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Vertical Restraints: A Look Ahead

By Vinicius Marques de Carvalho, Marcos Paulo Verissimo, and Paulo Burnier da Silveira[1]

Competition authorities worldwide are constantly facing the challenges involved in the design of an effective competition policy towards vertical restraints. This may be explained by two main reasons. First, vertical restraints are ambiguous by nature, since they may cause anticompetitive impacts and, at the same time, generate important efficiencies. Secondly, vertical restraints may take a large variety of forms, such as resale price maintenance, exclusivity clauses, loyalty discounts and tie-in sales, which may all produce similar effects. In general, vertical restraints are simply viewed as competition restrictions in commercial agreements at different levels of the production and distribution chains, as opposed to horizontal restraints which are related to agreements between direct competitors.

In addition, one may ask if developing countries should take the opportunity to address particular problems in designing their competition policy towards vertical restraints. In a certain way, a possible lenient approach of certain developed countries towards some vertical restraints may be justified by their placement in a given economy, which may not be the same when analyzed through a different set of economic standards. Developing countries may need to contextualize their approach to vertical restraints considering particular elements, such as a recent introduction of competition in certain sectors, a history of economic concentration, the presence of state-owned enterprises and regulatory restraints in some markets, a weak capacity of innovation, as well as inequality in general and the need to foster mobility and access.

This paper will first analyze the current Brazilian framework for vertical restraints, including the new Brazilian legal provisions for vertical restraints control and a few past cases analyzed by the Brazilian Administrative Council for Economic Defense – CADE (I). Then, a look ahead of vertical restraints through the lens of resale price maintenance (RPM) practices will be carried out, considering RPM practices just recently had its first case condemnation in Brazil - this should likely indicate a direction for future similar cases (II).

I. THE CURRENT BRAZILIAN FRAMEWORK FOR VERTICAL RESTRAINTS

The new Brazilian Competition Act (Law nº 12,529 from 30 November 2011) states which practices shall be deemed unlawful:

> Art. 36. The acts under any circumstance, which have as object or may have the following effects, shall be considered violations to the economic order, regardless of fault, even if not achieved:

I – to limit, restrain or in any way injure free competition or free initiative;
II – to control the relevant market of goods or services;
III – to arbitrarily increase profits, and
IV – to abusively exercise a dominant position.

The Brazilian legislation establishes that practices which have as object, or that may lead to effects indicated above, shall be considered illegal from a competitive point of view. This instantly raises the question of measuring the effects for the purpose above, which could possibly include the extension of costs and benefits to consumers, companies and competition. It also raises the question of the possibility of a *per se* condemnation by simple proof of an unlawful practice by its object. The *per se* approach has been applicable to certain cartel cases and it reduces or eliminates the ambiguity addressed in the introduction of this paper, since it does not open the possibility for compensation through possible efficiencies.

The Brazilian experience demonstrates that vertical restraints correspond to less than 10 percent of CADE's total condemnations. Nevertheless, case law indicates a certain consistency for the general approach to vertical restraints, which is usually analyzed through a rule of reason approach based on three steps: (i) confirmation of the existence of market power; (ii) potential negative effects of anticompetitive conducts, such as the creation of barriers to entry; and (iii) efficiencies. The analysis is thus carried out by balancing the economic justifications of the conduct against its negative anticompetitive effects.

CADE's case law indicates that vertical restraints condemnations have been issued under the forms of exclusivity, refusal to sell, rebound discounts, price discrimination, and, just recently, Resale Price Maintenance (RPM) practices.

For instance, in 2004, the former Secretariat of Economic Law (SDE for its acronym in Portuguese) initiated an Administrative Proceedings against AmBev, a company that owns the main brands of the commercialized beers in Brazil, to investigate if its loyalty program named "*Tô Contigo*" could produce anticompetitive effects in the market. The program basically established that the sale shops could earn points, depending on the amount and type of beers acquired, which could later be exchanged for gifts. Thus, from a formal point of view, the loyalty program would be a simple linear program of awarding. However, inspections and market inquiries showed that AmBev demanded exclusivity from the sale shops as a requisite to participate in the loyalty program. At the end of the investigation, SDE concluded that the loyalty program had an anticompetitive potential, as it reduced the degree of contestability in the market and artificially increased the barriers to entry. Thus, in March 2007, the process was sent to CADE with a suggestion of conviction for abuse of dominant position and, in July 2009, CADE imposed on AmBev, among other sanctions, a fine of around R$352 million, which was, at that time, recognized as the biggest fine in CADE's history.[2]

