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Basic Elements for Analyzing Resale Price Maintenance

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I. INTRODUCTION

There are two main views espoused by scholars on how to apply Article 14 of China's Anti-Monopoly Law ("AML"), which covers vertical agreements. The first view is that the current case law in the United States ("U.S.") at the federal level should be followed, whose guiding principle is the "rule of reason." Following that framework, the burden of proof falls on the plaintiff to prove the existence of a vertical agreement and that the agreement restricts competition.

The second view is that European Union ("EU") law should be used a reference, which could be described as providing a "presumption of illegality, subject to the possibility of exemption." Under the EU framework, vertical agreements are presumed illegal, unless the defendant succeeds in proving that one of the exemption reasons in Article 15 of the AML applies.[2]

As can be seen, these two views refer to different sets of rules and do not allocate the burden of proof in the same way. Nonetheless, neither of the two approaches follows a rule of "*per se* prohibition" of vertical agreements. Both types of approaches are meant to address the same question, and their common starting point is that vertical agreements are not inevitably illegal. This then begs the question of which criteria—*i.e.*, which specific factors—are relevant to determine the legality of a vertical agreement. These questions touch upon the very substance of vertical price agreements and, more importantly, the administration of justice in private litigation. Unfortunately, these questions have not received sufficient attention by academia and other stakeholders in China.

This paper argues that, for antitrust law to intervene, a resale price maintenance ("RPM") practice—including the setting of a fixed- or a minimum-resale price—must produce restrictive effects on competition that cannot be overcome or offset. In addition, it is necessary to examine the following four most important factors to assess whether or not an RPM practice is legal:

- whether there is sufficient competition in the relevant market;
- whether the defendant has a strong market position;

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[2] Huang Yong, *Resale price maintenance agreements and the path for law enforcement analysis*, Price Theory and Practice No. 12 (2012).

- the defendant's motives for engaging in RPM; and
- the RPM's effect in practice.

These factors will be addressed in more detail on the pages that follow.

II. DEGREE OF COMPETITION IN THE RELEVANT MARKET

In a sufficiently competitive market—for example, the apparel market—there are many operators competing with each other, making it difficult for manufacturers of different brands to engage in tacit collusion on pricing. In that industry, it would be even more difficult to reach an—express or implicit—agreement on prices. Hence, in a fully competitive market, economics suggest that it would not be feasible to establish a cartel on the manufacturers' or distributors' level through vertical pricing agreements.

Moreover, if the relevant market is sufficiently competitive, consumers have adequate alternatives. For example, if—for some reason—a company decides to set a fixed- or minimum-resale price for its product, this may have the effect of somewhat reducing the number of consumers who are willing to purchase the product. But consumers can still select other manufacturers' products that may be cheaper, or more expensive but of higher quality. Under such circumstances, consumer interests are not harmed and economic efficiency has not been diminished.

Yet in a market that lacks sufficient competition, users will rely on a particular brand or several brands if there is an insufficient number of alternatives. If a particular brand manufacturer decides to set a price floor for its product, then there will be a loss of intra-brand price competition. But the RPM conduct may also facilitate a tacit agreement on prices among different brands. Alternatively, even if there is no tacit agreement on prices, the effect of the RPM practice may still cause market prices to rise or remain at a high level. This, in turn, would harm consumer interests and society's overall welfare.

Therefore, an analysis of the degree of competition in the relevant market must be the first step—a pre-requisite—for holding an RPM agreement to be an illegal monopoly agreement. Only if the conclusion is that the market is characterized by insufficient competition, does it become necessary to conduct a further examination into the competitive effects of the allegedly anticompetitive agreement.

As for the analysis of whether the relevant market is sufficiently competitive, all circumstances of the specific case should be considered. This does not only include the degree of market concentration, but also requires examination of the substitutes for the products in question, the degree of difficulty for potential competitors to enter the market, competition in the downstream market, and other factors that affect the degree of competition in the relevant market.

III. EXISTENCE OF A STRONG MARKET POSITION

At the outset, it should be pointed out that Articles 13 and 14 of the AML—on "monopoly agreements"—and Article 17—on "abuse of a dominant market position"—use different benchmarks as to the market positions of the companies involved. In particular, Article 17

requires that a company have a dominant market position for its conduct to be held abusive and hence illegal.

