

# LEEGIN V. PSKS: NEW STANDARD, NEW CHALLENGES

By Ashley Doty

## I. INTRODUCTION

In *Leegin Creative Leather Products, Inc v. PSKS, Inc.*,<sup>1</sup> the Supreme Court, taking heed of years of economic research identifying procompetitive benefits of vertical resale price maintenance (RPM), declared that the practice shall be evaluated under the rule of reason analysis. In a 5-4 split, the Court explicitly overruled *Dr. Miles Medical Co. v. John D. Park & Sons Co.*,<sup>2</sup> in which ninety-six years ago, the Court pronounced RPM to be *per se* illegal. The *Leegin* majority reasoned that in light of the voluminous economic research detailing procompetitive benefits, a *per se* rule of illegality is inappropriate for RPM; the minority dissented almost exclusively on grounds of *stare decisis*.<sup>3</sup>

This Note argues that the *Leegin* majority's decision to reverse the *per se* standard of liability in RPM cases was economically prudent. Unfortunately, because RPM has been *per se* illegal for ninety-six years, lower courts have little or no experience weighing procompetitive effects against anticompetitive effects under a rule of reason analysis in vertical RPM cases. Therefore, instead of dismissing *stare decisis* as virtually insignificant in the antitrust realm,<sup>4</sup> the majority should have more thoroughly addressed the concerns the dissent raised about the consequences of breaking with *stare decisis*.<sup>5</sup> Toward that end, the Court could have provided the lower courts with more detailed guidance as to what to look for when evaluating the anticompetitive effects of RPM under the rule of reason in

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1. 127 S. Ct. 2705 (2007).

2. 220 U.S. 373 (1911).

3. See generally *Leegin*, 127 S. Ct. 2705. *Stare decisis* is “[t]he doctrine of precedent, under which it is necessary for a court to follow earlier judicial decisions when the same points arise again in litigation.” BLACK’S LAW DICTIONARY 1173 (Abridged 8th ed. 2005).

4. *Leegin*, 127 S. Ct. at 2720 (“*Stare decisis* is not as significant in this case, however, because the issue before us is the scope of the Sherman Act. From the beginning the Court has treated the Sherman Act as a common-law statute.”) (internal citations omitted).

5. *Id.* at 2731 (Breyer, J., dissenting) (“We write, not on a blank slate, but on a slate that begins with *Dr. Miles* and goes on to list a century’s worth of similar cases, massive amounts of advice that lawyers have provided their clients, and untold numbers of business decisions those clients have taken in reliance upon that advice.”).

hopes of producing a more uniform application in the modern nationalized economy. Additionally, the majority's language restricting the applicability of the common law doctrine against restraints on alienation to the real property context may indicate the Court's willingness to fundamentally change the first sale doctrine in patent law in the October 2007 term. A more patentee-friendly first sale doctrine, combined with a more relaxed standard for RPM, could lead to unintended and unfortunate consequences.

This Note reviews and synthesizes the economic literature dealing with vertical RPM in order to supplement the limited advice the majority gave the lower courts in *Leegin*, and examines how the *Leegin* decision would interact with the Federal Circuit's version of the first sale doctrine in patent law. Part II provides background on the practice of vertical RPM, its procompetitive and anticompetitive effects, the different standards of antitrust analysis, and the legal status of vertical RPMs before *Leegin*. Part III summarizes *Leegin*. Finally, Part IV analyzes the possible detrimental effects of the majority's failure to address the dissent's *stare decisis* concerns, provides more structured guidance to lower courts in light of economic literature regarding vertical RPM, and explores the likely effects of an interaction between the new *Leegin* standard and the more permissive first sale doctrine adopted by the Federal Circuit.

## II. BACKGROUND

Vertical RPM is a restraint of trade regulated by Sherman Act § 1,<sup>6</sup> which makes illegal "every contract . . . or conspiracy, in restraint of trade or commerce."<sup>7</sup> Because every commercial contract imposes some degree of "restraint of trade," if read literally, the Sherman Act could proscribe "the entire body of private contract law."<sup>8</sup> Therefore, Congress must have adopted the broad prohibition in the Sherman Act with the expectation that the courts would delineate the boundaries of the statute by drawing upon common law tradition.<sup>9</sup>

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6. See, e.g., *Leegin*, 127 S. Ct. at 2712-13.

7. 15 U.S.C. § 1 (2006).

8. *Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 687-88 (1978).

9. *Nw. Airlines v. Transp. Workers Union*, 451 U.S. 77, 99 n.42 (1981); *Nat'l Soc'y of Prof'l Eng'rs*, 435 U.S. at 688; see also 21 Cong. Rec. 2456 (1890) (comments of Sen. Sherman) ("[The Sherman Act] does not announce a new principle of law, but applies old and well recognized principles of the common law to the complicated jurisdiction of our State and Federal Government.").

## A. Vertical Resale Price Maintenance

This Section explains the practice of vertical RPM and presents its possible procompetitive and anticompetitive effects.

### 1. *What is Vertical Resale Price Maintenance?*

Vertical RPM is a business practice whereby a manufacturer sets a minimum price that retailers must observe as a condition of selling that manufacturer's product.<sup>10</sup> Vertical RPM, by creating a price floor, limits price competition among retailers of the same product<sup>11</sup> because, in an RPM scheme, market competition can only drive prices to the stipulated minimum, thus significantly reducing intrabrand price competition.<sup>12</sup>

### 2. *Procompetitive Effects of Resale Price Maintenance*

RPM can serve as a solution to the free-rider problem and facilitate market entry by new, small competitors.

#### a) A Solution to the Free-Rider Problem

The free-rider problem in the RPM context occurs when one retailer who furnishes desired point-of-sale services for a particular product is undersold by discounting "price cutters": retailers who provide no services, and who sell at lower prices than their competitors because they "free-ride" from point-of-sale information, such as product demonstrations, that other retailers provide to the consumer.<sup>13</sup>

Free-riding discounters discourage other retailers from providing valuable point-of-sale services and information to consumers.<sup>14</sup> Customers typically seek point-of-sale services such as product demonstrations, which are often provided by knowledgeable sales staff when shopping for complex, infrequently purchased goods.<sup>15</sup> In the absence of any preventative policy, customers can enjoy the services provided by some retailers and then purchase the same product from a free-riding discount seller who

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10. J.F. PICKERING, *RESALE PRICE MAINTENANCE IN PRACTICE* 13 (1966).

11. B.S. Yamey, *Introduction: The Main Economic Issues*, in *RESALE PRICE MAINTENANCE* 13, 13 (1966).

12. *See id.*; PICKERING, *supra* note 10, at 13.

13. William S. Comanor, Comment, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 HARV. L. REV. 983, 987 (1985); Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. L. & ECON. 86, 91-92 (1960). William Comanor is now a Professor of Economics at the University of California, Santa Barbara.

14. Telser, *supra* note 13, at 91.

15. Roger D. Blair, Jill Boylston Herndon & John E. Lopatka, *Resale Price Maintenance and the Private Antitrust Plaintiff*, 83 WASH. U. L. Q. 657, 698 (2005).

did not invest to provide those services.<sup>16</sup> Thus, many of the increased sales generated by point-of-sale services do not go to the retailer that provided the services.<sup>17</sup>

As a practical example, during the “format war,” a customer looking to get a next-generation DVD player would likely go to an in-store retailer with knowledgeable sales staff who would inform the customer of what he needs to use the new player (an HD TV, HD disks) and discuss the pros and cons of choosing either blu-ray (better technology) or HD DVD (lower price). After getting this valuable advice, the customer is under no obligation to purchase his next generation DVD player from that retailer. In fact, it is in the customer’s best interest to leave the store empty-handed and buy the player from whichever retailer sells it cheapest. Since maintaining a knowledgeable sales staff is a significant overhead expense, the service-providing retailer is likely not the cheapest on the market, and thus the customer would not buy the DVD player from the service-providing retailer. Because a retailer will only invest in services insofar as it benefits its own sales, this phenomenon, if unchecked, forces service-providing retailers to decrease beneficial services to compete based on price.<sup>18</sup> Although this does lower prices in the marketplace, overall consumer utility does not necessarily increase, as valuable information becomes more and more difficult to find, especially for customers who are not internet-savvy or otherwise do not know where to look to find detailed product reviews.

Vertical RPM can alleviate the free-rider problem by guaranteeing service-providing retailers a sufficient profit margin to induce them to provide services. In this situation, the hypothetical DVD player customer has little to no incentive to spend time and effort finding a cheaper retailer, since all of the retailers in the market will be selling at around the same price, and the retailer is rewarded for the resources spent on training sales staff. When the manufacturers guarantee a minimum price, which allows a sufficient profit margin throughout the marketplace, retailers push to sell more units based on the quality of the manufacturer’s product as compared to substitutes instead of by price cutting.<sup>19</sup> Thus, RPM promotes inter-brand competition by reducing intra-brand competition.

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16. Telser, *supra* note 13 at 91; Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON 346, 348 (1984).

