**I. Introduction**

The US Supreme Court's decision in *Leegin* [1] appears to signal greater tolerance for vertical resale price maintenance (RPM) agreements, in which the manufacturer imposes a minimum price level on its resellers. A brand seller would likely pursue such an agreement in order to protect its resellers' margins, thereby attracting qualified downstream retailers; to protect brand image and exclusivity; and to prevent free riding by low price retailers who take advantage of the promotional activities of others. Further, a minimum RPM agreement will suppress intrabrand price competition, while enhancing the procompetitive effects of interbrand competition. Within the context of increased likelihood that vertical minimum price agreements will be permitted, bricks-and-clicks (mixed channel retailers) and pure play retailers (e-tailers) may be constrained in mounting traditional defenses against competitive forces, such as retaliatory price cutting.

The *Leegin* decision could have important strategic implications for on-line retailers, many of whom secure a competitive advantage through a classic low cost leadership strategy ([27] Porter, 1980). With a vertical minimum RPM agreement in place, e-tailers may be deterred from using their low cost structure to under price brick-and-mortar traditional competitors. This article explores the implications for on-line strategies in this post- *Leegin* environment in which price competition is restrained. In addition, this article will address the feasibility for online retailers to pursue an integrated strategy, combining both the low cost leadership and differentiation strategies.

This article begins with a discussion of Porter's model of generic strategies as currently applied. Section III provides a brief history and legal background of the Sherman Act, and includes an explanation of the basis for prohibiting anticompetitive behavior. This section also analyzes the nature of vertical price maintenance agreements to ascertain the anticompetitive and/or procompetitive effects that result from the respective price maintenance agreements. Section IV of the article focuses on the *Leegin* case, which shifted the standard of review from the *per se* prohibition to the rule of reason. Section V will explore the competitive implications of the *Leegin* case, and how it alters the feasibility of Porter's low cost leadership strategy for e-retailers. We conclude with a discussion of the current outlook for the sustainability of the *Leegin* holding.

**II. Porter's generic strategies**

Porter enumerated a series of generic strategies that a business could implement in order to secure a competitive advantage ([27] Porter, 1980) in an era that predated the current e-commerce business environment. Porter concluded that there are five generic strategies that a business could pursue in order to maintain a sustainable competitive advantage over its competitors within the industry, thereby earning a higher profit ([27] Porter, 1980). The five strategies are comprised of three basic classifications: cost leadership, differentiation, and focus, which target either a broad or a narrow market segment ([27] Porter, 1980).

According to Porter, a business should focus its resources toward pursuing one of the strategies, as opposed to trying to implement two or more of the generic strategies ([27] Porter, 1980). If a business pursues more than one strategy, it will become "stuck in the middle" ([27] Porter, 1980). Owing to the inherent contradictions in these strategies, a firm could overextend its resources and fail to instill a seamless business philosophy consistent with one of the generic strategies. Cost leadership dictates that costs are kept to a minimum, while differentiation depends on the development of unique features and attributes, which often requires increased development and production costs. When a business becomes stuck in the middle, it is at risk of losing its competitive advantage, and becoming unable to differentiate its product or service from a competitors', often resulting in poor financial performance ([27] Porter, 1980).

Porter further stated that a firm's competitive environment comprises five competitive forces, unique to its respective industry, including threat of new entry, intensity of rivalry, pressure from substitute products and bargaining power of both buyers and suppliers. The preferred strategy is determinant upon the industry's cumulative competitiveness and profitability ([27] Porter, 1980). E-commerce sales in the retailing sector operate within the context of a rapidly changing competitive environment. The [31] US Department of Commerce (2009) reports that e-tailing sales increased 18.4 percent in 2007 over previous year's levels, and in the five-year period between 2002 and 2007, grew at an average annual rate of 23.1 percent.

