

Vertical Agreements: Comparison of EU, US and China Enforcement Experiences & Practices

EU-China Trade Project (II)

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Evolution of EU Rules on Vertical Restraints (I)

Historical context and background

- Creation of a single market is one of the main objectives of the EU competition policy
 - Price differences between Msts. provide incentives for new entrants, also erect barriers
 - Arrangements between producers and distributors (vertical agreements) can be used to partition the market and exclude new entrants
 - B/C the strong link to market integration (pros or cons effects), vertical restraints have been of particular importance to the EU competition policy
- Analytical Framework for vertical restraints started to shape in 1966
 - In 1966, Joint Cases 56/64 and 58/64 Grundig Consten, ECJ had clearly stated that Art. 85 (now Art.101) was also applicable to vertical restraints
 - Since then, a large demand for exemptions emerged on individual basis
 - Commission began issuing Block Exemption Regulation (“BER”) to exempt a class of similar agreements (pros outweigh cons) in 1980s



Evolution of EU Rules on Vertical Restraints (II)

Review and Development

- In 1997, EC started an in-depth review of its competition policy on vertical restraints – Green Paper on Vertical Restraints:
 - Shortcomings include form-based assessment and the lack of market share limits
 - Need for more economics-based approach
- Outcomes of the Review:
 - A renewed framework: General BER 1999 + Guidelines 2000
 - Specific BER for motor vehicle distribution in 2002 + specific BER for technology transfer in 2004
 - Vertical restraints are no longer regarded as per se suspicious, or per se pro-competitive, more rule of reason
 - Effects-focused assessment



EU General Approach to Enforcement

Basic principle – Vertical arrangements (between companies operating at different levels of the supply chain) are less likely to give rise to competition issues.

EU approach is that companies remain free to decide how their products are distributed, unless

- the agreements contain **hard-core restraints**; and
- where one of the parties to the arrangement enjoys **market power** at their level of the market

Use of Block Exemption (BERs)

- Revised version (and Guidelines) issued in 2010
- Apply broadly to arrangements where manufacturer and distributor do not have more than a 30% market share
- Encourage conformity to acceptable arrangements
- Companies to self-assess for compliance
- Individual exemption still available where market share > 30% (if conditions met)



Recent Enforcement Practice in the EU



1. Resale Price Maintenance
2. Price relationship agreements
3. Restrictions on online sales
4. Hub-and-Spoke arrangements

Enforcement on vertical restraints almost entirely at
NCA level in recent years



Resale Price Maintenance

Impact of *Leegin* on enforcement priority against RPM in Europe?

Fixed/Minimum RPM traditionally treated as almost *per se* illegal in EU- hard core restraint

US Supreme Court over-ruled entrenched *per se* rule against RPM – legality of RPM to be analysed under rule of reason

RPM indispensable to achieving efficiencies?

2007

Strong presumption of illegality appropriate?

2010

New EU guidelines on vertical restraints concedes that presumption of illegality may be rebutted in certain circumstances

In practice, NCAs continue to treat RPM as an enforcement priority



Resale Price Maintenance

Active enforcement on RPM by NCAs

Germany	Aug 2012 - Threat by power tools manufacturer TTS Tooltechnic to cancel contracts if retailers did not adhere to minimum retail price	<i>EUR 8.2m fine RMB 67m fine</i>
	Sept 2009 - Unilateral setting of recommended online retail price by contact lens maker Ciba	<i>EUR 11m fine RMB 90m fine</i>
	Aug 2009 - Refusal by Phonak to sell hearing aids to an online retailer that resold the products to consumers below the recommended retail price	<i>EUR 4m fine RMB 33m fine</i>
Portugal	July 2012 - Fixing of minimum prices in distribution contracts by Lactogal for its products across several hotels, cafes and restaurants	<i>EUR 340k fine RMB 2.8m fine</i>



Resale Price Maintenance

Key points on RPM



- Suppliers may not require distributors to resell at fixed or minimum prices
- Includes ‘formulas’ that determine the resale price: e.g. fixed distribution margin, maximum discounts, etc
- Also includes offering or withholding benefits to induce distributors to obey resale prices: e.g. rebates, threats to withdraw supply
- Permitted to communicate recommended resale prices, but must not go beyond that
- Technically does not apply in the context of agency agreements, but authorities will scrutinise closely



Price Relationship Agreements

Price relativities agreements

- Retailer undertakes to set the price at which it resells manufacturer A' s products with reference to the price at which it sells the products of manufacturer B
 - reduces retailer' s ability to independently set its *relative* retail prices
 - restriction of competition by object