17. Telser, *supra* note 13 at 91.

18. *Id.*

19. *Id.*

b) Facilitate Market Entry

Vertical RPM can facilitate market entry for new manufacturers, which subsequently increases product selection available to consumers from an increased number of market participants. First, by establishing a vertical RPM policy, new manufacturers can guarantee retailers that they will not have to compete with free-riders, which would allow a service-providing retailer to safely invest capital to introduce consumers to the new product.<sup>20</sup> Second, vertical RPM can help stabilize demand uncertainty for a product, which is common when a retailer must order goods before consumer demand is known.<sup>21</sup> In the absence of vertical RPM, if retailers overestimate consumer demand, the good's price will plummet, causing substantial losses to retailers, as retailers have to liquidate their supply.<sup>22</sup> By insulating retailers from the risks of unexpectedly low demands, vertical RPM minimizes the risk of investing in innovative but riskier products and of introducing those unknown products to consumers.<sup>23</sup>

3. *Anticompetitive Effects of Vertical Resale Price Maintenance.*

Some have argued that vertical RPM should remain *per se* illegal because of several possible anticompetitive effects that may result from RPM arrangements, which this Section will explain.

a) Higher Prices

Many have argued that vertical RPM harms consumers because it inevitably raises prices to supra-competitive levels.<sup>24</sup> Several studies have chronicled empirical evidence that vertical RPM leads to price increases.<sup>25</sup> Prior to Congress's passage of the Consumer Goods Pricing Act<sup>26</sup> in 1975, the Miller-Tydings Fair Trade Act<sup>27</sup> and the McGuire Act<sup>28</sup> gave states the authority, under state laws, to permit manufacturers to engage in vertical RPM—despite the *Dr. Miles* holding—when the goods subject to the RPM policy were branded with the manufacturer's name. A National As-

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20. *Cont'l T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 55 (1977)

21. Brief of Amici Curiae Economists in Support of Petitioner, *Leegin Creative Prods., Inc. v. PSKS*, 127 S. Ct. 2705 (2007) (No. 06-480).

22. *Id.*

23. *See id.*

24. *See, e.g., Leegin*, 127 S. Ct. at 2727-28 (Breyer, J., dissenting).

25. *See, e.g., THOMAS R. OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE: BUREAU OF ECONOMICS STAFF REPORT TO THE FEDERAL TRADE COMMISSION* 106-16 (1983).

26. Pub. L. No. 94-145, 89 Stat. 801 (1975).

27. 75 Pub. L. No. 314, 50 Stat. 673 (1937).

28. 66 Stat. 632.

sociation of Chain Drug Stores' survey of drug prices during this "fair trade" period found that drug prices rose 3.1%.<sup>29</sup> Another study found that prices in states which allowed vertical RPM were between nineteen and twenty-seven percent higher than prices in states which did not.<sup>30</sup>

If prices do increase because of vertical RPM, the alleged harm to consumers will be borne by what Professor William Comanor dubs "inframarginal" consumers.<sup>31</sup> While some "marginal" customers will not purchase a product if its price rises, "infra-marginal" customers, who value the product higher than the current price, will continue to buy the product at the increased price. The price increases associated with vertical RPM harm these customers insofar as they may bear the cost of supplemental services they never desired.<sup>32</sup>

b) Cartel Facilitation

Vertical RPM may also facilitate horizontal cartels.<sup>33</sup> The concern is that stipulating a minimum price, particularly if that price is supra-competitive, allows manufacturers to police and stabilize horizontal price fixing at either the retailer or manufacturer level.<sup>34</sup>

Vertical RPM can facilitate cartels by providing a mechanism through which the cartel could prevent a firm from cheating.<sup>35</sup> Suppose, for example, that five firms manufacture DVD players in a particular market. Ideally, these five firms would compete with each other for business in retail stores. In an unrestrained market, the lower the price the manufacturing firm can offer the retailer, the more DVD players the firm will sell because more retailers will buy their DVD players. Furthermore, a lower wholesale

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29. OVERSTREET, *supra* note 25 at 109.

30. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2728 (2007) (Breyer, J., dissenting) (citing Hearings on H. R. 2384 before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary, 94th Cong., 1st Sess., 122 (1975)). Thomas Overstreet criticized these studies for methodological flaws, such as the inability to separate price increases due to vertical RPM from general inflation. Overstreet further notes that price increases are not an indicator of anticompetitive effects, as the procompetitive effects of vertical RPM would also lead to higher prices. THOMAS R. OVERSTREET, JR., *RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE: BUREAU OF ECONOMICS STAFF REPORT TO THE FEDERAL TRADE COMMISSION 106-16* (1983).

31. Comanor, *supra* note 13, at 991-92.

32. *Id.*

33. *See, e.g.*, Robert Pitofsky, *Commentary: In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing*, 71 GEO. L. J. 1487, 1490 (1983).

34. *Id.*

35. Telser, *supra* note 13 at 97.

price allows retailers to offer a lower retail price, which in turn induces more consumers to buy that manufacturer's DVD Players.<sup>36</sup> Suppose further that all of the DVD player manufacturers collectively agreed to fix wholesale prices of DVD players at \$10 when the competitive price would be \$5.<sup>37</sup> In a competitive market, this arrangement would be highly unstable and susceptible to cheating. Although the collective cartel has an interest in maintaining the \$10 price, any single member has a powerful incentive to cheat on the cartel and undercut the fixed price to increase its own sales. A manufacturer in this example may offer DVD players to retailers at \$8. The cheating manufacturer will probably raise his profit margin because, absent exclusive dealings arrangements, retailers will likely buy their DVD players primarily from him.<sup>38</sup> Furthermore, the cheating manufacturer continues to benefit from the cartel arrangement because it can still maintain a supra-competitive profit of \$3 while the rest of the members sell at \$10.<sup>39</sup> Because all five independent cartel members have this same incentive structure, even absent antitrust enforcement<sup>40</sup> the cartel members would continuously undercut the group, and the arrangement would fall apart.<sup>41</sup>

A vertical RPM policy may serve as an effective policing mechanism to prevent cartel members from cheating. If the hypothetical cartel described above implements an RPM policy that fixes the wholesale price at \$10 and dictates a resale price of \$15, any cheating manufacturer will increase the retailer's profit margin, but will not increase the number of DVD players sold to consumers because the retail price remains \$15.<sup>42</sup> Thus the RPM policy destroys most of the incentive to undercut the fixed wholesale price.<sup>43</sup> While a cheating manufacturer in this situation could not affect aggregate retail consumption, the cheating manufacturer could still increase its market share by inducing retailers to purchase more from it than from other cartel members, unless an exclusive dealing arrange-

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36. *See id.*

37. For purposes of this analysis, this Note ignores the availability of substitute goods and elasticity of demand and assumes that the cartel can maintain the fixed \$10 price.

38. *Id.*

39. *See id.*

40. Horizontal price fixing is *per se* illegal. *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 223 (1940).

41. *See* Telser, *supra* note 13, at 96.

42. Blair et al., *supra* note 15, at 690.

43. *Id.*

ment is in place.<sup>44</sup> This is why the combination of an RPM scheme and an exclusive dealing arrangement is so powerfully anticompetitive.<sup>45</sup>

In addition, firms can also use vertical RPM to strengthen retailer cartels because, left without a minimum vertical RPM, those cartels are also vulnerable to the same cheating concerns discussed above.<sup>46</sup> Retailers may solicit manufacturers to impose vertical RPM as a means to eliminate cartel-cheating at the retailer level.<sup>47</sup> Here, unlike in the manufacturer example where manufacturers could undercut the cartel to increase its market share to retailers (absent an exclusive dealing arrangement), a vertical RPM policy enforcing the retailer cartel price would eliminate all price competition because manufacturers would refuse to supply retailers who undercut the cartel under the RPM policy.<sup>48</sup>

c) Powerful Retailer and Manufacturer Abuse

A powerful retailer may be able to force a vertical RPM scheme upon a manufacturer so that the retailer may forestall or avoid altogether an expensive and risky research and development investment that could lead to beneficial and efficiency-increasing innovations in distribution methods.<sup>49</sup> The manufacturer may feel it has no choice but to comply if the manufacturer feels it “needs access to the retailer’s distribution network.”<sup>50</sup> The subsequent inevitable reduction in retailer innovations, which could lower the retailer’s overhead costs, hurts the consumer, who never realizes the savings the retailer could pass on to him.

Similarly, a powerful manufacturer may use vertical RPM as a means to induce retailers not to carry the products of smaller rivals or new entrants.<sup>51</sup> Well-known and powerful manufacturers can impose supra-competitive prices through a vertical RPM policy, and thus guarantee a supra-competitive profit margin to retailers.<sup>52</sup> Conversely, manufacturers of newer or lesser-known brands, which do not benefit from the consumer loyalty that their more powerful competitors enjoy, have more elastic de-

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44. Blair et al., *supra* note 15, at 690 n.192.

45. *See infra* Section IV.C.2.

46. Blair et al., *supra* note 15, at 695.

47. *Id.*

48. OVERSTREET, *supra* note 25, at 13-14.

49. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2717 (2007); OVERSTREET, *supra* note 25, at 30-31.