According to Porter, the threat of new entry by competing firms is correlated with economies of scale; if a firm is able to purchase and sell in bulk, it then increases the barriers to entry ([27] Porter, 1980). This is important as low barriers to entry put downward pressure on price, derived from the influx of competing firms contending for an increase in market share ([27] Porter, 1980). As a result, firms are forced to strictly manage costs in order to stay competitive. In addition, a stream of previous research has identified the richness of the information available online and the ease with which consumers can comparison shop, thereby increasing pressure from substitute products ([18] Grimes, 2009; [21] Kim *et al.* , 2004; [2] Ancarani and Shankar, 2004; [11] Carlton and Chevalier, 2001).

Porter argued that the strength of the five competitive forces and the organization's profitability are inversely correlated. In other words, the stronger the factors, the more competitive, and less profitable, the industry is considered. Moreover, if a practitioner understands the strength of the industry's competitive forces, the firm can implement defensive or offensive measures to coincide with the status of the industry ([25] Ormanidhi and Stringa, 2008). According to Porter, a business should implement one of the generic strategies to secure a competitive advantage based upon the nature of the industry's competitive forces ([27] Porter, 1980).

At the time of Porter's article, however, the Sherman Act placed far more stringent restrictions on the permissibility of agreements in restraint of trade. One such restriction was the prohibition from allowing manufacturers to establish a minimum resale price at which a retailer could resell the product. This restriction established the framework for the cost leadership model, capitalizing upon economies of scale as well as cost minimization in order to offer the product at a discounted price. In 2008, however, the US Supreme Court issued a decision, which significantly transformed the ability of businesses to enter into price maintenance agreements, and thus changes the viability of a cost leadership strategy within certain industries.

**III. The *Sherman Antitrust Act***

The *Sherman Antitrust Act* was passed in 1890 to protect trade and commerce against unlawful restraints, and has been a powerful weapon in allowing the government to regulate commerce and to promote a procompetitive economy[2] . The Act serves as a consumer protection tool, prohibiting any vertical restraint (between members in the marketing channel) that adversely affects the consumer[3] . The legislative intent facilitating the enactment of Section One of the *Sherman Antitrust Act* was to prevent restraints on trade that curbed productivity and placed upward pressure on consumer prices[4] . While Section One prohibits "every contract ... in restraint of trade," courts have not strictly interpreted the legislative language (Khan, 1997). Instead, courts have held that the legislative intent of Section One of the Sherman Act was to prohibit unreasonable restraints of trade (Khan, 1997).

**A. Standards for evaluating restraints of trade**

In ascertaining whether an agreement violates Section One, courts have held that there are two standards for evaluating the reasonableness of trade restraints (Khan, 1997). The reasonableness of the restraint will be decided by either the rule of reason or the *per se* violation[5] .

The primary standard of review applied to alleged violations of the Sherman Act is the rule of reason[1] . The rule of reason is a flexible test that compels the court to make a thorough analysis of all the procompetitive and anticompetitive effects of a restraint[6] . Under the rule of reason analysis, the courts utilize a balancing test, whereby each factor is assigned a weight to ascertain whether trade is promoted or suppressed, and whether the restrictive agreement imposes an unreasonable restraint on competition[7] . Some of the factors considered within the balancing test include the particular facts pertaining to the businesses that are in relation to the restraint; the market power of the respective parties to the agreement; and the reason for adopting the restraint[8] . Once these factors are explored, the court must determine whether the agreement serves to promote competition. If it found to have procompetitive effects, the agreement will be enforced.

The *per se* analysis of alleged restraints is the exception to the general rule of reason. The *per se* standard is only appropriate "[o]nce experience with a particular kind of restraint enables the Court to predict with confidence that the rule of reason will condemn it"[9] . The confidence is acquired through a series of disallowed agreements pertaining to that specific type of agreement[10] . When this occurs, such agreements are presumed to violate Section One of the Sherman Act[10] . While it is well settled that there are two applicable standards of review, there has been a recent change as to which is the appropriate standard in alleged cases pertaining to vertical minimum price maintenance agreements.

