VERTICAL RESTRAINTS VERSUS HORIZONTAL AGREEMENTS IN THE MANUFACTURER-DISTRIBUTOR RELATIONSHIP

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I. INTRODUCTION

Since the enforcement of the Anti-Monopoly Law ("AML") in China on August 1, 2008, there have been several high-profile antitrust litigations involving vertical restraints in the manufacturer-distributor relationship. In China vertical restraints are also called vertical monopoly agreements in the context of the AML. In the first and foremost case ruled in 2013, *Beijing Rainbow v. Johnson & Johnson*, the Shanghai Higher Court set precedence of applying the "rule of reason" doctrine in the cases involving vertical monopoly agreements, as opposed to the more common "*per se* illegal" doctrine that is widely applied in situations of vertical monopoly agreements in China. The Shanghai Higher Court emphasized the need for the plaintiff to bear the burden of proof in providing not only evidence of the existence of the agreement behavior (resale price maintenance in this case), but more importantly, also analysis and corresponding evidence that such conduct precludes and limits competition as per Article 14 of the AML.[2] The seventy-one page final verdict from the Shanghai Higher Court specifically mentioned four aspects in the analysis that the plaintiff needs to demonstrate in discerning the legality of a vertical agreement: (1) the relevant market lacks adequate competition; (2) the defendant holds significant market power in the relevant market; (3) the defendant has clear motivation to preclude and restrict competition in maintaining the resale price; and (4) the defendant has indeed achieved its objective of precluding and restricting competition from the perspective of actual outcome.

Understandably, the high standard established in the *Beijing Rainbow v. Johnson & Johnson* case vis-à-vis the "*per se* illegal" doctrine that was typically used in previous situations of vertical monopoly agreements greatly raises the bar for the distributor to resolve conflicts with its producer in the court of law, although the distributor can also resort to the administrative antitrust enforcement via the National Development and Reform Commission ("NDRC"), which is one of the three antitrust law enforcement agencies in China and is responsible for going after price-related antitrust violations. Notably, the NDRC has repeatedly maintained its position that resale price maintenance ("RPM") is a *per-se* illegal matter and particularly its own enforcement actions should not be influenced by the court rulings. This generates an interesting legal landscape where the judicial and the administrative wings of the AML enforcement have different legal

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2 Article 14 of the AML prohibits any of the following agreements among business operators and their trading parties: (1) fixing the price of commodities for resale to a third party; (2) restricting the minimum price of commodities for resale to a third party; or (3) other monopoly agreements as determined by the Anti-Monopoly Authority under the State Council.

standards, which may provide incentives for related litigants to take different legal approaches. Cases like this tend to blur the boundary between vertical and horizontal monopoly agreements in manufacturer-distributor relationships.

II. CASE BACKGROUND

A recent lawsuit brought against Panasonic Electronics at the Shanghai No. 1 Intermediate People's Court is a case in point.[3] Panasonic Electronics in China sells a set of factory automation control equipment including mostly programmable logic controllers ("PLC"), low voltage electric transformers and generic sensors. The company's contractual relationship with its distributors covers a critical charter document that regulates the management of its end customers. The document, called "Panasonic Eastern China End Customer Management Charter," essentially establishes a client protection system, whereby important and quality clients are protected from being approached by other distributors who previously do not have a business relationship with these clients. When a distributor approaches a prospective client, he needs to first check with a database regarding these clients' information, to make sure this particular prospective client is not in the list already belonging to another distributor. The protection is essentially in the form of a RPM practice where other distributors' quoting prices to a protected client have to be at least 15 percent higher than the standard distributor-suggested-price from Panasonic. This mechanism makes sure that the quoted price of an unrelated distributor is uncompetitive, and thus protects the incumbent distributor.

The client protection database is constantly updated such that non-active clients for a period of time are downgraded to another database including a list of prospective clients. Client entries in the second prospective client database are entered by Panasonic's distributors, who are entitled to protection for a maximum of three months. That means other distributors are not supposed to approach those prospective clients in this list. If no transaction takes place after three months, this client is taken off the list and becomes available to any distributor.