50. *Leegin*, 127 S. Ct. at 2717.

51. Howard P. Marvel & Stephen McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J. L. & ECON. 363, 366-68 (1985) (finding that the motivation for using RPM in the sugar trust was to deny distribution to rivals).

52. *See id.*

mand, and cannot afford to promise retailers a supra-competitive price. Therefore, with the presence of RPM, retailers have less incentive to invest in the products of an unknown competitor and more incentive to carry only brands upon which they enjoy a supra-competitive profit margin.<sup>53</sup> The subsequent decrease in availability of substitute goods hurts consumers because fewer competitors leads to less price competition and less innovation to create a superior product.

In sum, vertical RPM has the potential to produce both procompetitive and anticompetitive effects. As will be discussed below, the relative likelihoods of each of those possibilities drives the standards of liability the Court imposes on the practice. Section II.B. will present the rule of reason and *per se* standards of liability in Antitrust law, after which Section II.C. will discuss how the Court has historically categorized vertical RPM within that framework.

## **B. Antitrust Analysis: Rule of Reason and *Per Se* Standards**

When analyzing a restraint of trade under antitrust laws, courts apply either a *per se* or rule of reason standard.<sup>54</sup> Courts evaluate most restraints of trade under the rule of reason approach.<sup>55</sup>

The rule of reason standard requires the court to examine all of the particular circumstances surrounding the restraint to decide whether the practice constitutes an unreasonable restraint on competition.<sup>56</sup> Under the rule of reason, “the true test of legality is whether the restraint is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.”<sup>57</sup> Factors to consider when making this determination include “the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable.”<sup>58</sup>

In contrast, categories of restraints of trade which fall under the *per se* analysis are necessarily unlawful, and courts do not consider any of the offender’s defenses or conduct any inquiry as to procompetitive effects of

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53. *See id.*

54. In certain limited circumstances, courts will apply a “quick look” analysis, which is not at issue here. *See* Cal. Dental Ass’n v. Fed. Trade Comm’n, 525 U.S. 756, 779 (1999) (discussing the categories of analysis in antitrust cases).

55. *See, e.g.,* Texaco v. Dagher, 547 U.S. 1, 5 (2006); Arizona v. Maricopa County Med. Soc’y, 457 U.S. 332, 343 (1982).

56. *Id.*

57. Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

58. *Id.*

the restraint.<sup>59</sup> The justification for the harshness of the *per se* inquiry is that “certain kinds of agreements will so often prove so harmful to competition and so rarely prove justified that the antitrust laws do not require proof that an agreement of that kind is, in fact, anticompetitive in the particular circumstances.”<sup>60</sup> These restraints have a demonstrated a “pernicious effect on competition” and lack “any redeeming virtue.”<sup>61</sup> The Court recognizes that this judgment can be imperfect, but “[f]or the sake of business certainty and litigation efficiency [it] tolerate[s] the invalidation of some agreements that a full-blown [rule of reason] inquiry might have proved to be reasonable.”<sup>62</sup>

Because a *per se* categorization reflects a judicial judgment that a particular restraint is almost always harmful, courts disfavor declaring *per se* illegal a restraint with which it has limited experience.<sup>63</sup> The Court generally does not declare a particular restraint *per se* illegal until its experience with that “particular kind of restraint enables the Court to predict with confidence that the rule of reason will condemn it.”<sup>64</sup> The Court has reserved the *per se* analysis for a limited category of restraints such as horizontal conspiracies to fix prices,<sup>65</sup> concerted horizontal market division,<sup>66</sup> and until *Leegin*, vertical RPM.<sup>67</sup>

### C. Legal Developments of Vertical Resale Price Maintenance

#### 1. *Dr. Miles and Per Se Illegality of RPM*

In *Dr. Miles*, the Supreme Court held that vertical RPM is *per se* illegal under the Sherman Act.<sup>68</sup> The Court based its decision, in part, on the common law property rule against general restraints on alienation.<sup>69</sup> The Court found that while a manufacturer may choose whether or not to sell its product to a particular purchaser, the manufacturer is not free to impose a restraint on alienation (here, a minimum retail price) as a condition of sale because such restraints were ordinarily invalid under the common

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59. *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 723 (1988).

60. *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128, 133 (1998).

61. *N. Pac. Ry. v. United States*, 356 U.S. 1, 5 (1958).

62. *Maricopa*, 457 U.S. at 344.

63. *See id*; *see also* *Broad. Music, Inc. v. Columbia Broad. Sys.*, 441 U.S. 1, 9 (1979).

64. *Maricopa*, 457 U.S. at 344.

65. *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 223 (1940).

66. *Palmer v. BRG of Georgia*, 498 U.S. 46, 49-50 (1990).

67. *Dr. Miles*, 220 U.S. 373, 404, 408 (1911).

68. *Id.*

69. *Id.* at 404.

law.<sup>70</sup> The Court opined that a contract between a manufacturer and a retailer to fix a minimum retail price was “injurious to the public interest and void” because the benefit to the parties involved in the vertical RPM policy did not outweigh the injury to the public.<sup>71</sup> The Court concluded that because the retailer in *Dr. Miles* “sold its product at prices satisfactory to itself, the public [w]as entitled to whatever advantage may be derived from competition in the subsequent traffic.”<sup>72</sup> Therefore, the Court ruled that vertical RPM policies were *per se* illegal under the Sherman Act.<sup>73</sup>

## 2. *Circumventing the Dr. Miles Prohibition*

Since *Dr. Miles*, the Court has complicated the legal status of vertical RPM by authorizing practices allowing manufacturers to effectively set minimum prices without technically running afoul of *Dr. Miles*. For example, in *United States v. General Electric*, the Court held that it was *per se* legal for a manufacturer to engage in vertical RPM when it sold those products directly to the public through its own agents or under a consignment contract.<sup>74</sup> The Court declared that that the owner of an item did not violate antitrust laws or common law by “seeking to dispose of his article directly to the consumer and fixing the price by which his agents transfer the title from him directly to such consumer.”<sup>75</sup>

While *General Electric* created a method to circumvent the *Dr. Miles* rule, *United States v. Colgate* led to true confusion over the (il)legality of vertical RPM. Under *United States v. Colgate*, manufacturers could effectively institute a vertical RPM scheme by announcing a minimum resale price and then unilaterally refusing to sell its product to price cutters.<sup>76</sup> The Court found that absent a purpose to create or maintain a monopoly, a manufacturer has a “long recognized right” to “exercise his own independent discretion as to parties with whom he will deal” and that a manu-

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70. *Id.*

71. *Id.* at 408.

72. *Id.* at 409.

73. *See id.* at 408 (holding that vertical RPM agreements are against the public interest and void, and that they are not vindicated by any advantages to the parties involved).

74. 272 U.S. 476, 488 (1926).

75. *Id.* Manufacturers must ensure they have a true agency or consignment contract with their retailers to exercise this right. *See Simpson v. Union Oil Co.*, 377 U.S. 13, 24 (1964) *rev'd on other grounds*, 396 U.S. 13 (1969) (distinguishing *General Electric* to find a vertical price fix illegal because the manufacturer passed the risk of loss to the retailer, and thus it did not have a true consignment agreement).

76. 250 U.S. 300, 306-308 (1919).

facturer is free to “announce in advance the circumstances under which he [would] refuse to sell.”<sup>77</sup>

In sum, while a vertical RPM “policy” was *per se* illegal under *Dr. Miles*, a manufacturer could still dictate minimum retail prices either by altering its distribution scheme such that its products reached the market through consignment contracts, or by “announcing” a mandatory minimum price with no disciplinary mechanism other than the manufacturer’s right of unilateral refusal to deal. Needless to say, it was never entirely clear which behaviors fell under *Dr. Miles* and which did not.

### 3. *Practices Analytically Equivalent to Vertical RPM not Per Se Illegal*

Adding to the confusion surrounding the legal status of vertical RPM was the Court’s decision to not declare practices analogous to vertical RPM *per se* illegal.

The Court did not apply the *per se* standard to non-price vertical restraints, although the economic effects of such practices are analogous to those of vertical RPM.<sup>78</sup> For example, under *Continental TV v. GTE Sylvania*, the Court held that vertical non-price restraints, such as market division—a practice by which manufacturers authorize resellers to sell the manufacturer’s goods only within a particular territory—fall under the rule of reason.<sup>79</sup> The Court overruled its previous *per se* ban<sup>80</sup> on vertical market division, finding that vertical restriction promoted interbrand competition and that this “redeeming virtue” rendered a *per se* ban inappropriate.<sup>81</sup> The Court ruled that the decision to impose a *per se* standard “must be based upon demonstrable economic effect rather than . . . formalistic line drawing.”<sup>82</sup>

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77. *Id.* at 307. A manufacturer must be acting *unilaterally* to exercise this right. See *Monsanto Co. v. Spray-Rite Serv. Co.*, 465 U.S. 752, 764 (1984) (holding that where a retailer termination followed another retailer’s complaint, and retailer showed evidence beyond mere termination that the action was concerted, manufacturer incurred antitrust liability).