In contrast, Articles 13 and 14 do not require a company to have a dominant position. The reason is that Article 17 addresses unilateral conduct by a single market player, while Articles 13 and 14 target joint conduct by various business operators. Both types of conduct can only be held illegal if they lead to anticompetitive effects that must be remedied through antitrust enforcement. However, the requirements as to the market positions of the companies at issue are not the same. As a result, it is not necessary to show that the perpetrator has a dominant position for RPM to be illegal.

That said, however, a company's market position is the basis for its pricing behavior, which will in turn influence market competition. For companies suspected of RPM that have a strong market position and are able to influence competition in the relevant market, that position is a pre-requisite for a finding of a monopoly agreement.

If a company does not have a strong market position, it will not have the power to influence competition to an appreciable degree but is usually only a "follower." Such a company is likely incapable of "dominating" competition in the relevant market. If a company's market share, raw material supply, key technologies, sales channels, brands, and other aspects do not indicate any advantages it would enjoy, then it does not have the power to influence market competition. If a company in those circumstances adopts a RPM policy, it will not be able to affect competition in the market. Even if its RPM policy did influence competition in the market—but only in the short run and to an insignificant degree—then this influence would be quickly corrected by market forces themselves.

In short, this type of RPM practice should not create the need for antitrust enforcement to remove any anticompetitive effects. As a result, it becomes clear that the showing of a strong market position should be a pre-requisite—and basis—for determining that RPM has anticompetitive effects. Viewed from a different angle—an illegal monopoly agreement may only exist if the RPM policy is practiced by a company which already enjoys a certain degree of market power that is equivalent to a "strong market position."

This paper argues that companies' pricing power is mainly determined by their market position and the degree of market concentration. A company has a strong market position that enables it to influence competition in the market if it:

- has significant pricing power;
- has an absolute advantage in price negotiations with buyers; and
- is unconstrained in setting prices, without having to follow market prices, while the pricing practices of other operators in the relevant market are constrained.

If after adopting RPM a company's market share does not decrease—or even increases—this will be an indication of its strong market position. However, the opposite is not true—the fact that a company's market share decreases after establishing an RPM policy does not mean it has no strong market position.

It should be noted that, among the four factors mentioned above, the first two—*i.e.*, that the market is not sufficiently competitive, and that the company at issue has a strong market position—are indispensable elements for holding that a specific RPM practice constitutes a monopoly agreement.

Actually, this approach is equivalent to using the market structure as a screening criterion for the antitrust review of RPM agreements—an approach that draws upon the case law developed in other countries.[3] This is especially relevant in China, given the state of development of China's market economy, which is still in transition. RPM is prevalent in many industries, and hence using market structure as a screening criterion helps identify and prevent those practices that genuinely harm market competition.[4]

IV. MOTIVE FOR ENGAGING IN RESALE PRICE MAINTENANCE

In the midst of complex market activities, motives and actual conduct do not always overlap. Moreover, it is difficult to clearly identify motives, or "intent."

However, if a company in a strong market position displays anticompetitive intent through employing its strengths—such as financial resources, technology, information, etc.—and is able to significantly influence upstream and downstream market activities, then its RPM practice is even more likely to produce anticompetitive effects.

As a result, even though it is impossible to characterize the intent to restrict competition as a pre-condition for determining that RPM has anticompetitive effects—thus constituting a monopoly agreement—it is still possible to consider intent as an important element in analyzing RPM.

The motives behind a company's fixing of resale prices or minimum resale prices may be beneficial to market competition and consumers—for example, improving services, maintaining a brand's image, promoting new brands and products, etc. Conversely, the motives may be to achieve goals that are not beneficial to market competition and consumers—for example, seeking to organize a price-fixing cartel, using the company's market power to obtain high profits or drive out competitors, abusing its dominant market position to engage in price discrimination, etc.

In an actual case, the analysis of whether the defendant had the intent to engage in RPM conduct should include a careful examination of the specific evidence put forward.

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[3] In the *Leegin* case in the United Stated, the Supreme Court considered the following three elements when assessing the legality of RPM clauses: (1) was the RPM initiated by upstream manufacturers or downstream retailers; (2) do the manufacturers or retailers party to the RPM agreement have market power; and (3) does the RPM agreement facilitate a cartel? *Leegin Creative Leather Products Inc. v. PSKS Inc*., 551 U.S. 877 (2007), p. 897-898. American scholars Phillip E. Areeda and Herbert Hovenkamp put forth that, in relation to RPM cases, it is possible to examine the following seven elements when carrying out a rule of reason analysis: concentration on the manufacturers' level and distributors' level, market coverage of the RPM, the distributor's motives, brand strength, the distributor's dominant position, selective use of RPM, and degree of homogeneity of products. PHILLP E AREEDA & HOWARD HOVENKAMP, ANTITRUST LAW (2ND ED.), NEW YORK, ASPEN PUBLISHERS, 2004, p. 328-329, quoted from SANDRA MARCO COLINO, VERTICAL AGREEMENTS AND COMPETITION LAW – A COMPARATIVE STUDY OF THE EU AND US REGIMES, OXFORD AND PORTLAND, OREGON (2010), p. 85-87.