**B. Vertical minimum price maintenance agreements**

A vertical restraint is an agreement or restriction entered into between parties at different levels of the marketing channel, such as a manufacturer of a product and the distributor[11] . When two channel participants agree upon a set price in which the retailer or distributor can resell the product, it constitutes a vertical price maintenance agreement[12] . A minimum price maintenance agreement occurs when a manufacturer establishes a price floor at which distributors or retailers may sell the product (Khan, 1997). Historically, the US Supreme Court vigorously opposed minimum price maintenance agreements, as evidenced by over a century of precedence proscribing such restrictions. The basis for proscribing such agreements is that they are conducive to fostering cartels, an organization of businesses at the same level of the distribution channel that agree to collude on price or other restrictions, as well as being predisposed to exhibit anticompetitive effects. In 2007, however, the US Supreme Court issued a holding in *Leegin Products* that reversed the century long *per se* prohibition on vertical minimum price maintenance agreements.

**IV. *Leegin* *Creative Leather Products* v. *PSKS, Inc.***

*Leegin* was a manufacturer of consumer goods that sold its products to retailers for resale to consumers. PSKS was a retailer that bought *Leegin's* products. *Leegin* followed the common practice of setting suggested retail prices for its products. PSKS, however, set a retail price for these products lower than *Leegin's* suggested retail price. When PSKS would not raise its retail prices to an amount no lower than *Leegin's* suggested retail price, *Leegin* refused to continue selling its products to PSKS. PSKS filed a lawsuit against *Leegin* , arguing that *Leegin's* practice of forcing compliance with its suggested retail prices amounted to a minimum price maintenance agreement in violation of Section 1 of the *Sherman Antitrust Act* . The issue before the court was whether the minimum price control agreement placed an unreasonable restraint on trade and should therefore be construed as a *per se* violation of Section 1 of the *Sherman Antitrust Act* .

The US Supreme Court held that the primary purpose of antitrust law is to protect interbrand competition. Interbrand competition is competition among manufacturers selling different brands of the same type of product[1] . The court held that minimum price maintenance agreements can stimulate interbrand competition by encouraging market entry for new firms[1] . New manufacturers can use the restrictions to entice competent and aggressive retailers to make the requisite investment that is often required in the distribution of products that are still in their introductory stage. This occurs since the retailer is guaranteed a sufficient profit margin to warrant such an infusion of capital at an early stage in the product's life cycle.

Moreover, the minimum price maintenance agreement assures the retailer that it will not be undercut by a "free rider" capitalizing upon the retailer's marketing efforts, and is generally accepted as a procompetitive rationale for such an agreement. Free riding occurs when one distribution channel, such as a traditional retail "bricks-and-mortar" firm engages in the necessary promotional activities necessary to sell a product, including informed sales staff, advertising, and the physical store where customers can personally experience a product, only to have the product be sold through a different channel or outlet at a lower price, such as a "pure play" e-tailer ([11] Carlton and Chevalier, 2001). Such free riding could induce retail stores to minimize their promotional efforts, thereby resulting in a reduced level of total sales and foster increasing channel conflict. As a result, minimum price agreements with the incentive of a guaranteed profit margin and without the risk of free riders, serve as an attractive investment opportunity for new firms.

A second manner in which a minimum price maintenance agreement can increase interbrand competition is by threatening termination of the contract if the retailer does not meet a preset level of sales or market share as negotiated between the retailer and manufacturer[1] . Such a clause will encourage the retailer to offer aggressive and effective promotional strategies, as well as offering a high level of customer service[1]. If the retailer fails to meet these goals, it will risk having the contract terminated at the manufacturer's election. These efforts will assist the manufacturer in increasing or maintaining its market share.