78. See ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 280 (1993) (arguing that vertical price fixing and vertical market division have the same economic impact and the same relation to consumer welfare, though the law does not treat vertical maximum price fixing and vertical market division with as much severity as it does vertical minimum price fixing).

79. *Cont’l T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 59 (1977).

80. *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 379-80 (1967).

81. *GTE Sylvania*, 433 U.S. at 54.

82. *Id.* at 58-59. In contrast, the *Dr. Miles* Court based its decision primarily on the common law policy disfavoring restraints on alienation, and not on any demonstrable market harm of vertical RPM. See *Dr. Miles*, 220 U.S. 373, 404, 408.

Under *State Oil Co. v. Khan*, the Court established that *maximum* vertical price fixing is subject to the rule of reason standard.<sup>83</sup> The Court reasoned that because “low prices . . . benefit consumers regardless of how those prices are set” the rule of reason analysis was the appropriate way to evaluate maximum price fixing.<sup>84</sup> Further, while the Court in *Dr. Miles* relied heavily on the common law doctrine disfavoring restraints on alienation to declare vertical RPM illegal *per se*, in subsequent cases the Court relied on economic theory and failed to mention the presumption against restraints on alienation when it ruled that equally restrictive practices should be evaluated under the rule of reason.<sup>85</sup> The *Leegin* majority used this fact to support its assertion that the common law rule against restraints on alienation does not control in the modern antitrust context.<sup>86</sup>

Therefore, even though vertical RPM was *per se* illegal, courts evaluated vertical non-price restraints and maximum price fixing, which have similar economic effects to vertical RPM under a rule of reason standard.<sup>87</sup> Part III will discuss how the Supreme Court addressed this inconsistency in *Leegin*.<sup>88</sup>

### III. *LEEGIN v. PSKS*

#### A. Facts and Procedural History

Petitioner Leegin manufactured leather goods and accessories for women under the brand name Brighton.<sup>89</sup> Leegin sold its goods primarily to independent boutiques and specialty stores, believing that they treated customers better and provided more services than large retailers.<sup>90</sup>

Respondent PSKS operated Kay’s Kloset, which began selling Brighton goods in 1995.<sup>91</sup> In 1997, Leegin instituted the “Brighton Retail Pricing and Promotion Policy” under which it refused to sell to retailers who

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83. 522 U.S. 3, 22 (1997).

84. *Id.* at 15, 22 (internal quotation marks omitted).

85. *See, e.g., State Oil Co. v. Khan*, 522 U.S. 3 (1997) (vertical maximum price fixing); *GTE Sylvania*, 433 U.S. at 58-59 (vertical non-price restraints).

86. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2714 (2007).

87. BORK, *supra* note 78 at 280.

88. For a more in-depth discussion of the antitrust case law regarding vertical RPM that was unnecessarily complicated before *Leegin*, *see* BORK, *supra* note 78, at 280-98.

89. *Leegin*, 127 S. Ct. at 2710.

90. *Id.* at 2710-11.

91. *PSKS, Inc. v. Leegin Creative Leather Prods.*, 171 Fed. Appx. 464, 465 (5th Cir. 2006).

sold certain Brighton goods below suggested prices.<sup>92</sup> Leegin contended that it adopted the policy to give retailers sufficient margins to provide customers with quality services without worrying about competing on price.<sup>93</sup>

In 2002, Leegin discovered that Kay's Kloset had been discounting Brighton's entire line by twenty percent.<sup>94</sup> When Kay's Kloset refused to cease its discounting practice, Leegin stopped supplying the store with Brighton products.<sup>95</sup>

PSKS sued Leegin in the U.S. District Court for the Eastern District of Texas, alleging that Leegin had violated antitrust laws by entering into agreements with retailers to charge prices fixed by Leegin.<sup>96</sup> The District Court excluded Leegin's economic expert's testimony as to the procompetitive effects of the Brighton Retail Pricing and Promotion Policy because vertical RPM was *per se* illegal under *Dr. Miles*.<sup>97</sup> Leegin then asserted that its action was unilateral and therefore lawful under *Colgate*.<sup>98</sup> However, the jury did not agree with that assertion, and it awarded \$1.2 million in damages.<sup>99</sup> The court trebled damages and awarded PSKS attorney's fees and costs.<sup>100</sup>

Leegin appealed the ruling to the Fifth Circuit.<sup>101</sup> On appeal, Leegin argued that the rule of reason should have been applied to its RPM practice.<sup>102</sup> The Fifth Circuit rejected this argument and affirmed the lower court ruling, awarding attorney's fees and costs of the appeal to PSKS.<sup>103</sup> Leegin then appealed to the Supreme Court, who granted certiorari in December of 2006.<sup>104</sup>

## B. The Majority Opinion

The Supreme Court voted 5-4 to overrule *Dr. Miles* and reverse the lower court's finding that Leegin's practice was illegal, and remanded the case to the district court to evaluate Leegin's conduct under the rule of

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92. *Id.*

93. *Leegin*, 127 S. Ct. at 2711.

94. *Id.* at 2711.

95. *Id.*

96. *Leegin*, 171 Fed. Appx. at 465-66.

97. *PSKS, Inc. v. Leegin Creative Leather Prods.*, 2004 U.S. Dist. LEXIS 30414 \*7 (E.D. Tex. March 26, 2004) (order limiting economic expert testimony).

98. *Id.* at \*13.

99. *Leegin*, 171 Fed. Appx. at 466.

100. *Id.*

101. *Id.*

102. *Id.* at 467.

103. *Id.* at 470.

104. *Leegin Creative Leather Prods., Inc. v. PSKS*, 127 S. Ct. 763 (2006).

reason standard.<sup>105</sup> The Court reasoned that the procompetitive effects of vertical RPM were too substantial to make the practice appropriate for *per se* analysis.<sup>106</sup> The Court first discussed why a rule of reason analysis was more appropriate for vertical RPM.<sup>107</sup> It then addressed the issue of *stare decisis*.<sup>108</sup>

The Court held that *Dr. Miles* was incorrectly decided, noting that given that the arguments of economic analyses, a *per se* inquiry was inappropriate for vertical RPM.<sup>109</sup> The Court opined that the *Dr. Miles* Court placed undue emphasis on the common law rule against restraints on alienation when it decided that vertical RPM was *per se* illegal.<sup>110</sup> In so doing, the Supreme Court explained, the *Dr. Miles* Court based its decision on “formalistic” doctrine instead of a demonstrable anticompetitive effect of vertical RPM.<sup>111</sup> The Court further noted that reliance on the common law was inappropriate because the traditional rule against restraints on alienation was aimed at preventing the removal of real property from the stream of commerce, and that the former state of the common law is irrelevant to modern antitrust law.<sup>112</sup>

The Court next weighed the possible procompetitive and anticompetitive effects of vertical RPM and concluded that a *per se* analysis was no longer appropriate.<sup>113</sup> Citing various *amici curiae* briefs, the Court ruled that it was “essentially undisputed” that vertical RPM can have a variety of procompetitive effects and that it is unlikely to have anticompetitive effects.<sup>114</sup> The procompetitive effects included: promoting interbrand competition,<sup>115</sup> enhancing efficiency,<sup>116</sup> facilitating market entry for new

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105. 127 S. Ct. at 2725.

106. *Id.* at 2718.

107. *Id.* at 2712-20.

108. *Id.* at 2720-25.

109. *Id.* at 2714.

110. *Id.*

111. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 U.S. 2705, 2714 (2007) (quoting *Cont'l T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 58-59 (1977)).

112. *Leegin*, 127 S. Ct. at 2714.

113. *Id.* at 2715-18.

114. *Id.* at 2715 (citing Brief of Amici Curiae Economists in Support of Petitioner, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.* 127 U.S. 2705 (2007)(No. 06-480), 2006 U.S. Briefs 480.).

115. *Id.* (citing Brief for the United States as Amici Curiae, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.* 127 U.S. 2705 (2007)(No. 06-937), available at <http://www.usdoj.gov/atr/cases/f225500/225544.htm>).

116. *Id.* (citing ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW AND ECONOMICS OF PRODUCT DISTRIBUTION 76 (2006)).

brands,<sup>117</sup> and the ability to effectively combat “free riders.”<sup>118</sup> The Court weighed these procompetitive effects against the possible anticompetitive effects,<sup>119</sup> reiterating the concerns it previously expressed in *Business Electronics v. Sharp*<sup>120</sup> that vertical RPM could facilitate manufacturer and/or retailer cartels by discouraging retailers from cutting prices, or assisting the cartel in disciplining price-cutting manufacturers.<sup>121</sup> Vertical RPM could also facilitate retail cartels because powerful retailers could fix prices and then compel a manufacturer to aid them through resale price maintenance.<sup>122</sup> The Court noted that empirical studies confirmed that this scenario is a legitimate concern.<sup>123</sup>

After acknowledging the anticompetitive concerns, the Court held that courts could effectively deal with these concerns under a rule of reason approach.<sup>124</sup> The Court then gave a cursory overview of some possible indications of anticompetitive behavior.<sup>125</sup> For example, it opined that courts should scrutinize vertical RPM more carefully if many competing firms adopt the practice, or if there is evidence that retailers were the impetus for the restraint.<sup>126</sup>

The majority then gave brief consideration to the dissent’s *stare decisis* objection. The majority contended that *stare decisis* was not an insurmountable obstacle because the Court treats the Sherman Act as a common law statute, and thus the presumption that legislative changes should be left to Congress carries less weight.<sup>127</sup>

### C. The Dissent

Justice Breyer, writing for the dissent, argued that the *Leegin* Court had insufficient grounds to overturn ninety-six years of precedent.<sup>128</sup>

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117. *Leegin*, 127 S. Ct. at 2716 (citing *Cont’l T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 55 (1977); *Marvel & McCafferty*, *supra* note 16, at 349).