[4] Li Jian & Tang Fei, *Illegality and regulation of resale price maintenance*, Contemporary Law No. 6 (2010).

Some people will wonder why intent should be a factor at all if harm to competition is an objective judgment. This paper's response is that, first, while we must bear in mind the possible disconnect between the motive and the conduct's actual effects, intent to bring about harm to competition is merely an ancillary—but still important—element in the antitrust analysis. Intent need not be considered a pre-condition for determining that RPM constitutes a monopoly agreement, and is not a "fact" that the plaintiff must prove. Second, it should also be recognized that—irrespective of whether it is backed by regulations—the analysis of intent can be an important factor in RPM cases.[5]

V. EFFECT OF RESALE PRICE MAINTENANCE IN PRACTICE

RPM can create a variety of negative effects on competition; conversely, it may lead to a number of positive effects that promote competition.

Clearly, RPM does not always lead to a negative outcome. On the one hand, as the market has a certain capacity to "heal itself," some anticompetitive effects can be corrected swiftly by market forces themselves. On the other hand, when positive and negative effects on competition are simultaneously present, the anticompetitive effects may be outweighed by the pro-competitive effects.

Antitrust law should only intervene against those negative effects on competition that are difficult to be "corrected" by the market itself and are not outweighed by pro-competitive effects. Therefore, when analyzing the competitive effects of RPM, one needs to look at both the positive and negative effects that substantially impact market competition.

A. Negative Effects Arising From Restrictions to Price Competition

In current economic literature, RPM is considered to have the following negative effects on competition:

1. restrict intra-brand price competition and reduce consumer welfare;
2. restrict distributors' pricing freedom, thus making it impossible for efficient distributors to distinguish themselves;
3. facilitate manufacturer or distributor cartels, thus restricting inter-brand competition;
4. improve distribution services where consumers want to obtain lower prices, not high-quality services;

[5] In the *Monsanto* case, the U.S. Supreme Court took the view that the court of appeals applied an incorrect evidentiary standard. The fact that Monsanto terminated the plaintiff's sales agreement upon complaints by other distributors was not sufficient to permit the conclusion that Monsanto and other distributors concluded agreements or acted jointly. From a manufacturer's perspective, distributors are an important source of information. Their complaints about cost-cutters normally occur in the course of business. As such, it is necessary to have direct or indirect evidence reasonably proving that the manufacturer and others intentionally conspired to achieve an illegal objective. Only then can it be determined that the manufacturer and the distributors acted jointly in fixing prices. The court's opinion addresses an evidentiary standards issue. From a different perspective, it is a way to re-construct "bad faith" on the manufacturer's part through pieces of evidence. After the *Leegin* case, when applying the rule of reason, explanations and evidence related to the defendant's motives became an important factor to be considered by the courts.

5. with intra-brand price competition eliminated—and if there are no other ways to compete—there is a possibility that distributors engage in inefficient competition by investing in high-cost advertising and packaging; and
6. the elimination of intra-brand price competition might give distributors incentives to resort to commercial bribery or other improper means in order to compete.

Points (4) and (5) above involve "excessive" services, advertising, packaging, and other problems of inefficient competition. The market can self-correct these problems, thus making it unnecessary to initiate antitrust enforcement to tackle them.

As for the problems of “improper” competition mentioned in point (6) above, they rely on a few assumptions. For example, in an actual case, it needs to be carefully examined whether distributors do not have legitimate means to compete and—even taking into account the risk of sanctions—distributors believe that the benefits to be obtained through “improper” means outweigh costs, etc.

Points (1) to (3) above directly or indirectly influence intra-brand and inter-brand price competition. As price is the most important mechanism for companies to compete in the marketplace, restrictions on pricing are more serious than non-pricing restrictions. Hence, the concerns expressed in these points become important elements in the analysis of RPM agreements.