Another important case concerns the exclusivity agreements between the construction company Odebrecht and suppliers of hydroelectric turbines (GE, Alstom, VA Tech and Voith Siemens). The agreements unduly foreclosed the participation of these companies in an important auction for the granting of a hydroelectric plant concession by the Madeira River in the Amazon region. The investigations were undertaken by the former SDE and the case was settled by CADE in 2007. As a result, the price for energy was substantially lower than the reserve

price, which resulted in savings of around R$16 billion for Brazilian consumers over the total 30-years concession contract granted to Odebrecht.[3]

II. A LOOK AHEAD THROUGH THE LENS OF RPM PRACTICES

RPM practices are a controversial topic in the antitrust community. Traditionally, competition authorities have dealt with RPM either as a *per se* infringement, or by a "rule of reason" approach, since they differ on their assessment of their pro- or anticompetitive effects. In fact, many economists claim that RPM practices may have positive impacts on distribution chains, for instance by reinforcing inter-brand competition. However, many competition authorities remain skeptical when it comes to the possible efficiencies generated by this kind of vertical restriction.

The Brazilian Administrative Council for Economic Defense (CADE) has recently issued an important decision that will likely guide its assessment of RPM practices. Its importance lies in the intense debate held amongst CADE's Commissioners who attempted to identify a cornerstone policy. CADE condemned a company under RPM practices and decided that the company must prove economic efficiency gains if the retail price fixing is to be lawful.

This article analyzes the potential Brazilian policy towards RPM practices. It will first analyze the general debate on the adequate approach towards RPM conduct - that is, to treat it as a *per se* infringement as opposed to a rule of reason approach (A). Then, it will focus on the aforementioned Brazilian case in an attempt at drawing a forecast and conclusions (B).

A. Debate between *per se*, or rule of reason, approaches

Academics have often argued that RPM can be typified under diametrically opposite, binary lenses: either the "rule of reason" or the *per se"* approach. If a jurisdiction adopted the rule of reason approach in its "hardcore version," following the definition given by the academic works of the Chicago School, then the Public Administration would have the integral burden of proving, on a case-by-case scenario, that a given conduct concretely produced negative economic effects to the general welfare. On the other hand, if the *per se* approach was adopted, and thus an illegality of the practice itself, there would be no consideration of the abstract potential of a given conduct to produce negative effects – or, even, the consideration of eventual counterproofs that demonstrated efficiencies capable of overcoming the potential negative effects.

A COMPARATIVE STUDY SEEMS TO INDICATE THAT COMPETITION AUTHORITIES ANALYZE RPM CASES AS SOMEWHERE IN BETWEEN THE PER SE ILLEGALITY AND THE RULE OF REASON APPROACH FOR LEGALITY.

Nevertheless, from a practical standpoint, this seems to be essentially an academic debate, and it would be inaccurate to build a jurisprudence based on this classical dichotomy. A comparative study seems to indicate that competition authorities analyze RPM cases as somewhere in between the *per se* illegality and the rule of reason approach for legality. In addition, most jurisdictions apply a rigorous approach to RPM practices, namely the minimum RPM where a minimum price is fixed for retailers, often with penalties to those who sell above the established price due to high anticompetitive risks that this kind of practice encompasses.

In order to sustain the argument that there is no clear dichotomy – as for practical grounds – between these two approaches, it is important to analyze the main jurisdictions worldwide to empirically perceive how the competition authorities analyze RPM cases. Thus, this section will analyze past decisions in the United States, European Union, Austria, Germany, France, and the United Kingdom, especially based on the recent OECD roundtable discussions published in 2009.