Across-platform parity agreements (retail “Most Favoured Nation” (MFN) clauses)

- require the seller to sell a good or service on a platform at a price that is not higher than the price the seller charges on other platforms



Price Relationship Agreements

Hotel Online Booking (UK) – Statement of Objections issued by the OFT in July 2012

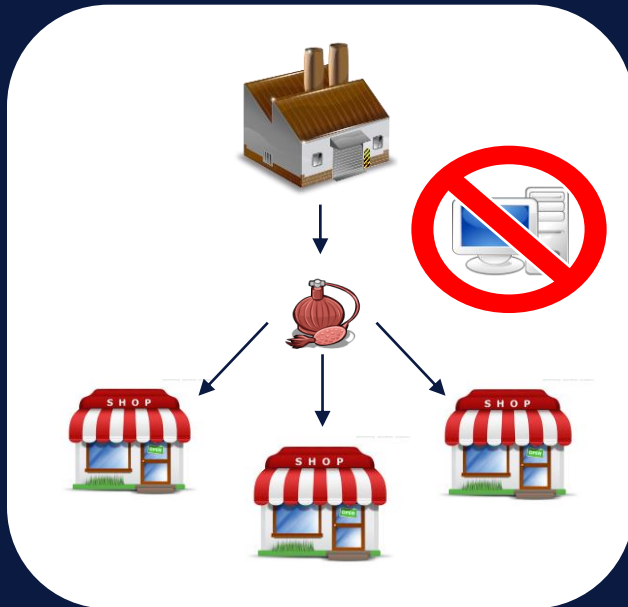


- OFT's provisional view
 - Discounting restrictions amount to RPM unless intermediary (e.g. the agent) whose ability to determine the sale price is restricted can be regarded as “an auxiliary organ forming an integral part of the principal’s undertaking – ie a genuine agent
- Genuine vs. Non-Genuine agent
 - Criteria for assessment
 - if agent non-genuine, discounting restrictions = RPM?



Online Sales in Selective Distribution

The *Pierre Fabre* case – internet sales ban difficult to justify



Facts: Selective criteria that qualified pharmacist be present at all times to advise customers considered to be a ban on internet sales

Key messages from ECJ

- Ban on internet sales in a selective distribution agreement constitutes an infringement by object unless ‘objectively justified’. ECJ appears to rule out as legitimate aims:
 - (a) the need to provide individual advice / protect customers from incorrect use
 - (b) maintain prestigious brand image
- Block exemption excludes from its benefit any restrictions of “active or passive sales to end users by members of a selective distribution system”, including internet sales which “at the very least has as its object the prohibition on passive sales” to certain customers
- Exceptions to treating prohibition on selective distributor “operating out of an unauthorized place of establishment” as sales restriction to be interpreted narrowly

Online Sales in Selective Distribution



“Distributors should be free to satisfy consumer demand, whether in brick and mortar shops or on the Internet” ~ EU Competition Commissioner, Joaquin Almunia

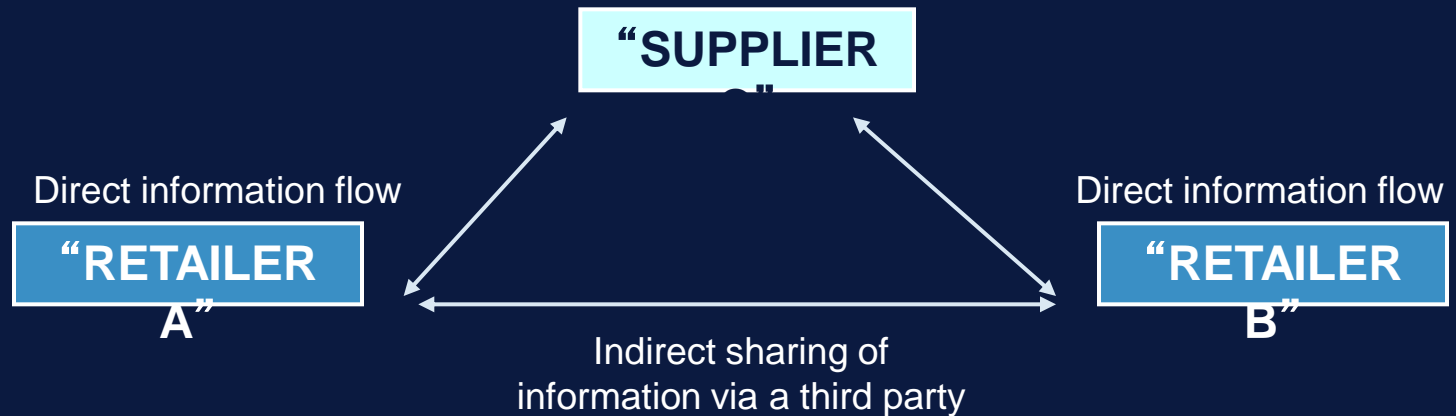
Options available to control internet sales

