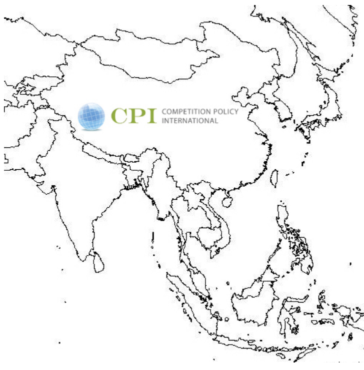

China's Current Approach to Vertical Arrangements Under the Anti-Monopoly Law

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I. INTRODUCTION

Traditionally in competition law, vertical arrangements (where parties to the transaction or agreement in question are active up and downstream of each other) are normally subject to a lower level of scrutiny compared with horizontal arrangements. Some jurisdictions have even taken the policy decision not to subject vertical arrangements to the reach of competition law. For instance, the United Kingdom until recently had in place an exemption for vertical agreements. This approach is also proposed under the hotly anticipated Hong Kong Competition Bill.

The position in China is, however, different. Under the Chinese Anti-monopoly Law ("AML"), the legislation expressly seeks to regulate agreements involving undertakings operating at different levels of the value chain, and this is reinforced in regulatory guidance. The merger control provisions make no distinction as to horizontal, vertical or conglomerate mergers, and in practice, the Ministry of Commerce ("MOFCOM") has indeed imposed remedies in two cases involving vertical mergers.

This article summarizes the extent to which vertical arrangements have been scrutinized by antitrust regulators, and instances where they have been challenged in the private sphere.

II. MOFCOM'S APPROACH IN VERTICAL TRANSACTIONS

Under the AML, transactions involving mergers or acquisition of control or decisive influence are notifiable if they meet specified turnover thresholds. In the four years since the AML has taken effect, the antitrust merger control regulator, MOFCOM, has been actively enforcing the merger control provisions. Based on statistics released in December 2011, MOFCOM had examined, in total, just over 400 cases since August 2008. MOFCOM is required to publish its decision only in cases where it has intervened. To date, there have been no fewer than two instances of MOFCOM imposing conditions on vertical transactions in a total of 13 intervention decisions.

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Although MOFCOM's public decisions are typically concise and tend not to elaborate or explain the reasoning, it is possible to discern a trend of MOFCOM's maturing approach in relation to vertical transactions, as outlined below.

A. First case: the GM-Delphi decision (September 2009)[1]

The GM-Delphi transaction is the first vertical merger on which MOFCOM imposed conditions. The global automotive manufacturer General Motors ("GM") proposed to acquire the car parts business and four U.S. sites of Delphi Corporation ("Delphi"). The transaction had already been cleared unconditionally by the U.S. and the European Commission. However, MOFCOM imposed a set of behavioral remedies on the parties, requiring Delphi to continue to supply car parts to Chinese car manufacturers on a non-discriminatory basis, and GM to continue to source car parts from various suppliers and not to favour Delphi unreasonably.

In reviewing vertical transactions, antitrust agencies in more mature jurisdictions such as the U.S. and the EU would normally be concerned with foreclosure effects—namely, whether the merged entity would be able and have an incentive to foreclose its competitors or customers upstream or downstream by virtue of its dominant position in one or more of the relevant markets.

Yet in reviewing this transaction, MOFCOM simply alleged that GM and Delphi had a "leading position" in both global and Chinese automotive and car parts markets, respectively. MOFCOM did not justify its concerns by reference to any alleged dominant market position of either or both of the parties (for example, by citing the parties' market shares, the position of their competitors, and other prevailing competitive conditions in the markets). The decision also contains no evidence or analysis that would show that GM and Delphi had the ability and incentive to foreclose their respective competitors or customers other than by referring to the "post-concentration relationship and the common interests between the parties." The decision provides no discussion on the effect that any such foreclosure could have on the relevant markets.

Therefore while MOFCOM's approach in the GM-Dephi transaction was in line with the internationally accepted theory of harm for vertical transactions, nevertheless (at least on the face of the decision), such theory has not been fully expounded upon, nor supported by, evidence.

B. Second case: the Tiande-Henkel decision (February 2012)[2]

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1 MOFCOM Announcement No.76 of 2009.

2 MOFCOM Announcement No.6 of 2012.

Less than three years after the GM-Delphi decision, MOFCOM intervened again in another vertical transaction.

A green field joint venture ("JV") was to be established between Tiande Chemical Holding Limited ("Tiande"), a manufacturer of ethyl products, and Henkel Hong Kong Holding Limited ("Henkel"), a maker of monomer products and one of Tiande's important customers. The JV would involve a vertical integration of Tiande and Henkel's activities, as Tiande would supply the upstream ethyl products, an essential ingredient to the production of monomer products by the JV. Together, the JV and Henkel would consume 25 percent of Tiande's production capacity of the key upstream ethyl products.

The approach adopted by MOFCOM in this decision indicates remarkable maturity. As elaborated in the published decision, MOFCOM was concerned that Tiande, being one of the only two ethyl suppliers in the global market and having a strong global market share of 40 to 50 percent, could alter its supply strategy and discriminate against or "foreclose" other downstream competitors of the JV.