The American jurisprudence has sensitively changed through time. Regarding the first relevant case on RPM, the 1911's *Dr. Miles Medical Co. v. John D. Park & Sons Co.,* the US Supreme Court understood that RPM should be presumed as illicit in every circumstance, because its own object is unreasonable – which many have considered as a *per se* rule, even though some may argue that this analysis is simplistic. The Court's decision was in accordance with the Sherman Act, which proscribes unreasonable restrictions to trade. More than 50 years later, 1977's *Continental T.V., Inc. v. GTE Sylvania, Inc.*, became a cornerstone case with a strong influence from the Chicago School presenting, in this sense, a typical hardcore rule of reason-based decision. However, as it will be further analyzed, it imposes an expensive and hard-to-fulfill burden to the Public Administration that could be comparable to a *per se* rule regime which considered RPM to be licit.

Most recently, in 2007, the case of *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, inaugurated a less stringent form of rule of reason analysis, postulating a new problem: which form of rule of reason should be applied to RPM cases? Whilst the question remains unanswered, it is safe to state that the US most recent jurisprudence stopped considering RPM, *iure et de iure,* as presumably illicit, and began to subject RPM conducts to reasonable standards that still need to be defined by the Supreme Court.

In regard to the European Union, RPM is generally considered to be a hard core restriction, which is presumed to be anti-competitive. However, the EU also follows the same intermediate standard between absolute presumption of illegality and the submission of the conduct to a case-by-case analysis of its negative effects, since it accepts taking into consideration the effects. For this reason, some consider the EU's position as being rule of reason-based, but it is certainly much different from the one seen in American case-law: the case-by-case analysis only occurs in exceptional circumstances, where it is fundamentally the defendant's burden to be able to prove the efficiency of the particular RPM practice – which must be plausible and present, and unachievable through other means. The reason behind this exemption regime's existence is the highly suspicious character of RPM practices, especially minimum RPM ones, and its potentially anticompetitive aspects despite the market shares.

Austria follows the steps of the EU and presumes the illegality of minimum RPM conducts, and even of calculation guides to prices, margins, or discounts, unless it is proven that they are solely suggestive and that there was no intent of enforcement of those suggestions.

As for Germany, minimum RPM is expressly prohibited by competition law, requiring only a minimum level of "substantiality" for the conduct to be punished.

France also understands that minimum RPM is, practically speaking, presumed as hampering to competition and, for that, considers it illicit, and requires proof on the effective application of prices by distributors and on the implementation of control mechanisms by suppliers. No proof on the conduct's effective impact on competition is necessary, though.

On its behalf, the United Kingdom had multiple cases of condemnation for minimum RPM under the presumption of negative consequences to competition. In addition, 1998's UK Competition Act backs up such decisions, accepting exceptions only under very specific market conditions that would be able to remove, in its entirety, this presumption.

Other countries that present similar rules regarding minimum RPM include Belgium, Ireland, Italy, Spain, Czech Republic, Denmark, and Estonia. For instance, in Australia, Canada, China, Greece, Israel, Bulgaria, Lithuania, Colombia, Japan, and Korea, confirmation of minimum RPM *per se* is sufficient for the condemnation of the indicted. Therefore, it is safe to affirm that an expressive number of antitrust authorities worldwide consider minimum RPM to be a "hard core" restriction, resorting to multiple presumptions of its illegality and distinguishing between the treatment of minimum RPM and maximum RPM and/or price suggestion.

B. A pragmatic approach to "*per se*" or rule of reason debate

As mentioned, CADE has recently issued an important decision on RPM practices that may serve as guidance for future analyses of this conduct (CADE's administrative proceeding nº 08012.001271/2001-44). The administrative judgment started in 2009 after a few years of investigations carried out by the former Secretariat of Economic Law (known as "SDE" for its Portuguese acronym) over a minimum RPM practice promoted by the Brazilian SKF company with its commercial retailers. The company confirmed that it "collaborated" for the adoption of the "proceeding," and that the initiative to implement the RPM came from its network of distributors. It also failed to demonstrate the inexistence of unilateral or coordinated market power, considering that SKF had more than 20 percent of market shares on two of the four analyzed markets, including bearing and monitoring equipment in which the company's economic group had already been condemned for anticompetitive practices in France.