118. *Id.* (citing *GTE Sylvania*, 433 U.S. at 55).

119. *Id.* at 2716-18.

120. 487 U.S. 717.

121. *Leegin*, 127 S. Ct. at 2716-18.

122. *Id.* at 2717.

123. *Id.* (citing *Marvel & McCafferty*, *supra* note 51, at 373).

124. *Id.* at 1218.

125. *See id.* at 2719.

126. *Id.* at 2719.

127. *Leegin*, 127 S. Ct. at 2720 (citing *State Oil Co. v. Khan* 522 U.S. 3, 20 (1997); *Nat’l Soc’y of Prof. Eng’rs v. United States*, 435 U.S. 679, 688 (1978); *Nw. Airlines v. Transp. Workers Union*, 451 U.S. 77, 98 n.42 (1981)).

128. *See id.* at 2731 (Breyer, J., dissenting) (“I am not aware of any case in which this Court has overturned so well-established a statutory precedent. Regardless, I do not see

While he implied that if *stare decisis* were not an issue he might have voted with the majority,<sup>129</sup> Justice Breyer nonetheless concluded that reversing *Dr. Miles* was inappropriate because clients and lower courts have relied on advice based on *Dr. Miles* for ninety-six years, and the circumstances had not changed since *Dr. Miles*.<sup>130</sup> Additionally, Justice Breyer argued that Congress considered the same economic literature upon which the majority relied and deemed it insufficient to overturn the *per se* ban against vertical RPM.<sup>131</sup> Justice Breyer concluded that it is the purview of the legislature to change the Sherman Act, and, since it has deliberately chosen not to do so, the Court should not have changed it.<sup>132</sup>

#### IV. DISCUSSION

This Part will argue that the majority decision was correct but problematic in two principal respects. Section IV.A argues that the majority decision was correct; Section IV.B argues that the majority, however, insufficiently addressed the *stare decisis* concerns; and Section IV.C suggests a more detailed starting point from which to address vertical RPM cases under the rule of reason. Section IV.D argues that the *Leegin* majority's language confining the scope of the common law rule disfavoring restraints on alienation was overbroad and unnecessary, and may indicate a willingness to weaken the first sale doctrine in the patent context this term. Section IV.D then examines the unwanted effects that would arise where antitrust and patent law intersect if the Supreme Court were to adopt the Federal Circuit's weaker first sale doctrine.

##### A. The Majority Decision was Correct

The majority correctly held that vertical RPM is inappropriate for *per se* treatment<sup>133</sup> because vertical RPM is not "manifestly anticompetitive"<sup>134</sup> and does not "lack of any redeeming virtue."<sup>135</sup> Vertical RPM

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how the Court can claim that ordinary criteria for over-ruling an earlier case have been met.").

129. *Id.* at 2726 ("Were the Court writing on a blank slate, I would find these questions difficult. But, of course, the Court is not writing on a blank slate, and that fact makes a considerable legal difference.").

130. *Id.* at 2731.

131. *Id.* at 2726 (referring to Hearings on H.R. 10527 et al. before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 85th Cong., 2d Sess., 74-76, 89, 99, 101-102, 192-195, 261-262 (1958)).

132. *Id.* (stating that Congress's repeal of the McGuire and Miller-Tidings Acts constitutes a conscious extension of the *Dr. Miles per se* rule).

133. *See Leegin*, 127 S. Ct. at 2720.

134. *Cont'l T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 50 (1977).

serves a variety of procompetitive ends recognized by economists. As discussed above, RPM policies can induce retailers to provide point of sale information about complicated products, to take risks on products whose commercial viability is uncertain, and to combat the free-rider problem.<sup>136</sup>

Furthermore, widespread anticompetitive uses of vertical RPM are unlikely. In particular, market forces will, in most circumstances, prevent manufacturers or retailers from effectively using vertical RPM to strengthen a cartel.<sup>137</sup> The retailer cartel is particularly fragile. First, manufacturers have no economic incentive to reinforce a retailer cartel—the manufacturer will sell less and the retailers would absorb the monopoly profits.<sup>138</sup> Second, a retailer cartel is only viable when there are “(1) few [retailers]; (2) few manufacturers; (3) homogeneous products; and (4) easy policing.”<sup>139</sup> The cartel cannot survive if not all retailers and manufacturers in the relevant market cooperate; otherwise “outsiders” to the cartel will undercut the cartel price, stealing their customers and destroying their profitability.<sup>140</sup> Furthermore, even assuming an effective disciplinary mechanism and full industry participation, a retailer cartel will still crumble if market substitutes or differentiated goods are readily available.<sup>141</sup> Given the rarity of market conditions suitable for cartels, and the presence of procompetitive benefits, the dealer cartel concern does not justify a *per se* standard for vertical RPM. Furthermore, the rule of reason is well suited to addressing the problem of a powerful retailer who imposes vertical RPM upon manufacturers because these manufacturers would likely complain to enforcement agencies.<sup>142</sup> Under the rule of reason standard, as set forth by the *Leegin* majority, a retailer impetus for a restraint would weigh substantially toward a finding of anticompetitive behavior.<sup>143</sup>

Similarly, courts can adequately deal with the possibility of manufacturer cartels using vertical RPM under the rule of reason. First, policing a cartel remains difficult even with vertical RPM policies in place. While price cuts are easy to detect and easily punished under a vertical RPM policy, cartel members can still undercut the cartel by offering buyers subtle

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135. *N. Pac. Ry. Co. v. United States*, 356 U.S. 1, 5 (1958).

136. *See supra* Section II.A.2.

137. Frank H. Easterbrook, *Antitrust Law Enforcement in the Vertical Restraints Area: Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L. J. 135, 141-42 (1984).

138. *Id.* at 142.

139. *Id.*

140. *Id.*

141. *Id.*

142. *See BORK, supra* note 78, at 292-93.

143. *See Leegin*, 127 S. Ct. at 2719.

sales promotions such as more favorable credit policies, or putting slightly more product volume in a unit sold, which are far more difficult to detect than a simple price cut.<sup>144</sup> A manufacturer cartel could avoid this problem by implementing exclusive dealing arrangements in conjunction with vertical RPM.<sup>145</sup> However, because both vertical RPM and exclusive dealing arrangements are explicit, it will be easy for enforcement agencies and courts to identify this particular anticompetitive combination and proscribe it under the rule of reason.<sup>146</sup>

While the majority's holding was correct, its reasoning was overbroad. The majority's dismissal of the importance of the *stare decisis* concern creates unnecessary uncertainty. Further, the majority's narrowing of the common law rule against restraints on alienation was unnecessary to reach its conclusion and could have unintended (or, perhaps, shrewdly calculated) ramifications outside the bounds of antitrust law. Section IV.B below discusses the possible ramifications of ignoring *stare decisis* concerns. Section IV.C then synthesizes economic research to recommend more substantial guidance to lower courts. Finally, Section IV.D explores the possible effects of the majority's narrowing of the common law rule against restraints on alienation where patent and antitrust law intersects.

## **B. The Problem of Ignoring *Stare Decisis***

The *Leegin* majority inaccurately characterized its decision as if *stare decisis* had never been a serious factor in antitrust analysis because the Sherman Act is effectively common law.<sup>147</sup> For example, in *Flood v. Kuhn*<sup>148</sup> although the Court found that a previous decision to exempt baseball (but not other professional sports)<sup>149</sup> from the federal antitrust laws was "illogical" and an "aberration,"<sup>150</sup> the Court nevertheless held that the case still controlled because of *stare decisis*, and that any remedy for the consequent inconsistency was the responsibility of Congress.<sup>151</sup> Furthermore, in *Illinois Brick v. Illinois*<sup>152</sup> the Court reasoned that even if it was convinced that its prior decision in *Hanover Shoe, Inc. v. United Shoe Ma-*

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144. See BORK, *supra* note 78 at 294.

145. Robert L. Steiner, *Exclusive Dealing + Resale Price Maintenance: A Powerful Anticompetitive Combination*, 33 SW. U. L. REV. 447, 456 (2004).

146. See *id.* at 447 (explaining that both exclusive dealing arrangements and RPM involve an explicit agreement between manufacturer and reseller).