- Impose quality standards on distributors’ websites and internet selling activities
- Impose quality standards require distributors to achieve a certain minimum volume or value of offline sales
- To pay distributors a fixed fee to support offline sales effort
- To require distributors to have at least one physical shop or show room



'Hub and Spoke' Agreements

Indirect information exchange via a third party is prohibited



If

- (i) Retailer A discloses its future retail prices to Supplier C, in circumstances where Retailer A intended or foresaw that Supplier C would pass it on to Retailer B...
- (ii) and Supplier C does pass that information on to Retailer B;
- (iii) and Retailer B knew the circumstances in which the information was passed to it and Retailer B does, in fact, use this information to determine its future retail prices...

THEN, Retailer A, Retailer B and Supplier C are all in breach of competition law.



'Hub and Spoke' Agreements

Leading authority in the UK

**Toys & Games and Replica Kits
(UK Court of Appeal)**



**Dairy
(Judgment on appeal pending)**



Key points:

- Bilateral exchange of commercial information (including future pricing information) is necessary and legitimate in many commercial negotiations
- Requisite state of mind crucial in determining whether indirect sharing of information (through vertical relationships) amounts to a concerted practice



US General Approach to Enforcement

Basic principle – Vertical agreements generally withstand antitrust scrutiny in the US.

- They are generally seen as pro-competitive. They are not *per se* illegal, but can be successfully challenged if anticompetitive harm is proven
- Certain vertical agreements do raise issues:
 - Resale price maintenance
 - Exclusive distributorships
 - Other exclusivity arrangements (i.e., product exclusivity at a certain retailer)
 - Price discrimination
 - Customer or territorial restrictions
 - Tying and bundling

Vertical agreements are more likely to raise concern where a monopolist or leading firm imposes a restraint



Recent Enforcement Practice in the US



1. Resale Price Maintenance
2. Exclusive Supply Agreement
3. Tying and bundling
4. Price Discrimination



Resale Price Maintenance

Also called Vertical Price Fixing, and can be minimum or maximum

Maximum RPM was originally *per se* illegal, but the Supreme Court changed the standard to Rule of Reason, and **now nearly always justifiable under the federal antitrust laws**

Five years ago in the *Leegin* decision, the Supreme Court ruled that minimum RPM should also be examined under the Rule of Reason. Economists almost uniform in concluding that RPM is not always anticompetitive.

Evolving area of the law— not thoroughly tested in the courts



Exclusive Supply Agreement

Vertical arrangements such as exclusive supply agreements that foreclose a substantial portion of the market or significantly limit opportunities for competing sellers may be illegal

- *Conwood Co. v. US Tobacco Co.*
 - United States Tobacco Co. (USTC) marketed smokeless tobacco, holding over 75% of the market; Conwood was a growing #2 firm
 - Conwood alleged that USTC used its monopoly position to unlawfully exclude competitors in the moist snuff tobacco market in violation of Section 2
 - exclusive racks, limiting placement of competitors' brands
 - removing Conwood's retail displays without authorization
 - providing misleading information to retailers
 - District court found for Conwood; Jury awarded over \$1 billion (RMB 6.3 billion)
 - Sixth Circuit affirmed; Supreme Court denied hearing



Tying or Bundling

Tying or bundling arrangements without valid business justifications that foreclose a substantial portion of the market or significantly limit opportunities for competing sellers may be illegal

- *3M v. LePage's*
 - LePage's, a producer of office supplies, entered the transparent tape market where 3M (Scotch™ brand tape) had monopoly power
 - LePage's alleged that 3M attempted to drive competition out of the market by offering “bundled” rebates to large retailers
 - District court returned a jury judgment for LePage's of \$68.5 million (RMB 431million) in damages
 - The court found that the exclusionary practices and bundled rebates were without valid business justification and allowed 3M to maintain its monopoly
 - 3M's conduct foreclosed LePage's from the market
 - Third Circuit panel initially ruled in favor of 3M; the circuit vacated the panel decision, reheard, and affirmed district court's ruling against 3M



