpose of the vertical agreement between a manufacturer and its dealers is to support illegal horizontal agreements between multiple dealers."

The district court presiding over the multidistrict litigation In re Electronic Books Antitrust Litigation has taken the opposite approach. In Electronics Books, the plaintiffs have alleged that Apple coordinated a series of substantively identical vertical agreements with publishers, the purpose of which was to raise prices by converting the e-book industry from an "wholesale model" in which the retailers (most notably Amazon) determined sales prices to an "agency model" in which the publishers determined the sales price and paid retailers a percentage commission.

As in Toledo Mack, Electronic Books involved a horizontal agreement (among the publishers) and vertical agreements (between Apple and the publishers). The alleged horizontal agreement in Electronic Books was at the top of the distribution chain, rather than at the bottom as in Toledo Mack, but there is no apparent reason why that should affect the analysis.

In Electronic Books, however, the district court concluded the per se rule should apply to the vertical agreements between Apple and the publishers. In doing so, the court took the opposite interpretation of Leegin's dicta from Toledo Mack. In denying the defendants' motion to dismiss private class action claims, the court reasoned that "it is difficult to see how this passage can possibly help the defendants in this case. Such conduct would seem to either be per se unlawful, or necessarily unlawful under the rule of reason." (Toledo Mack was cited in the motion papers, but was not discussed in the district court's decision.)

In the July 10, 2013, order finding Apple liable under the Sherman Act in U.S. v. Apple Inc., the court continued to apply the per se standard, reasoning that "[w]hile vertical restraints are subject to review under the rule of reason, Leegin, 551 U.S. at 907, Apple directly participated in a horizontal price-fixing conspiracy. As a result, its conduct is per se unlawful. The agreement between Apple and the Publisher Defendants is, 'at root, a horizontal price restraint' subject to per se analysis."

Toledo Mack and Electronic Books thus present divergent views regarding the treatment of vertical restraints following Leegin. While Toledo Mack concluded that vertical agreements are subject to the rule of reason even if their alleged purpose was to facilitate a horizontal cartel, Electronic Books concluded that vertical agreements are subject to the per se rule where they constitute "direct participat[ion]" in a horizontal cartel.

Which Approach Is Consistent With Leegin?

The approach taken by Toledo Mack seems more consistent with Leegin's central holding — that vertical restraints should be evaluated under the rule of reason. In Leegin, the Supreme Court reasoned that the the per se rule should not be applied to vertical RPM agreements because"[n]othwithstanding the risks of unlawful conduct, it cannot be said with any degree of confidence that resale price maintenance always or almost always tends to restrict competition and decrease output."

Electronic Books' view that the per se standard applies to those vertical agreements that constitute "direct participat[ion]" in a horizontal cartel, while the rule of reason (presumably) applies to all other types of vertical agreements, is contrary to the Supreme Court's view that, given the uncertain competitive impact of vertical restraints they should be evaluated under the rule of reason. The Supreme Court emphasized in Leegin that there were a number of circumstances under which vertical agreements could violate the rule of reason, but its language does not suggest that the per se rule should still be applied to certain types of vertical agreements.

Electronic Books provides little, if any, of the "guidance to businesses" that the Supreme Court suggested would "make the rule of reason a fair and efficient way to prohibit anticompetitive [vertical] restraints and promote procompetitive ones." As a practical matter, it is unclear how to distinguish vertical agreements that constitute "direct participation" in a horizontal cartel from those that fall somewhere short of "direct participation." In finding Apple liable, the court relied in part on the Supreme Court's decision in Interstate Circuit v. United States, 306 U.S. 208 (1939), and the Seventh Circuit's decision in Toys "R" Us, Inc. v. F.T.C., 221 F.3d 928 (2000).

These decisions, which concern "hub-and-spoke" conspiracies, predate Leegin and present factual circumstances absent from Electronic Books. Most notably, Apple's status as a new entrant to the electronics book market meant that it lacked the market power of the "hubs" in Interestate Circuit and Toys "R" Us, a fact the court acknowledged but dismissed. Moreover, Toys "R" Us concerned a group boycott, and the Supreme Court has recognized that a group boycott implemented through complimentary vertical and horizontal agreements may be subject to the per se rule. Toys "R" Us' application to restraints other than group boycotts is unclear, given Leegin's holding that vertical price restraints are subject to the rule of reason, and its dicta assuming the rule of reason should be applied where vertical price restraints facilitate a horizontal cartel.

It remains to be seen whether the Second Circuit affirms Electronic Books' application of the per se standard to Apple's agreements with book publishers in an opinion that creates a clear circuit split with the Third Circuit's decision in Toledo Mack. In the meantime, however, plaintiffs are likely to cite Electronic Books in arguing that the vertical price restraints at issue in their cases should be subject to the per se rule, notwithstanding Leegin.

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