**V. Strategic implications for e-tailers**

Initially the competitive environment for e-commerce in the retailing sector was conducive to a cost leadership strategy, as e-commerce advancements began to mirror the concept of a perfect market ([13] Choi *et al.* , 2006). The explosion of Internet use as a distribution channel fueled price competition, eased barriers to entry, and offered a platform that supported low transaction costs. However, as a result, competition and the pursuit of capturing large market share based on cost leadership, drove increasingly lower profit margins ([20] Kauffman *et al.* , 2009; [13] Choi *et al.* , 2006).

Owing to the diminution in information asymmetries a significant number of e-tailers implemented a cost leadership strategy, whereby they competed based upon price ([13] Choi *et al.* , 2006). The cost leadership strategy is popular as e-tailers often possess significantly reduced transactional costs as compared to a brick-and-mortar business, since the internet market is likely to have less friction resulting from those reductions in transaction costs ([6] Bailey *et al.* , 2007). Specifically, certain consumers may be price sensitive on the internet, in part, because of the reduction in search costs ([7] Baye *et al.* , 2006). Moreover, due to the richness of information available on-line, the consumer can easily and expeditiously ascertain the price offered by competitors for the same product.

Based on the new standards, e-tailers may be forced to pursue an alternative competitive strategy. In the following subsections, we will review each of Porter's generic strategies in light of this new competitive landscape and also consider whether an integrated e-commerce strategy is now both feasible and preferable, contrary to Porter's admonition that being "stuck in the middle" would weaken a firm's competitive advantage.

**A. Cost leadership**

While at first blush it would appear that the low cost strategy remains a viable strategy for e-retailers based upon their reduced operating costs. The *Leegin* case, however, impacts the feasibility of such a strategy. Under the *Leegin* holding, minimum price maintenance agreements between manufacturers and retailers are substantially more likely to be upheld[1] . If manufacturers start implementing these types of agreements, the e-tailer's cost leadership competitive advantage will be diminished. The low overhead will not assist the e-retailer in competing with brick-and-mortar businesses, as they will face the same restraints traditional firms encounter as it relates to price.

However, [18] Grimes (2009) posited that a superior brand will mitigate the need for the seller to impose a RPM on its distribution channel, because the brand in and of itself will attract distributors (both traditional and online) who want to carry the product in order to attract customers. In this scenario, procompetitive forces will come into play, and intrabrand competition will result in lower prices and increased sales. Under such circumstances, an e-tailer could still employ the cost leadership strategy and take advantage of its inherent cost advantage over the bricks-and-mortar channel.

Conversely, previous research shows that certain manufacturers may be more amenable to discounting by e-tailers, because those on-line sellers help differentiate between knowledgeable and "service intensive" consumers, allowing the manufacturer to allocate their resources on those potential customers who require the value added benefits of higher cost services ([11] Carlton and Chevalier, 2001). Several researchers have found that price dispersion is still apparent in a variety of product categories, particularly when shipping costs are included ([2] Ancarani and Shankar, 2004; [8] Baylis and Perloff, 2002; [9] Bock *et al.* , 2007). The use of added-value services, such as free shipping, in-stock inventory and ease of on-line access and use, contribute to the successful utilization of a cost leadership strategy within the competitive environment of the online channel by certain e-tailers. Furthermore, consumers will resist a premium priced product if they do not perceive any additional value to that product

[2] Ancarani and Shankar (2004) further found that when price comparison is easy and accessible, e-tailers are likely to be the cost leaders, but may not be when non-price attributes, such as quality information and brand recognition are as readily available. A pure-play e-tailer may be able to maintain its cost leadership strategy when competing across different channels, when selling homogeneous products that require neither specialized service nor extensive information gathering, and where there already exists a broad knowledgeable market segment.

