CPI's Cartel Column Presents:

Cartel Risks in Dual-Distribution Models – Too Soon to Tell?

By Anisha Chand and Anmol Awasthi [1]

(Khaitan & Co.)

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Introduction

Consider a typical supply chain – in the market for supply and sale of plastic bottles, for example, the manufacturer procures raw materials from upstream suppliers to manufacture bottles of various colors and sizes. Depending on the size and scale of its business, the manufacturer then engages a distributor or a network of distributors to facilitate downstream sales to the ultimate consumers. While there may be a network of players (such as distributors, sub-distributors, wholesalers, franchisee networks, etc.) to cover the "last mile" to the ultimate consumer, from a competition law perspective, the relevant point is the one at which economic activity occurs between any two given legal entities.

Under competition rules, these legal relationships can either be categorized as "horizontal" (where they occur between entities operating at the same level of the supply chain) or "vertical" (where they occur between entities operating at different levels of the supply chain). Across jurisdictions, horizontal agreements such as cartels are treated more severely than vertical restraints, and are considered to be illegal *per se*. In India, cartels are presumed to cause an appreciable adverse effect on competition (but this presumption is rebuttable).[2] On the other hand, testing the legality of vertical restraints requires a balancing test between their efficiency-enhancing, pro-competitive effects and their anti-competitive effects (a so-called "rule of reason" approach).

But what happens when in a typical supply chain, a manufacturer operates at both the manufacturing level and the distribution level (alongside independent distributors), such that, from a demand-side perspective, consumers regard them as two alternative sources of supply for the same product or brand?

In antitrust parlance, such hybrid distribution models are commonly known as dual-distribution models. On the one hand, the manufacturer acts as a supplier of the product to its independent distributors (with whom it has vertical relationships). On the other hand, the manufacturer also distributes the product directly to consumers and therefore operates at the same level in the supply chain as its independent distributors (and therefore also has horizontal relationships with them).

Over decades, the fundamental quandary for courts has always been (and continues to be) whether restraints imposed by a dual distributor on its independent distributors should be viewed as being horizontal or vertical in nature. A further question is whether the "source" of the restraint (i.e. whether it was imposed by the manufacturer, or by the independent distributors) is a determining factor, or whether the purpose and economic effect of the restraint is more relevant for a meaningful assessment.

It is important to note that a routine exclusive distribution or supply restraint in a pure-play distribution arrangement is typically assessed under a straightforward and settled rule of reason test. This is because, as described above, vertical agreements can have both pro- and anti-competitive effects. On the one hand, they can result in benefits to consumers, and improve production and distribution processes. But on the other hand, they can create entry barriers, foreclose competition, etc.[3] As such, a blanket *per se* prohibition should not be applied to such agreements, since this type of rule is best limited to restraints that always (or almost always) restrict competition and/or decrease output of goods or services.[4]

However, would the rules of the game change simply because a manufacturer doubles up as a distributor? Against this background, this article seeks to briefly outline case law trends in

the treatment of such hybrid distribution restrictions in other jurisdictions and queries their implications for Indian enforcement.

Exploring International Jurisprudence

Historically, both vertical price- and non-price restraints were tested under a *per se* rule in most jurisdictions. One of the earliest cases concerning dual distribution was *United States v. McKesson & Robbins, Inc.* ("McKesson").[5] McKesson was one of the largest manufacturers of drugs in the U.S. It distributed drugs through independent wholesalers, but also operated as a wholesaler itself. McKesson had entered into so-called "fair trade" agreements with independent wholesalers to set the resale price of drugs. The U.S. Supreme Court held that these agreements were horizontal in nature. The Supreme Court reasoned that, in essence, McKesson, as a dual distributor, competed with each of the wholesalers with which it had agreements. Thus, the arrangement was horizontal rather than vertical.

Progressively, following authoritative rulings in the U.S., which held that vertical restraints required assessment under the rule of reason approach,[6] the trend gradually shifted towards assessing vertical restraints (or at least non-price vertical restraints) in dual distribution models under the rule of reason approach.[7] In this regard, one of the earliest and most significant cases was *Norman E. Krehl, et al. v. Baskin-Robbins Ice Cream Co., et al.* ("Baskin Robbins").[8] Baskin-Robbins had a dual distribution model, whereby it licensed its trademarks and formulae to independent ice cream manufacturers (which exclusively operated as area franchisors in assigned territories), and also operated as an area franchisor itself in certain reserved territories. It was held that this arrangement could not be assessed under the *per se* rule in the absence of evidence of collusion between Baskin-Robbins and its area franchisors to allocate or fix territories. The Court held that the allocation of territories was a unilateral decision by Baskin-Robbins, without any coercion or requests by the other area franchisors, and without any hindrance to inter-brand competition. Notably, an increase in inter-brand competition was a relevant factor in the Court's assessment. It noted that Baskin-Robbins' distribution system had in fact resulted in the expansion of its business to new territories and had increased the promotion and availability of its products.