In 2014, the plaintiff, Rijin Electric Co., which is one of Panasonic's regional distributors, brought Panasonic together with two other distributors to court for allegedly forming a monopoly agreement for a market division scheme. The major reason behind the allegation is that the plaintiff was penalized by Panasonic for violating the business practice regulation which was mutually agreed upon and articulated in the End Customer Management Charter. Initially the plaintiff was vague on what particular type of monopoly agreement it was referring to, specifically with respect to the vertical monopoly agreement as referred to Article 14 of the AML or with respect to the horizontal monopoly agreement as referred to Article 13 of the AML.[4] Later on, the plaintiff switched to a horizontal monopoly agreement allegation during the rest of the trial. The court clarified in its decision that the case involved an action whose legality belongs to the realm of vertical monopoly agreement instead, and dismissed all anti-competitive allegations and damage claims brought by the plaintiff.

III. CASE ANALYSIS

The Provisions of the Supreme People's Court on Several Issues Concerning the Application of Law in Civil Dispute Cases Arising out of Monopolistic Conduct ("Provisions") have allocated a higher burden of proof on defendants under horizontal monopoly agreements than under vertical monopoly agreements.[5] Article 7 of the Provisions relates to monopoly agreements such as horizontal price-fixing agreements or other cartel conducts prohibited by Article 13 of the AML, and provides that once a plaintiff proves the existence of such

3 *Shanghai Rijin v. Panasonic Electronics*, Civil Judgment of Shanghai No. 1 Intermediate People's Court, (2014) HU YI ZHONG MIN WU (ZHI) CHU ZI No. 120, June 29, 2016, available at: http://cclp.sjtu.edu.cn/Show.aspx?info_lb=672&info_id=3943&flag=648.

4 Article 13 of the AML prohibits any of the following monopoly agreements among the competing business operators: (1) fixing or changing prices of commodities; (2) limiting the output or sales of commodities; (3) dividing the sales market or the raw material procurement market; (4) restricting the purchase of new technology or new facilities or the development of new technology or new products; (5) making boycott transactions; (6) other monopoly agreements as determined by the Anti-Monopoly Authority under the State Council. For the purposes of this Law, "monopoly agreements" refer to agreements, decisions or other concerted actions which eliminate or restrict competition.

5 Article 7 of the Provisions states that "when the alleged monopolistic conduct is found to be the monopolistic agreement stipulated in Article 13 (1) to (5) of the AML, the defendant shall undertake the burden of proof that the alleged monopolistic agreement doesn't have the effect of eliminating or restricting competition." See the Supreme People's Court, *Provisions of the Supreme People's Court on Several Issues Concerning the Application of Law in Civil Dispute Cases Arising out of Monopolistic Conduct*, May 8, 2012, Chinese version available at: http://www.chinacourt.org/law/detail/2012/05/id/145752.shtml. The significance of the Provisions is discussed in Supreme People's Court Judge Li Zhu's article. See Li Zhu, New Developments in Civil Antitrust Litigation in China, Antitrust Chronicle, January 2012, available at: https://www.competitionpolicyinternational.com/assets/Uploads/ZhuLiJAN-4.pdf.

an agreement, that agreement will be presumed to have the effect of eliminating or restricting competition unless the defendant can provide evidence rebutting this presumption. Apparently, the approach of horizontal monopoly agreements that the plaintiff has chosen aimed to move more burden of proof to the defendant, no matter if it is relevant to the case or not. Regardless of claims the plaintiff brought to the court, the dispute resolved around the manufacturer-distributor relationship. Therefore, the defendant's legal team offered a vertical restraints defense during the first court appearance. The economics expert team postulated several arguments that the pricing requirement of 15 percent premium to protected clients does not constitute the RPM practice, and the actual outcome of the practice is far from a complete market division.