**B. Differentiation**

According to Porter's generic strategies, a business could still pursue either a differentiation or focus strategy ([27] Porter, 1980). A differentiation strategy exists when a business distinguishes its product from the competition with unique non-price attributes that are perceived by the consumer as better than the alternatives. Even though electronic markets may have fewer market imperfections than traditional markets, price dispersion may persist if Internet retailers can continue to differentiate themselves ([6] Bailey *et al.* , 2007). This is particularly true when a consumer is not just buying a homogeneous good, but a bundle of goods, which consists of convenience and price ([6] Bailey *et al.* , 2007). In addition, the discerning consumer can easily migrate from one channel to another, choosing bricks-and-mortar, bricks-and-clicks and pure play based on the product, brand loyalty and service requirements of the buyer.

There are several ways in which an internet business can differentiate its product from its competitors. For example, a business can differentiate its product through the enhanced quality of the web site or based upon the quality of product delivery ([8] Baylis and Perloff, 2002). Establishing online brand recognition and providing varying levels of service will also contribute to the uniqueness of the e-tailer's product offerings ([5] Ba *et al.* , 2006). By implementing a differentiation strategy, the e-retailer can minimize the adverse consequences of a minimum price maintenance agreement ([8] Baylis and Perloff, 2002). In fact, a minimum RPM can help establish exclusivity of a superior brand by limiting on-line price dispersion. By guaranteeing a new entry a minimum profit margin, RPM can benefit the marketplace by encouraging interbrand competition, which broadens consumer choices and encourages firms to concentrate on expanding their non-price attributes.

**C. Focus**

Porter's remaining generic strategy is the focus strategy, which consists of focusing resources on a select few niche target markets. By focusing the marketing mix on the narrowly defined target markets, the business can position itself to increase brand loyalty and customer satisfaction, thus shielding itself from the perils of the minimum price maintenance agreement and deflecting the impact of potentially higher costs. A new entrant can compete against more well-established firms due to ease of entry, lower investment costs, and the ability to customize products to meet a narrowly defined customer base ([21] Kim *et al.* , 2004).

This supports the "long-tail" theory ([3] Anderson, 2006), which proposes that increased profitability can be realized by servicing a small, but demanding customer base, willing to pay a premium price for its unique product desires. Product assortment is growing because goods are no longer constrained by physical limitations in an e-commerce marketplace. More recently, [17] Elbrese (2008) found that while the "tail" (representing unique, customized offerings) in potential demand volume is indeed long, it is also flat. Since demand is extremely low, the firm requires stringent cost controls in order to recover its investment ([17] Elbrese, 2008), potentially minimizing its ability to continue to supply those unique products.

**D. Integrated strategy**

An integrated strategy, which combines both cost leadership and differentiation elements of Porter's framework, is a promising alternative online retailing strategy in an environment where price competition is constrained ([21] Kim *et al.* , 2004). In addition, [21] Kim *et al.* (2004) argues that internet capabilities, which enable concurrent servicing of both broad markets and narrowly focused niche markets, mandate that a redefinition of the focus strategy is a competitive and strategic "imperative" that successful e-business firms must adopt.

A combined strategy would incorporate the best features of both cost leadership and differentiation without the constraints of the market scope dimension due to the scalability of the internet ([21] Kim *et al.* , 2004). Owing to the richness of information on the internet, cost comparisons are readily available and can contribute to the success of an e-tailer utilizing the cost leadership strategy, if the product is relatively homogenous, which in turn could result in a price cutting downward spiral. For a product offering with specific attributes, including brand exclusivity, customization, or one in which additional services are required, a differentiation strategy will be most successful, albeit potentially augmenting costs. An integrated strategy would position the e-tailer as an innovative mass customizer, offering differentiated services including brand offerings, extensive inventory, competitive pricing, easy on-line interface and non-price attributes, such as free shipping.