Similar rulings were also given in the context of price-related restraints. For instance, in *Jacobs v. Tempur-Pedic Int'l, Inc.* ("Jacobs"),[9] the defendant ("TPX") was a mattress manufacturer that sold its products on its own website, but also through third-party distributors. Interestingly, TPX sold the mattresses at the same price as its distributors. It was alleged that TPX had entered into price-fixing agreements with its distributors, containing both vertical and horizontal restraints. It was argued that the restraints completely foreclosed price competition in the downstream market, and that there was barely any price variance between mattresses sold either through third-party distributors' brick-and-mortar stores or on TPX's own website.

In its ruling, the Court held that although TPX (as a dual distributor) used vertical minimum resale price agreements, both TPX and its third-party distributors nonetheless independently set their own prices. The fact that these prices were similar was because TPX's direct sales (through its website) acted as a sort of "enforcement mechanism" to keep a check on prices charged by distributors. Thus, if distributors raised their prices above the minimum resale price set by TPX, consumers would automatically shift and purchase almost exclusively from TPX's website, thereby driving the distributors out of business.

In the same vein, it was economically advantageous for TPX to sell (through its website) at the agreed minimum price, as any price reduction would affect its distributors' business. As such, the commercial significance of maintaining distributor showrooms for consumers to test the mattresses before purchasing was crucial for TPX to maintain price parity. Put another way, the court noted that the allegations raised competing inferences of conscious parallelism and independent business judgment/economic interest. Given that price parallelism by itself was not sufficient to establish horizontal price fixing, the court dismissed the complaint in the absence of additional evidence to demonstrate that, somehow, TPX and its distributors signaled to each other and coordinated price adjustments.

The ruling in *Jacobs* is significant in the context of the growing trend for manufacturers to rely on e-commerce channels, given that having both a conventional physical store and an online sales channel has now become the "new normal."

Cartel Risks – How Can They Arise?

While the case law cited above demonstrates a progressive trend towards adopting a rule of reason approach in assessing dual distribution restraints, the primary dilemma of sorting dual distribution arrangements into the "horizontal" and "vertical" categories continues to confound antitrust authorities worldwide.

In 2016, in stark contrast to the case law trend analyzed above, the High Court of Australia ("High Court") in *ACCC v. Flight Centre Limited* ("Flight Centre")[10] held that Flight Centre, a travel agent for international airlines/carriers (that offered air ticket booking services to customers) had attempted to collude with carriers (dual distributors of air tickets through direct website sales) by inducing them not to offer price discounts through their direct sales channels. Despite the presence of an agency relationship, the High Court observed that Flight Centre and the international carriers operated in the same market (i.e. the market for supply of international airline tickets) and directly competed with one another. As such, from a consumer perspective, both were competitors in the same relevant market, and the attempt to collude on price impeded competition.

To arrive at this conclusion, the High Court primarily focused on two crucial aspects: (i) the fact that Flight Centre exercised pricing discretion over the tickets it sold to customers; and (ii) the scope of the authority given to Flight Centre by the international carriers insofar as it was free to act/operate in its own best interests.

A 2016 consent order by the U.S. Federal Trade Commission ("FTC") involving a dual distribution model follows in a similar vein. Fortiline LLC ("Fortiline"), a U.S. ductile iron pipe distributor,[11] was charged with "invitation to collude" with its competitor (a manufacturer/dual distributor). In short, Fortiline distributed iron pipes from several players including those of a certain company ("Manufacturer "A"), which was also a direct distributor in the market. While the FTC recognized the importance of market and price-related communications between a manufacturer and its distributor(s), it noted that Fortiline's invitation to collude with Manufacturer A was an attempt to fix prices across the board, and therefore impeded horizontal competition. As such, any pro-competitive benefits or improvement in inter-brand competition emanating from Fortiline's vertical relationship with Manufacturer A could not shield it from a finding of price collusion contrary to Section 5 of the U.S. FTC Act.

Ultimately, the FTC approved a consent agreement whereby Fortiline, among other things, was prohibited from entering into or soliciting agreements with competing distributors to fix prices or allocate markets. The agreement contained an exception permitting communications between Fortiline and manufacturers to the extent necessary to achieve the pro-competitive benefits of a lawful manufacturer-distributor relationship, and for negotiating/entering into sale/purchase agreements.

These rulings show that antitrust risks in dual distribution models depend on the facts, and a case-by-case assessment is required to assess their legality. The cases also emphasize that the presence of an agency relationship may not necessarily immunize parties from the applicability of antitrust principles if the principal and the agent are found to compete in the downstream market.