B. Positive Effects Arising From Improvements to Product/Service Quality, Promotion of New Products, or New Entry Into The Market

The economic literature also considers that RPM can produce positive effects on market competition, such as:

1. prevent distributors from engaging in free-riding between each other;
2. help protect the reputation of manufacturers, distributors and their products, as well as reassure consumers of product quality;
3. give consumers a basis for comparing prices, by avoiding inconsistent retail prices;
4. protect small-scale distributors by safeguarding their profits and prevent market power by large-scale distributors and dealer concentration, as well as prevent arbitrage between distributors, thus helping to build a distribution network;
5. where distributors sell products of multiple manufacturers, RPM by one manufacturer can give distributors an incentive to sell its products, as well as protect against competitors that might offer discounts;
6. where uncertainty exists in the market, reduce risks for distributors in relation to inventory and sales volume and help new manufacturers and products enter the market; and
7. enhance competition between manufacturers in terms of product quality, and increase the quality level.

Looking at the above factors in more detail, point (1) recognizes that free-riding can negatively affect sales of a manufacturer if its distributors that do not provide services (such as

advertising, product introduction, or promotion, etc.) use discounts to lure away customers from those distributors that do provide services. Hence, the prevention of free-riding can contribute to the improvement of distribution services. However, point (1) assumes that there is aggressive price competition, and the potential for arbitrage, between distributors.

The protection of brands and products—discussed in points (2) and (3)—enables consumers to obtain reliable information on prices. Conversely, in instances where buyers are quite familiar with the products in question, there is no obvious need for this protection.

In my view, the argument relating to the development of distributor networks—as mentioned in point (4) above—may not provide any benefits to consumers.

The argument in point (5) assumes that distributors sell products of multiple manufacturers and that there is aggressive price competition at the distributor level.

Finally, I believe the arguments that RPM has positive effects on competition due to its improvement of product and service quality and facilitation of market entry for new products and manufacturers are perhaps better than other reasons.

C. Comparative Assessment With Overall Consumer Welfare as Objective

When RPM displays both positive and negative effects on competition, it is difficult to accurately measure and balance the "size" of these effects in the antitrust analysis. It thus becomes necessary to have a clear benchmark when evaluating the positive and negative effects of RPM.

Article 1 of the AML indicates that the law pursues multiple objectives such as protecting fair market competition, promoting efficiency of economic operations, safeguarding consumer welfare and the public interest, etc. However, for the analysis of RPM conduct, the most important legislative objective is to protect consumer welfare.

This is illustrated by the text of Article 15 of the AML. Article 15 provides the possibility to “exempt” an agreement for specified reasons, disapplying the RPM prohibition in Article 14. But the provision also requires that a company arguing for an exemption "prove that the concluded agreement does not significantly restrict competition in the relevant market, and allows consumers a share of the resulting benefit." Hence, the last condition for proving that Article 14 does not apply—*i.e.*, consumers are able to enjoy a share of the benefits resulting from the agreement—shows that overall consumer welfare is the key benchmark for applying Article 14.

With overall consumer welfare as benchmark for the analysis, we need to be (more) attentive to the long-term impact of RPM on consumer welfare:

1. In the long run, price is the core mechanism for market competition, providing consumers with the most important right to choose. In a market with effective competition—that is, a market where price mechanisms play a normal role—consumers are the ultimate decision-makers. Consumers always select the most important product in terms of quality, service, and price. Their choices improve competition based on multiple factors including quality, service, and price, to their benefit.
2. In the long run, if companies with significant market power or a dominant market position set the lowest prices for their products on supra-competitive levels, then

competitors will be attracted by the high margins and engage in competition. However, while the ultimate outcome possibly benefits competitors, consumers will have no choice but to accept higher prices during the process it takes for competitors to (re-)position themselves, to the detriment of consumer welfare.

3. In the long run, the improvement of product quality, the launch of new products, and the arrival of new entrants can increase the number of options for consumers, and may compensate for any reduced choice which consumers endure in the short run. This potentially outweighs or removes the RPM conduct's negative effects on competition that occur in the short run. Such an outcome could be considered as a long-term positive effect.

It may be possible to simplify the principles used in evaluating the effects of RPM agreements: if such agreements do not have the negative effect of restricting price competition, then they can generally be considered not to constitute a monopoly agreement. If agreements do have this effect, but do not improve product quality and services or promote the entry of new products or companies, then they can generally be considered to be an illegal monopoly agreement.