147. See *Leegin*, 127 S. Ct. at 2720 ("From the beginning the Court has treated the Sherman Act as a common-law statute").

148. 407 U.S. 258 (1972).

149. *Federal Baseball Club v. National League*, 259 U.S. 200 (1922).

150. *Flood*, 407 U.S. at 281.

151. *Id.* at 285.

152. 431 U.S. 720 (1977).

*chinery Corp.*<sup>153</sup> was inconsistent with antitrust policy, it would have upheld the decision because “the considerations of *stare decisis* weigh heavily in the area of statutory construction, where Congress is free to change this Court’s interpretation of its legislation.”<sup>154</sup> Therefore, while the *Leegin* majority might be correct to say that *stare decisis* is less significant in Sherman Act cases,<sup>155</sup> it is misleading to assert that “from the beginning the Court has treated the Sherman Act as a common law statute”<sup>156</sup> in order to excuse its dismissal of legitimate *stare decisis* concerns.

The majority should have further addressed the reliance interest of lower courts, firms, and enforcement agencies on *Dr. Miles*. The Court dismissed this interest, noting that only, “the reliance interest here . . . cannot justify an inefficient rule.”<sup>157</sup> This sentence was insufficient to deal with a “century’s worth of similar cases, massive amounts of advice that lawyers have provided their clients, and untold numbers of business decisions those clients have taken in reliance upon [*Dr. Miles*].”<sup>158</sup>

Justice Breyer predicted that the majority’s decision will “create considerable legal turbulence as lower courts seek to develop workable principles.”<sup>159</sup> Ironically, although the majority’s decision purports to benefit the market by removing an unnecessary judicial and regulatory restraint, the “legal turbulence” it may create is actually harmful to a capitalist market.<sup>160</sup> One obvious consequence is increased cost for legal advice because the pool of legal professionals with the requisite expertise for advising clients as to whether a particular vertical RPM scheme will pass the rule of reason test will shrink, as compared to what it was before *Leegin*.<sup>161</sup> Similarly, uncertainty as to the state of the law increases both transaction and dispute resolution costs.<sup>162</sup>

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153. 392 U.S. 481 (1968).

154. 431 U.S. at 736.

155. *See State Oil Co. v. Khan*, 522 U.S. 3, 20 (1997) (“In the area of antitrust law, there is a competing interest, well-represented in this Court’s decisions, in recognizing and adapting to changed circumstances and the lessons of accumulated experience. Thus, the general presumption that legislative changes should be left to Congress has less force with respect to the Sherman Act.”).

156. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2720 (2007).

157. *Id.* at 2724.

158. *Id.* at 2731 (Breyer, J., dissenting).

159. *Id.* at 2737.

160. *See* Michael P. Van Alstine, *The Costs of Legal Change*, 49 UCLA L. REV. 789, 813 (2002) (“Some degree of legal certainty in fact is essential to the very functioning of a capitalist system.”).

161. *See id.* at 829.

162. *Id.* at 830-31.

For actors in the private sector, many businesses may choose to forego using vertical RPM, even if it benefits them, because of the uncertainty as to what will pass the rule of reason in each of the jurisdictions in which the business operates.<sup>163</sup> The majority could have largely foreclosed this scenario simply by giving lower courts more specific guidance for future cases in light of *Leegin*. While the rule of reason, by definition, leaves lower courts broad discretion to decide the legality of a particular restraint,<sup>164</sup> by giving a more detailed account of the factors which bear on the procompetitive or anticompetitive nature of vertical RPM, the *Leegin* Court could have left the lower courts with a more uniform starting point from which to develop their own standards. This could have substantially reduced Justice Breyer's "legal turbulence" concern.<sup>165</sup>

### C. Factors for the Rule of Reason for Future Vertical RPM Cases

The majority briefly instructed lower courts that (1) the number of manufacturers engaging in the vertical RPM within a given industry (whether or not retailers were the impetus for vertical RPM) and (2) whether or not manufacturers engaging in vertical RPM have market power are relevant considerations for determining whether a particular vertical RPM policy is anticompetitive.<sup>166</sup> This Part proposes a more detailed starting point for lower courts to follow when evaluating vertical RPM cases under the rule of reason. A more detailed set of standards will lead to a more uniform application of the rule of reason, which is particularly important in the modern marketplace, where few businesses operate in only one jurisdiction. The less variance of RPM standards a business is subject to, the better.

#### 1. Market Power

The *Leegin* majority suggested a firm's market power as one of many factors under the rule of reason.<sup>167</sup> "Market power is the ability to raise price significantly without losing so many sales that the increase is unprofitable."<sup>168</sup> A finding that a firm does not have market power should create

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163. *See id.* at 835 (explaining that uncertainty as to a practice's legality works to deter economic actors from adopting it, even when it benefits them).

164. *See* *Chicago Bd. of Trade v. United States*, 246 U.S. 231, 238 (1918) (articulating the rule of reason standard).

165. *See* *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2737 (2007) (Breyer, J., dissenting).

166. *Leegin*, 127 S. Ct. at 2719 (2007).

167. *Leegin*, 127 S. Ct. at 2712.

168. *Id.*

a strong presumption in favor of legality.<sup>169</sup> When a firm lacks market power, it cannot sustain anticompetitive practices, such as cartels, because rivals will lure away the firm's customers with better deals.<sup>170</sup> Therefore, competitive rivals regulate a bad actor that does not have market power more efficiently than the courts.<sup>171</sup> Conversely, the presence of market power should weigh heavily toward a finding of anticompetitive behavior, since the natural market safeguards against anticompetitive behavior described above will not sufficiently affect a firm with market power to deter anticompetitive behavior. Because the absence or presence of market power so strongly affects a firm's ability to sustain anticompetitive effects, courts should begin a rule of reason evaluation of a vertical RPM policy with a market-power evaluation.

Courts have substantial experience determining whether a firm has market power in other antitrust areas such as monopolization,<sup>172</sup> tying,<sup>173</sup> and merger enforcement.<sup>174</sup> Thus, courts should apply the same expertise when evaluating an RPM arrangement.

## 2. *Presence of Restricted Dealing Arrangements*

A finding that a firm does not have market power should not end the inquiry. When a firm combines vertical RPM with an exclusive dealing arrangement, it can exercise anticompetitive effects despite its lack of market power<sup>175</sup> because exclusive dealing arrangements can prevent manufacturers from cheating on cartels.<sup>176</sup> When a vertical RPM policy is in place, exclusive dealing arrangements—which dictate the cartel members who may sell to certain retailers—eliminate a cartel member's ability to increase its market share within the cartel by enticing retailers with

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169. See Easterbrook, *supra* note 138, at 159 (“Vertical arrangements should be deemed lawful, without further inquiry if . . . the firm employing the arrangement lacks market power.”).

170. *Id.*

171. *Id.*

172. See, e.g., *Nat'l Collegiate Athletic Ass'n v. Bd. of Regents*, 468 U.S. 85, 111 (1984) (“As a factual matter, it is evident that petitioner does possess market power.”).

173. See, e.g., *Ill. Tool Works, Inc. v. Indep. Ink, Inc.*, 547 U.S. 28, 46 (2006) (“[I]n all cases involving a tying arrangement, a plaintiff must prove that the defendant has market power in the tying product.”).

174. *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 713 (D.C. Cir. 2001) (“Merger enforcement, like other areas of antitrust, is directed at market power.”) (internal quotations omitted).

175. See generally Steiner, *supra* note 145, at 456 (discussing the anticompetitive effects of combined RPM and exclusive dealings arrangements).

176. For a more detailed explanation on the mechanics of cartels, see *supra* Section II.A.3.b.

more favorable terms of sale.<sup>177</sup> However, it is important to note that for this arrangement to work nearly all of the manufacturers in a particular industry must use exclusive dealing, otherwise retailers would buy from “holdout” manufacturers offering lower prices and better terms of sale.<sup>178</sup> Therefore, courts should inquire as to whether a substantial proportion of retailers in a relevant market are bound by exclusive dealings arrangements. If a manufacturer institutes a vertical RPM policy in conjunction with an exclusive dealing arrangement, this should weigh against a finding of legality. If most of the manufacturers in the relevant market combine vertical RPM and exclusive dealing arrangements, this should create a strong presumption toward illegality.

### 3. *Uniformity of Practices in the Market*

Courts should look for the prevalence of uniform practices in the relevant product market because highly uniform practices within a given market can indicate the presence of a cartel.<sup>179</sup> The viability of a cartel requires that all members agree on a uniform price schedule and have the same mark-up for retailers.<sup>180</sup> Furthermore, when market demand changes, all cartel members must adjust their prices simultaneously.<sup>181</sup> In the event of a manufacturer cartel, one would expect to find coordinated price changes over time.<sup>182</sup> Therefore, uniformity of practices, such as distribution arrangements or coordinated price changes, should weigh against a finding of legality.

Conversely, if those uniform practices endured for a considerable length of time, this should weigh neither for nor against legality. Empirical research has shown that only rarely do cartels last more than five years.<sup>183</sup> Therefore, long-lasting uniformity of practices throughout an industry more likely indicates that those practices are the most efficient of the known possibilities, not that the market is cartelized.<sup>184</sup>

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177. Telser, *supra* note 13, at 97.