The Indian Position

While there has been no Indian case law thus far dealing specifically with the issue of dual distribution, it may be worthwhile to briefly discuss the CCI's recent decision in *In Re*: *Anticompetitive conduct in the Dry-Cell Batteries Market in India* (the "Batteries Case").[12]

Here, the CCI held that Panasonic Energy India Company Limited ("Panasonic India") and Godrej and Boyce Manufacturing Co. Ltd. ("Godrej") (jointly, the "Parties") were engaged in a price fixing cartel. The Parties had entered into a product supply agreement ("PSA") for institutional sales of dry cell batteries from Panasonic India to Godrej, pursuant to which Godrej would rebrand the batteries under its own name for resale. The PSA required both Parties to maintain price parity between their respective brands, and not to jeopardize each other's market interests. Additionally, the PSA also stipulated that both Parties were "independent principals," and that it did not create a joint venture, partnership, or agency agreement. The Parties argued that they were not cartelizing, given that the PSA was a supply arrangement and should therefore be considered (at most) to be a "vertical" agreement.

However, the CCI dismissed these arguments, and held that the Parties were engaged in a price-fixing cartel. To this end, the CCI observed that, from a demand-side perspective, Panasonic's distribution arm and Godrej were in a horizontal relationship and acted as independent competitors with separate brands, even though the products were manufactured by the same party (i.e. Panasonic India). Therefore, the PSA, which created price parity between two different brands, could not be viewed as vertical resale price maintenance between a buyer and a seller.

The Batteries Case is significant, in that the CCI arguably "pierced the veil" of an ostensibly vertical relationship by examining it as a horizontal agreement based on its substance and intent. The distinctive feature of this case is the presence of two separate market-facing brands competing with each other, as opposed to a typical dual distribution model where the product or brand remains the same – but is merely available to consumers via both the manufacturer (directly) and independent distributors. However, another school of thought suggests that the CCI's reasoning in the Batteries Case may have muddied the waters by treating a vertical pricing restraint as a cartel.

The Road Ahead

Today, e-commerce has made it extremely convenient for manufacturers to reach out directly to their consumers. Businesses now routinely adopt dual-distribution and multi-distribution models where the primary manufacturer has a direct presence in the downstream market through company-owned outlets, or online channels. This metamorphosis has rendered previously straightforward relationships between stakeholders and business partners complex. Such redefined roles have also obscured the lens under which such relationships were traditionally viewed.

Based on the evolving jurisprudence, it appears that while engaging in dual distribution in itself is not prohibited, direct competition between a manufacturer and its distribution channels requires scrutiny under competition rules to ascertain the intent behind certain restraints and the true character of seemingly harmless arrangements. Typically, the competition assessment of distribution restraints takes into account the effects of the restraint on inter-brand competition, considering its direct impact on and relevance to consumers. Whether or not the same principle should be extended to intra-brand competition is a material question for dual distribution.

Although trends in recent case law suggest that the relationship between a manufacturer and an independent distributor in a dual distribution model is primarily vertical in nature (requiring a rule of reason assessment), there is no bright-line test to govern all types of seemingly innocuous vertical agreements. As such, until clarity is provided by antitrust regulators on the treatment of dual distribution models, it is too soon to foretell their definitive fate. Given the rapidly changing business environment, it is recommended that an assessment of dual- or multi-channel distribution models be undertaken to evaluate the efficiencies and potential threats they present. It is small wonder that an increased number of distribution channels can enhance customer reach and result in tangible efficiencies. That said, lack of sufficient care in entering into such arrangements without an adequate rationale, and without putting in place appropriate safeguards, could compromise their legality, and raise antitrust risks for manufacturers and distributors alike.

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[1] Anisha Chand is a Partner in the Competition law practice group of Khaitan & Co., Mumbai. She is reachable at anisha.chand@khaitanco.com, and Anmol Awasthi is an associate in the Competition law practice group of Khaitan & Co., Mumbai. She is reachable at anmol.awasthi@khaitanco.com.

[2] Section 3(3), Competition Act, 2002 (the "Act").

[3] For example, *see* Section 19(3) of the Act.

[4] *Business Electronics Corp.* v. *Sharp Electronics Corp.*, 485 U. S. 717 (1988).

[5] 351 U.S. 305 (1956).

[6] *Continental T V, Inc. v. GTE Sylvania, Inc.;* 433 U.S. 36, (1977); *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

[7] *Red Diamond Supply v. Liquid Carbonic Corp.,* 637 F.2d 1001 (5th Cir. 1981); *H & B Equip. Co. v. Int'l Harvester Co.,* 577 F.2d 239, 245 (5th Cir. 1978).

[8] 664 F.2d 1348 (9th Cir. 1982).

[9] 626 F.3d 1327 (11th Cir. 2010).

[10] 2016 [HCA] 49.

[11] *In the Matter of Fortiline, LLC*, FTC File No. 151 0000, Docket No. C-4592, FTC (September 23, 2016).

[12] *Suo motu* Case No. 3 of 2017, CCI (January 15, 2019).