To resolve its concerns, MOFCOM imposed behavioral remedies that required Tiande to continue to supply ethyl to all downstream customers on a fair, reasonable and non-discriminatory basis. It also ordered Tiande not to sell ethyl at an unreasonably high price or supply to the JV on terms that are more favorable.

C. Other instances where vertical arrangements have been scrutinized in the context of merger reviews: Novartis-Alcon[3]

In addition to the GM-Delphi and Tiande-Henkel decisions, MOFCOM has also taken into account existing vertical arrangements that parties have outside of the transaction in question when assessing its impact. An example of this is the merger of two pharmaceutical giants, Novartis and Alcon, which was conditionally cleared in the EU, Canada and Australia, upon divestment of various businesses.

The Novartis-Alcon case involved key overlaps in China in ophthalmic anti-infective and anti-inflammatory compounds, and contact lens products. While the extent of overlap between the parties in contact lens products in China was not problematic in and of itself (the merging parties having a combined market share of almost 20 percent in China), MOFCOM was concerned with an existing vertical distribution relationship between Novartis and a leading contact lens products player, Hydron, which enjoyed a position of more than 30 percent market share. MOFCOM came to the view that the exclusive distribution arrangements may eliminate or restrict competition through coordination between Hydron and the merged entity over price, volume and sales territories of contact lens products. MOFCOM therefore required Novartis to terminate these exclusive vertical arrangements within 12 months.

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[3] MOFCOM Announcement No.53 of 2010.

D. Conclusion on MOFCOM's approach to vertical transactions

In conclusion, the fact that MOFCOM has imposed conditions on at least two occasions involving vertical transactions demonstrates that such transactions do not escape scrutiny. A comparative analysis of the two vertical decisions also shows MOFCOM's growing maturity in applying the theory of harm (although this may also partly be explained by MOFCOM's growing willingness to be more elaborate in its public decisions).

III. BEHAVIOURAL ENFORCEMENT IN RELATION TO CONDUCTS WITH A VERTICAL DIMENSION

A. A changing tide? NDRC's investigation into two telecommunications operators[4]

In Chinese competition law, much of the limelight has been focused on merger control. MOFCOM has been extremely active in reviewing transactions, as well as publishing interventions decisions and numerous final and draft guidances. In contrast, the non-merger antitrust authorities—the National Development and Reform Commission ("NDRC") and the State Administration for Industry and Commerce ("SAIC")—have not been as active, both in terms of the profiles of cases they have taken on and the number of guidances they have published.

Since the AML came into effect, the NDRC and SAIC have begun to prosecute companies engaging in predominantly hardcore horizontal arrangements such as price-fixing and market allocation. These prosecutions largely concern small-scale activities at local levels, and these cartels often involve trade associations playing facilitative roles. Additionally, the levels of fines are not very high, with the highest imposed in relation to such horizontal arrangements being around RMB 1 million.

Of the various guidances that the NDRC and the SAIC published in January 2011, none provide any further detail or clarification on the authorities' attitude or approach towards vertical arrangements, be it in the context of agreements (such as resale price maintenance), or in the context of abuse of dominance involving vertical elements. Then in November 2011, the NDRC announced that it was in the process of an abuse of dominance investigation into two state-owned companies, China Unicom and China Telecom, the country's two vertically integrated fixed-line operators.

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[4] *China Telecom, China Unicom Face Monopoly Probe*, WALL ST. J. (Nov. 9, 2011), *available at* http://online.wsj.com/article/SB10001424052970204358004577027283900972206.html.

The NDRC investigation is reportedly concerned with allegations of price discrimination in China's downstream broadband access market, of which, according to the NDRC, China Unicom and China Telecom account for over two-thirds, thereby holding a dominant market positions. The NDRC found that the two companies charged rival downstream internet services providers ("ISPs") fees for broadband access that were higher than those for non-rivals. NDRC alleged that such behavior constitutes "price discrimination."

What is not apparent from public sources is the extent to which the NDRC has considered the conduct from a vertical perspective. Under the PRC sector regulations, China Unicom and China Telecom are the only two operators that are permitted to operate networks connected to the internet backbones in China. Any ISPs wishing to provide broadband internet connection services in China must first seek access from either China Unicom or China Telecom.

In other jurisdictions, such as Europe, such conduct involving pricing of a key upstream input on terms that are unfavorable to downstream competitors would normally be considered a possible instance of abusive margin squeeze, as opposed to price discrimination. Examples of margin squeeze include the European Deutsche Telekom case[5] and the TeliaSonera case.[6] Both of these cases involved downstream pricing by incumbent telecommunications operators that sought to price in such a manner as to squeeze out downstream rivals.

While the NDRC has yet to conclude its investigation into China Unicom and China Telecom's pricing conduct in relation to their provision of access to the internet backbone, the case highlights the fact that the behavioral antitrust regulators such as the NDRC are now ready and willing to take on more high-profile and technically complex cases, including those involving vertical elements, which are traditionally considered to be a more difficult area to tackle. Therefore, vertically integrated companies with significant market presence in the upstream product market, or those who supply products or services that can be characterized as essential inputs need to pay heed to possible antitrust risks associated with their conduct involving downstream enterprises.