178. Easterbrook, *supra* note 138, at 142.

179. *See* Toys “R” Us, Inc. v. Fed. Trade Comm’n, 221 F.3d 928 (7th Cir. 2000) (upholding FTC’s inference of a horizontal agreement from multiple vertical arrangements).

180. Telser, *supra* note 13, at 98.

181. *Id.* at 99.

182. OVERSTREET, *supra* note 25, at 23.

183. Easterbrook, *supra* note 138, at 165 (proposing five years as an arbitrary cutoff period).

184. *See id.*

#### 4. *Other Factors to Consider*

After examining market power, the presence of restricted dealing arrangements, and the uniformity of certain practices, examining a few more minor factors could prove helpful to the rule of reason analysis. First, the *Leegin* majority suggests that courts should examine a vertical RPM arrangement more closely when a policy appears to have been initiated by retailers because horizontal retailer cartels are more likely in this situation.<sup>185</sup> Courts should easily be able to determine when this is the case, because manufacturers hurt by this practice will likely complain to enforcement agencies.<sup>186</sup> Second, courts should look to the restraint's effect on output. If the vertical RPM arrangement is anticompetitive, then, by definition, output must fall.<sup>187</sup> Therefore, if after holding demand and other variables constant, output remains stable or increases, this finding should weigh strongly in favor of legality under the rule of reason.<sup>188</sup>

#### 5. *Summary of Procedure*

When evaluating a vertical RPM arrangement, courts should first conduct a market analysis. Market power, or the combination of vertical RPM with an exclusive dealing arrangement, should create a rebuttable presumption of anticompetitive behavior. This presumption could be rebutted by a showing that output has not decreased since the implementation of the restraint, or by a satisfactory showing of pro-competitive effects in general. Following this inquiry, courts should proceed with the standard rule of reason analysis, inquiring whether retailers initiated the restraint and whether there are other indicators of cartel behavior, such as uniform practices in the industry.

### D. **Possible Implications for Patent Law**

The Court's limitation on the applicability of the common law against restraints on alienation in *Leegin*, coupled with the decision to grant cert in *Quanta Computer, Inc. v. LG Electronics*,<sup>189</sup> may indicate the Court's willingness to accept the Federal Circuit's first sale doctrine next term. The Court's evisceration of the common law doctrine against restraints on alienation was not necessary to justify its opinion. As discussed above, economic research has made clear that vertical RPM can have a myriad of

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185. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2719 (2007).

186. BORK, *supra* note 78, at 292.

187. Easterbrook, *supra* note 138, at 163.

188. *Id.* at 163-64 (noting that data availability is a necessary prerequisite for statistical tools to be useful).

189. *Quanta Computer, Inc. v. LG Elecs., Inc.*, 128 S.Ct. 28 (2007) (granting cert.).

procompetitive effects,<sup>190</sup> which makes *per se* treatment inappropriate.<sup>191</sup> The Court could, and should, have rested its decision on this argument. If the dicta about restraints on alienation has any purpose, it can only be to influence future, perhaps tangentially, related cases.

Section IV.D.1 will reexamine the *Leegin* Court's treatment of the common law rule against restraints on alienation. Section IV.D.2 will discuss the first sale doctrine in patent law and its relationship to the common law rule against restraints on alienation. Section IV.D.3 will compare the Supreme Court's first sale precedent with that of the Federal Circuit and introduce *Quanta, Inc. v. LG Electronics*. Finally, Section IV.D.4 will discuss how *Leegin* would interact if the Court adopts the Federal Circuit first sale doctrine.

1. *Leegin's Limiting of Common Law Doctrine Against Restraints on Alienation*

The *Leegin* majority criticized the *Dr. Miles* Court's reliance on the common law rule against restraint on alienation as an improper reliance on "formalistic legal doctrine rather than demonstrable economic effect."<sup>192</sup> The *Leegin* majority reasoned that the policy reasons for invalidating restraints on alienation (preventing the removal of land, though not necessarily chattels, from the stream of commerce) were "extraneous" to the antitrust concerns which control when evaluating RPM.<sup>193</sup> The Court then pronounced that "the state of the common law 400 or even 100 years ago is irrelevant to the issue before us: the effect of antitrust laws upon vertical distribution restraints in the American economy today."<sup>194</sup> More generally, the majority admonished that "the Court should be cautious about putting dispositive weight on doctrines from antiquity [such as the common law doctrine against restraint on alienation] but of slight relevance."<sup>195</sup>

2. *The First Sale Doctrine: An IP Equivalent of the Common Law Rule Against Restraints on Alienation*

The first sale doctrine is, in many ways, an analog to the common law rules against restraints on alienation in patent law. Under the first sale doctrine, an authorized sale of a patented product exhausts the intellectual

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190. *See supra* Section II.A.2.

191. *See supra* Section IV.A.

192. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2714 (2007) (internal quotations omitted) (quoting *Cont'l T.V., Inc. v. GTE Sylvania, Inc.* 433 U.S. 36, 58-59 (1977)).

193. *Id.*

194. *Id.* (internal quotations omitted) (quoting *GTE Sylvania*, 433 U.S. at 53, n.21).

195. *Id.*

property protection for that product.<sup>196</sup> Once the product passes into the purchaser's possession, it is wholly outside the authority of the patent laws, precluding the patentee from suing the user for infringement.<sup>197</sup> Therefore, disputes over post-sale restrictions on use must arise under contract, not patent laws.<sup>198</sup> The idea behind the first sale doctrine is that the patent owner is entitled to only one return on its government-conferred monopoly, and once the patent owner enjoys this first return, all subsequent returns have been exhausted.<sup>199</sup>

The first sale doctrine is closely related to the common law rule against restraints on alienation.<sup>200</sup> The idea that once the patentee sells the product, its control over the product ends, mirrors the rationale behind the traditional common law rule against restraints on alienation—that once a unit is sold, it wholly belongs to the buyer.<sup>201</sup> Because the *Leegin* Court implied that the common law rule against restraints on alienation is only relevant in the context of real property<sup>202</sup> the viability of the current conception of the first sale doctrine (which is applicable to intellectual property) is uncertain.<sup>203</sup>

### 3. *Legal Treatment of the First Sale Doctrine*

The Federal Circuit's first sale doctrine significantly deviates from the Supreme Court's last articulation of the first sale doctrine<sup>204</sup> in *United*

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196. 5-16 CHISUM ON PATENTS § 16.03(2)(a).

197. *Bloomer v. McQuewan*, 55 U.S. 539, 549-50 (1853). For a list of cases following *Bloomer*, see Brief for the United States as Amici Curiae: *Quanta Computer, Inc. v. LG Elecs., Inc.*, No. 06-937 (2007).

198. *Keeler v. Standard Folding Bed Co.*, 157 U.S. 659, 666 (1895).

199. Glen O. Robinson, *Personal Property Servitudes*, 71 U. CHI. L. REV. 1449, 1507 (2004).

200. Michael A. Carrier, *Cabining Intellectual Property Through a Property Paradigm*, 54 DUKE L. J. 1, 115 (2004).

201. See Julie E. Cohen & Mark Lemley, *Patent Scope and Innovation in the Software Industry*, 89 CALIF. L. REV. 1, 31 (2001).

202. See *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2714 (2007) (“Usually associated with land, not chattels, the rule [against restraints on alienation] arose from restrictions removing real property from the stream of commerce for generations. The Court should be cautious about putting dispositive weight on doctrines from antiquity but of slight relevance.”).

203. See Brief for the United States as Amici Curiae: *Quanta Computer, Inc. v. LG Elecs. Inc.*, No. 06-937 n.3 (2007) (arguing that the first sale doctrine survives the demise of the per se ban on retail price maintenance).

204. *Id.*; see also Brief of Consumers Union, Electronic Frontier Foundation, and Public Knowledge in Support of the Petitioner: *Quanta Computer, Inc. v. LG Elecs., Inc.*, No. 06-937 (2007).