Price Discrimination - Robinson-Patman Act (I)

Origins of the Robinson-Patman Act

- Enacted in 1936 for the explicit purpose of protecting small retailers from discriminatory pricing practices in favor of larger competitors

Enforcing the Robinson-Patman Act

- Federal antitrust enforcement
 - Federal antitrust enforcers have largely ignored the RP Act for the last 20 years
- Heavily criticized by many antitrust experts
 - Not grounded in consumer welfare – big may be efficient, not bad
 - Antitrust Modernization Commission recommended repeal of the RP Act
- Despite criticism, RP Act lives on in the US courts
 - Private parties have right to enforce
 - Private actions are still very common and are litigated
 - Treble damages and class actions



Price Discrimination - Robinson-Patman Act (II)

Illegal Price Discrimination

- Elements of a price discrimination action:
 - **Two or more sales**
 - Reasonably close in time
 - Involving commodities
 - **Of like grade and quality**
 - **With a difference in price**
 - **By the same seller**
 - **To two or more purchasers**
 - For use, consumption or resale in the US
 - Which results in competitive injury



Example

One of Company's large customers, Customer A, requests favorable pricing (2% discount) on a particularly large order of widgets.

Company sells the same widgets to other smaller customers, some of which compete directly with Customer A.

One such small customer struggles to compete on price, losing business to Customer A.

That customer then learns that Customer A received a lower price from Company and threatens a price discrimination lawsuit.



Price Discrimination - Robinson-Patman Act (III)

Defenses to Price Discrimination

- Cost Justification
 - Often difficult to prove; Price differentials may be justified by savings in the seller's costs of manufacture, delivery, or sale
- Meeting Competition
 - Price differentials permitted as a result of a good faith effort to meet (not beat) competition from one or more other firms on comparable product
- Changing Conditions
 - Changing conditions that affect the market for or marketability of the goods, such as actual or imminent deterioration of goods, obsolescence of seasonable goods, and distress sales
- Functional Availability
 - If the price/offer was functionally available to a purchaser who chose not to take advantage of it, there is no violation
- Class of Trade Distinction



China General Approach to Enforcement

China - AML

- Certain Vertical Agreements are classed as a type of “monopoly agreements” under Art.14 AML.
- However, no definition of vertical restraint is provided by the AML or other relevant rules.
- Explicitly prohibited vertical agreements under AML are:
 - Fixing resale price
 - Fixing Minimum Resale Price
- Art.15 AML provides a list of the circumstances where an agreement containing a vertical restraint can be exempted.
 - Improving R&D, product quality, cost reduction and efficiency, etc.

Enforcement Practice in China

- Two enforcement agencies have power in relation to “monopolistic conduct”, SAIC and NDRC, and their local bureaus
- To date, one publicly available decision concerning vertical restraints was issued by NDRC in 2011. This decision concerns a distribution agreement in the pharmaceutical sector.
- First vertical restraint case (private litigation) in China:
Case Johnson & Johnson (“J&J”)
 - RPM clause contained in the distribution agreement



Resale Price Maintenance – First case on RPM

- Case Johnson & Johnson
 - Ruibang, a distributor of J&J, brought the case before Shanghai Intermediate People's Court.
 - The Court found the plaintiff (Ruibang) failed to establish the “anti-competitive effect” of the RPM clause in question, and rejected the claim as unfounded.
 - The Court ruled: an infringement finding for Art14 AML requires an enquiry into whether the arrangement had the effect of “eliminating or restricting competition”, and there is no infringement by object (not a per se illegal).
 - Factors to assess a vertical arrangement: market share of the product subject to the pricing restrictions, state of competition (upstream and downstream), impact of the provision on the volume of the product supplied and on price.
- No clear rule under the AML on whether rule of reason or per se illegal rule should be applied to RPM
- Will NDRC follow the rule of reason test set up by the court in this case in reviewing RPM?



Conclusion and Recommendation in relation to Vertical Restraints in China

There is no uniform analytical framework that applies to the assessment of vertical restraints under China's AML laws.

Many areas are to be clarified, e.g., a block exemption or individual exemption?

Limited enforcement practice: So far only a limited number of agency's decision and a private court case (Case J&J).

Recommendation:

- NDRC and SAIC should publish more decisions on vertical cases they have reviewed and investigated
- Guidelines on vertical agreements should be published ASAP.
- Coordination between the agencies and courts on the review standard of vertical cases under the AML

Thank you for your attention!

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