IV. PRIVATE ENFORCEMENT IN RELATION TO VERTICAL ARRANGEMENTS

A. Ruibang v. Johnson & Johnson[7]

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5 European Commission Case C-280/08 P: Deutsche Telekom AG v Commission.

6 European Commission Case C-52/09: Konkurrensverket v TeliaSonera Sverige AB.

7 Press release published by Shanghai No.1 Intermediate People's Court in February 2012: http://www.a-court.gov.cn/platformData/infoplat/pub/no1court_2802/docs/201009/d_880113.html (in Chinese). A short report of this case can be found in English at: *Antitrust a buzz word at China's parliamentary meeting*, FIN. TIMES (Mar. 16 2012), *available at* http://www.ft.com/cms/s/2/5f49ace4-6f6e-11e1-9c57-00144feab49a.html.

As mentioned above, the AML contains an express prohibition against vertical agreements that fix resale prices or set minimal resale prices on products with respect to third parties. There is also a catch-all prohibition in relation to all vertical arrangements that may have the effect of eliminating or restricting competition.

To date, no known public enforcement actions have been taken in relation to any resale price maintenance arrangements. Furthermore, the NDRC and the SAIC generally do not scrutinize vertical arrangements if the undertakings concerned do not have substantial market presence of at least approximately 30 percent of market share in the relevant market. Companies with operations in China have therefore been able to derive some comfort from the NDRC or SAIC's generally understood position, and have not had to revise their go-to-market models which, for many companies (particularly multinational companies wishing to gain market presence rapidly), involved appointing distributors for their products.

Thus the widely-reported February 2012 litigation against Johnson & Johnson ("J&J") concerning its distribution arrangements in China may serve as a wake-up call to companies with a network of distributors to take a more cautious approach when it comes to their supply arrangements in China.

The case involved a claim by Johnson & Johnson's distributor alleging that the terms of its exclusive distributorship constituted unlawful resale price maintenance. The plaintiff, Ruibang Yonghe Technology and Trade Co., Ltd. ("Ruibang"), had been Johnson & Johnson's distributor of surgical products in the Beijing region for more than 15 years. The distribution agreement imposed a minimum resale price of the products on Ruibang. The dispute arose when J&J cancelled Ruibang's distribution rights for certain hospitals after discovering Ruibang was charging its hospital customers prices lower than those stipulated under the agreement. Ruibang therefore challenged the legality of the agreement based on the AML.

A number of key arguments were raised during the trial. In particular, Ruibang argued that Johnson & Johnson had violated the prohibition on monopoly agreements under the AML by unlawfully restricting Ruibang's ability to sell the products to its customers at a price below the stipulated minimum resale price, the purpose of which was to restrict competition. Ruibang sought RMB 14.4 million in damages for the harm resulting from its cancelled distribution rights.

Johnson & Johnson's first key responses was that the claim was not valid because the distribution agreement was terminated before the AML took effect. The second key response, and the more interesting one, was that even if the distribution agreement had breached the AML, Ruibang was a participant in the infringement and therefore not entitled to bring such a claim. This line of argument was very similar to that pleaded in *Courage v Crehan*[8] in Europe.

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[8] Case C-453/99 [2001] ECR I-6297.

The court has yet to render its judgment. However, the case demonstrates an increased risk profile associated with vertical arrangements. Businesses in China are becoming increasingly aware of the use of competition law claims as a sword in advancing one's commercial interests. In addition, companies with extensive distribution arrangements in China can no longer take the view that challenges would be unlikely, given that the high-profile *Ruibang v Johnson & Johnson* case may register on the radar screens of distributors across China and possibly whet their appetite in making similar claims. The risk of private action is further amplified by the combination of the relatively modest cost of litigation in China, as well as the promulgation by the Supreme People's Court on May 8, 2012 of a set of judicial interpretations that seek to encourage more private AML actions.

V. CONCLUSION

While the body of competition law in China is still relatively young, there have been some interesting decisions taken by regulators in relation to vertical arrangements, be it vertical mergers such as the case of GM-Delphi, or investigations into conduct involving vertical elements such as the abuse of dominance investigation against China Unicom and China Telecom. A review of these decisions and investigations reveals that the approach taken in relation to vertical issues is largely in line with the internationally accepted theory of harm. It is also notable that vertical arrangements have also come under attack in private courts, even though no private litigation has resulted in a successful claim to date.

Given the pace with which regulators are maturing in their application of the law, as well as the growing enthusiasm of private litigants in using competition law as a sword to advance their interests, it is likely that the level of scrutiny over vertical arrangements will not abate. As the jurisprudence in this area develops, and as Chinese regulators gain more experience in reviewing vertical arrangements, it is anticipated that they will be able to apply the theory of harm by reference to the factual matrix with greater confidence, and hopefully with a higher degree of predictability that follows international norms.