Despite these elements, CADE's Commissioners differed on the determination of the illegality of the conduct, particularly due to the analysis of its anticompetitive effects. While two Commissioners, including the first Reporting Commissioner, sustained that the RPM practice did not generate any anticompetitive effect, the rest of the Board argued for the condemnation of the company stating that the latter failed to demonstrate the positive impacts, in particular economic efficiency gain of the practice. For this reason, the Brazilian company SKF was fined to the amount of 1 percent of the company's revenues.

On economics grounds, it would not be adequate to simply prohibit the fixing of resale prices in all cases, as a classical *per se* approach, without admitting any kind of defense or exception. Yet, it would also be illogical to submit every RPM conduct case to a test of negative effects. This would be an unnecessary use of costly public resources, given the high probability that the conduct is anticompetitive. For this reason, the burden of efficiency gain should fall on the companies, and not the other way around in which the burden belongs to competition authorities to prove the anticompetitive effects of the RPM practice.

The decision enabled CADE to discuss and determine at which intermediate point the presumptions and standards of proof should be settled, rather than to focus on the academic debate of what category – *per se* or rule of reason – should be used to analyze the case, so that RPM practices could be clearly punished. Before this case, a careful and systematic analysis of how to deal with this kind of conduct had not been done in Brazil. The establishment of

standards in this area is particularly necessary, especially at its most "suspect" angle, which is a minimum RPM practice carried out by an agent who holds significant market share (under Brazilian legislation, 20 percent of a given market). Given the circumstances above, it seems that neither a "rule of reason" nor a "*per se*" rule approach would be able to deal properly with the case. As mentioned, the two classical approaches do not seem to be technically in opposition, but instead seem to be extremes of the same spectrum of intensity; the simple application of either in a concrete case may lead to undesirable consequences.

One may label CADE's decision either as a rule of reason or an illicit *per se* approach. From an enforcer standpoint, this is irrelevant. What is relevant is the consolidation of the understanding that CADE will consider minimum RPM practices as presumably illegal. Of course, this implies an *iuris tantum* presumption, where companies are entitled to prove the economic efficiencies of the conduct, knowing in advance that this must be clearly demonstrated since RPM practices continue to be considered with skepticism for their competition advantages.

ONE MAY LABEL CADE'S DECISION EITHER AS A RULE OF REASON OR AN ILLICIT PER SE APPROACH. FROM AN ENFORCER STANDPOINT, THIS IS IRRELEVANT.

III. CONCLUSION

Vertical restraints may take shape under different forms, such as exclusivity, refusal to sell, loyalty discounts, price discrimination, and RPM practices. Even though these practices should capture special attention of competition enforcers, the Brazilian experience demonstrates that they correspond to less than 10 percent of CADE's total condemnations. Just recently, in 2013, CADE issued its first decision concerning RPM practices, and it is likely to serve as guidance for future cases in this field, namely for the methodology employed in the use of the rule of reason versus *per se* approaches.

Indeed, the debate between a *per se* or a rule of reason approach is interesting and stimulating, particularly in academic circles. However, from an enforcer standpoint, it seems that it is a false dichotomy, since competition analyses will always make some sort of rule of reason approach. What may radically change is how to weigh the presumption of legality, or illegality, of a particular conduct. CADE has recently issued an important decision on minimum RPM practices, which enables CADE to send an important message to companies, since any behavior that is a restriction directly related to price may be targeted by the regulator, given that there is certain skepticism on the efficiencies that outweigh the anticompetitive risks. This case indicates that its denouement would have been the same from both the *per se* and the rule of reason, in its *Sylvania* conception, approaches. By transferring the burden of proof from the Public Administration to the defendant, under economic and legal grounds, it was possible for CADE to not only condemn this anticompetitive practice, but also to define its own standards regarding minimum RPM for future cases.

INDEED, THE DEBATE BETWEEN A PER SE OR A RULE OF REASON APPROACH IS INTERESTING AND STIMULATING, PARTICULARLY IN ACADEMIC CIRCLES. HOWEVER, FROM AN ENFORCER STANDPOINT, IT SEEMS THAT IT IS A FALSE DICHOTOMY, SINCE COMPETITION ANALYSES WILL ALWAYS MAKE SOME SORT OF RULE OF REASON APPROACH.

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2. CADE's Administrative Proceding nº 08012.003805/2004-10.

3. CADE's Administrative Proceding nº 08012.008678/2007-98.