*States v. Univis Lens Co.*<sup>205</sup> In *Univis*, the Court held that a lens-blank manufacturer could not exercise control over resale prices of its products through its patent monopoly or under the Sherman Act.<sup>206</sup> The Court found that the manufacturer could not use its patent to exercise control over resale prices because it had sold the lens blanks to the reseller, who used the blanks consistently with the patent, and thus the manufacturer's patent rights were exhausted.<sup>207</sup> The Court broadly noted that "the purpose of the patent law is fulfilled with respect to any particular article when the patentee has received his reward for the use of his invention by the sale of the article, and that once that purpose is realized the patent law affords no basis for restraining the use and enjoyment of the thing sold."<sup>208</sup>

Counter to the Supreme Court, the Federal Circuit held in *Mallinckrodt, Inc. v. Medipart, Inc.*<sup>209</sup> that the owner of a patent on a medical device could sue a customer under the patent law for violating the patentee's request that the product be for single use only.<sup>210</sup> Plaintiff Mallinckrodt sold its patented medical device to hospitals with an accompanying "single use only" notice.<sup>211</sup> Notwithstanding this notice, hospitals sent the devices to defendant Medipart to be refurbished.<sup>212</sup> Relying on *Univis*, the district court ruled that Mallinckrodt could not remedy violation of the single use only provision through a patent infringement suit.<sup>213</sup> The Federal Circuit reversed, holding that the single-use restriction did not violate antitrust law or the patent misuse doctrine, and that a patent holder may remedy violation a post-sale use restriction of a patented article with a patent infringement suit.<sup>214</sup> For the Federal Circuit, the validity of the restriction under patent law depended not upon whether the patented article had been sold, but upon whether the conditions imposed on the buyer violated some other law (e.g., antitrust regulations), and whether the restriction was properly within the scope of the patent.<sup>215</sup>

Against this legal backdrop, in *LG v. Quanta*, LG Electronics sued several electronics companies for patent infringement, alleging that the companies purchased microprocessors from Intel, LG's licensee, and in-

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205. 316 U.S. 241 (1942).

206. *Id.* at 250.

207. *Id.* at 249-50.

208. *Id.* at 251.

209. 976 F.2d 700 (Fed. Cir. 1992).

210. *Id.*

211. *Id.* at 701.

212. *Id.*

213. *Id.*

214. *Id.*

215. *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 708 (Fed. Cir. 1992).

corporated them into their own chip sets.<sup>216</sup> LG argued that Intel's sales of unpatented component parts to defendants did not exhaust LG's patent.<sup>217</sup> However, the District Court, relying on *Univis Lens*, held that licensee Intel's sale of unpatented microprocessors and chipsets did exhaust LG's patent because the components were "destined . . . to be finished by the purchaser in conformity with the patent."<sup>218</sup> LG appealed to the Federal Circuit, which upheld *Mallinckrodt* and reversed the District Court.<sup>219</sup> The Federal Circuit reasoned that LG's patents were not exhausted because the LG-Intel license expressly disallowed computer system manufacturers from combining licensed components with non-Intel components, and Intel notified licensees of this provision, making the sale *conditional* and non-exhaustive.<sup>220</sup>

On September 25, 2007, the Supreme Court granted certiorari to hear *Quanta Computer v. LG Electronics* on appeal from the Federal Circuit.<sup>221</sup> The Court requested additional briefing from the Solicitor General as to the Executive Branch's position.<sup>222</sup> The Solicitor General argued that the Federal Circuit's patent exhaustion precedent had significantly diverged from that of the Supreme Court.<sup>223</sup> The Solicitor General argued that the Federal Circuit's version of the first sale doctrine creates economic inefficiencies by allowing multiple rounds of infringement suits against various actors at multiple levels downstream in commerce.<sup>224</sup> Additionally, the Solicitor General warned that the Federal Circuit's rule would insulate patentees' resale and use restrictions from antitrust scrutiny because restrictions such as vertical RPM would be enforceable as a matter of patent law and subject to the Federal Circuit's exclusive jurisdiction.<sup>225</sup> Accordingly, the Solicitor General argued that the *Univis* Court's ruling that RPM policies for patented goods were not authorized under the Patent Act survives *Leegin*.<sup>226</sup>

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216. *LG Elecs., Inc. v. Asustek Computer, Inc.*, 248 F. Supp. 2d 912, 914 (N.D. Cal. 2003).

217. *Id.*

218. *Id.* at 915.

219. *LG Elecs. v. Biztek Elecs*, 453 F.3d 1364, 1369 (Fed. Cir. 2006).

220. *Id.* at 1370.

221. *Quanta Computer, Inc. v. LG Elecs.*, 453 F.3d 1364 (Fed. Cir. 2006), *cert. granted*, 128 S. Ct. 27 (U.S. Sept. 25, 2007) (No. 06-937).

222. *Quanta*, 127 S. Ct. 2087 (2007).

223. Brief for the United States as Amici Curiae: *Quanta Computer, Inc. v. LG Elecs., Inc.*, No. 06-937 (2007), available at <http://www.usdoj.gov/atr/cases/f225500/225544.htm>.

224. *Id.*

225. *Id.*

226. *Id.*

4. *A Mallinckrodt First Sale Framework Would Subject Price Cutters to Punitive Damages for Violation of the RPM Arrangement*

Before *Mallinckrodt*, a patent holder's resale and use restrictions, if enforceable, were a matter of contract law.<sup>227</sup> Under the *Mallinckrodt* framework, if the patent license is a valid contract under state law and gives appropriate notice of limited rights to downstream purchasers, then the patent holder can enforce its use restrictions as a matter of patent infringement.<sup>228</sup>

Calling a breach of contract over violation of an RPM policy or reuse provision patent infringement renders all appeals subject to the exclusive jurisdiction of the Federal Circuit, erasing the influence of traditional contracts precedent in the dispute's circuit of origin.<sup>229</sup> In the context of an RPM agreement, economic harm is the purview of antitrust law, not patent law, and should be dealt with under an antitrust legal framework rather than a patent law framework. The *Mallinckrodt* framework also intensifies the prices cutter's consequences for breach of contract, as patentees under *Mallinckrodt* could benefit from patent law's liberal damage rules, such as enhanced damages for willful infringement, which would not be available to punish violators of an RPM agreement in traditional contract actions.<sup>230</sup> Given that the impetus of the rule of reason inquiry is the uncertainty of a particular agreement's practical effect on the market, the Court should not tolerate a potentially overlapping legal scheme which creates an additional hurdle for bringing a meritorious antitrust claim.

Fundamentally, a licensee's violation of a vertical RPM provision is a breach of contract, not an infringement upon the licensor's *patent* right. A reseller's refusal to comply with a vertical RPM restriction does not entail a wrongful appropriation of the technology embodied in the patent. While "patent owners should not be in a worse position, by virtue of the patent right to exclude, than owners of other property used in trade,"<sup>231</sup> patent owners should not be in a better position than owners of other property to

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227. James B. Kobak, Jr., *Contracting Around Exhaustion: Some Thoughts About the CAFC's Mallinckrodt Decision*, 75 J. PAT. & TRADEMARK OFF. SOC'Y 550, 559 (1993).

228. *Id.* Litigating a licensee's deviation from an RPM arrangement under the Patent Act instead of under Contract law would have significant adverse consequences. *Compare* 35 U.S.C. § 284 (2000) (allowing up to treble damages for willful infringement) with 11-59 CORBIN ON CONTRACTS § 59.2 (explaining that punitive damages are not available in contract law).

229. Kobak, *supra* note 227 at 560.

230. *Id.* at 559.

231. *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 708 (Fed. Cir. 1992).

enforce potentially anticompetitive vertical RPM arrangements by virtue of a weak patent exhaustion doctrine.<sup>232</sup> Therefore, the Court should not permit a patent holder to call a simple breach of contract an act of patent infringement and then demand punitive damages—unavailable to manufacturers not holding patents<sup>233</sup>—from the user or retailer who legitimately questioned the RPM scheme's legality under the rule of reason. Violation of a vertical RPM agreement should not become subject to punitive damages remedies simply because a patented product is involved. In the particular case of vertical RPM agreements for patented goods, *Leegin*, not *Mallinckrodt* should govern. Therefore, the Solicitor General correctly articulated that the *Univis* ruling survives, and should survive, *Leegin*.<sup>234</sup>

## V. CONCLUSION

The Court correctly decided that vertical RPM should be subject to the rule of reason instead of a *per se* analysis under the Sherman Act. The fact that vertical RPM can have a myriad of procompetitive effects coupled with the fact that vertical RPMs anticompetitive effects are only possible in a very narrow set of economic circumstances renders the practice inappropriate for *per se* treatment.

However, in failing to adequately address the *stare decisis* concerns associated with overruling *Dr. Miles*, the Court created an uncertain environment, which in the short run may introduce more inefficiency into the market than the former *per se* rule did. Furthermore, the Court's treatment of the common law rule against restraints on alienation could facilitate a fundamental change to the first sale doctrine in patent law in such a way as to give unprecedented remedies for what would otherwise be mere breaches of contract. While the Court moved the analysis in the correct direction, the confusion over vertical RPM arrangements is far from over.

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232. Brief of Amicus Curiae Electronic Frontier Foundation at 11-12, *Ariz. Cartridge Re-mfrs. Ass'n, Inc. v. Lexmark Int'l, Inc.*, 421 F.3d 981 (9th Cir. 2005) (No. 03-16987), available at [http://w2.eff.org/legal/cases/ACRA\\_v\\_Lexmark/20040211\\_amicus.php](http://w2.eff.org/legal/cases/ACRA_v_Lexmark/20040211_amicus.php).

233. See 11-59 CORBIN ON CONTRACTS § 59.2 (explaining that punitive damages are not available in contract law).

234. Brief for the United States as Amici Curiae: *Quanta Computer, Inc. v. LG Elecs., Inc.*, No. 06-937 (2007), available at <http://www.usdoj.gov/atr/cases/f225500/225544.htm>.