**VI. Sustainability of the *Leegin* Holding**

The *Sherman Antitrust Act* is a creature of federal legislation. The Act is designed to afford consumers a minimum level of protection by proscribing specified agreements. While the Act provides a minimum level of protection, each state reserves the right to afford a heightened level of protection to its citizens. As a result, practitioners must be cautioned to review the applicable state laws pertaining to the viability of minimum price maintenance agreements within their respective state. Following the *Leegin* holding, the *Antitrust Source* published a list of relevant state statutes and precedence pertaining to the respective laws for each state ([23] Lindsay, 2009). In almost every instance, the controlling authority expressly incorporates the intent to harmonize the interpretation of the state statute with the interpretation of the *Federal Sherman Antitrust Act* . As a result, most states will construe their state statute in conformity with the *Leegin* holding.

With that said, there have been a couple recent developments whereby two states have addressed the feasibility of minimum price maintenance agreements post-*Leegin* ([23] Lindsay, 2009). In the most overt instance, Maryland enacted a statute expressly repudiating the use of the rule of reason in the analysis of vertical minimum price agreements ([23] Lindsay, 2009). Maryland, however, is the only state that has statutorily rejected the *Leegin* holding. In the other instance, a Kansas trial court was confronted with the issue in *O'Brien* v. *Leegin Creative Leather Products Inc.* [13] . In that case, the trial court utilized the rule of reason analysis consistent with the *Leegin* holding. The case has since been appealed and is currently in the Kansas appellate courts ([23] Lindsay, 2009).

In addition to challenges derived at the state level, some wholesalers and retailers, such as Ebay, are aggressively lobbying the US Congress to pass legislation designed to overturn the *Leegin* holding ([26] Periera, 2009). There is currently a congressional proposal, the *Discount Pricing Consumer Protection Act of 2009* [14] , being debated which is designed to reverse the *Leegin* decision. The *Discount Pricing Protection Act* would restore the rule that vertical minimum price maintenance agreements between manufacturers and retailers, distributors, or wholesalers are a per se violation of the Sherman Act.

**Conclusion**

For the past century the United States Supreme Court had prohibited the use of minimum price maintenance agreements on the basis that they were predisposed to exhibit anticompetitive effects, and thus violate Section 1 of the *Sherman Antitrust Act* . In 2007, however, the Supreme Court issued the *Leegin* holding pertaining to the viability of minimum resale price maintenance agreements, overruling a century of established precedence, and substantially changing the premise under which Porter's generic strategies were conceived.

By permitting minimum RPM agreements, manufacturers retain power over wholesalers and retailers as it relates to the resale price of their product, guaranteeing a set profit margin for these downstream channel members and mitigating the threat of free riding. Moreover, the *Leegin* holding has the potential of infringing upon one of the inherent advantages associated with e-tailing, that of a cost leadership strategy due to the lowered barriers to entry, low transaction costs and ease of channel migration.

While RPM agreements are not yet widely adopted, e-tailers should explore alternative strategies, including the use of added-value services, such as free shipping, in-stock inventory and ease of online access and use, in order to compensate for the potential change in the competitive landscape and legal regulations derived from the *Leegin* holding. E-tailers should also consider implementing an integrated strategy which combines elements of cost leadership, differentiation and focus elements of Porter's framework, despite the admonition that pursuing more than one strategy will mean the firm will become "stuck in the middle". The internet retail environment supports the viability of an e-tailer positioning itself as a mass customizer, focusing on both broad and narrow niche markets simultaneously, while maintaining cost leadership due to the inherent reduced operating costs of the pure play firm.

This article does raise several questions that deserve future study. For instance, future empirical research should be conducted to determine the frequency in which manufacturers are requiring RPM agreements as a condition of selling a product. Another issue worth exploring is to measure the actual impact of an RPM agreement on e-tailers across different product assortments, and how those e-tailers have modified their business model to compensate for these price constraints. Moreover, state and federal legislation designed to prohibit the use of minimum RPM agreements should also be monitored, in order to assess the future sustainability of the *Leegin* holding.