First, the client protection database does not apply to all of the distributors' clients, but only applies to those clients who are important and of high quality. That means only these clients who show a track record of repeated purchases in significant amounts are protected. Thus only a subset of the market is singled out for protection, resulting in an incomplete division of the market, if it can be called "market division" at all. Consequently, the so-called RPM practice does not apply to all clients in the market, but only applies to a small subset. A distributor is free to quote its own prices to prospective clients who are not in the client protection list. More importantly, the list of protected clients in the database keeps changing overtime. If a client places no order for a period of time, usually after three months, he would be eliminated from the list and become available to other distributors.

Second, the 15-percent overpricing practice does not withstand the "rule-of-reason" analysis under the analytic framework established in the *Beijing Rainbow v. Johnson & Johnson* case. That is, the relevant market for PLC and other related electronics equipment is highly competitive where the HHIs were well below 1400 for three consecutive years from 2011 to 2013, while Panasonic's market share was well below 10 percent, entailing hardly any significant market power. On the motivation issue, Panasonic's implementation of a client protection system clearly has merits of preventing distributors' free-riding behavior as opposed to the intention to preclude and limit competition. This is because the sale of PLC and related electronics equipment involves a fair amount of pre-sales and post-sales activities whose costs can sometimes run as much as 15 percent of the total costs. Typically, the distributor needs to understand the equipment's intended working environment and its particular application, work out an involved specification document, add or modify the equipment's software, install the equipment, conduct testing and offer other after-sales services. In a nutshell the distributor is offering a customized solution as opposed to simply reselling PLC equipment. In terms of the actual effect of precluding and limiting competition, the total impact of the defendant's practice on the entire market competition is minimal at best. This is because the impact on the intra-brand competition is modest, but on the contrary, more likely conducive to competition among its distributors, let alone on the inter-brand competition with the defendant's less than 10 percent market share.

Understandably these are fairly strong pro-RPM arguments very much in favor of the defendant. Facing the probable prospect of losing the lawsuit, the plaintiff's legal team switched gear in the second court appearance to pursue the horizontal monopoly agreements allegation under Article 13 of the AML. The plaintiff's team decided to take this avenue against the presiding judge's warning ahead of the second court appearance that a horizontal relationship for a manufacturer-distributor dispute case may not be relevant nor appropriate to a fundamentally upstream-downstream relationship. The plaintiff insisted that the defendant played a leading role in organizing a horizontal monopoly agreement among its distributors via the vehicle of the End Customer Management Charter, and was effectively engaged in forming a cartel for market division, which is explicitly prohibited in a statutory manner by Article 13 (3) of the AML. The two distributor co-defendants were alleged as participants of this cartel.

In the second expert witness report to rebut the plaintiff's horizontal monopoly agreement position, there were essentially two arguments. First, the End Customer Management Charter at issue was not an agreement jointly signed among the defendant's distributors, but rather an agreement signed individually and mutually between the defendant and its distributors. In other words, it regulated a vertical contractual relationship as opposed to a horizontal relationship that is typically characterized by competition among signing parties. Distributors had not been previously engaged in mutual discussions or negotiations in formulating the agreement, nor had they provided any inputs into the final agreement draft. Therefore, Article 13 of the AML, which is pointedly concerned with horizontal monopoly agreement, simply does not apply to this case. Second, Article 13(3) of the AML indeed prohibits market division. But the statutory meaning of the market in this instance refers to the entire relevant market that encompassed other competing brands from competing firms. Therefore, even if a subset of market division within one brand indeed holds, it did not constitute a market division in the relevant market that the statutory language in Article 13(3) refers to. Therefore, this kind of client protection practice was not illegal. On the contrary, it was a common practice in the defendant's industry around the world.

On June 29, 2016, the court entered a judgment, which dismissed all of the plaintiff's allegations against the defendants. The judge agreed with the defendants' position that Article 13 of the AML did not apply in this case. He further wrote in the verdict that even if a horizontal agreement among parallel members (meaning distributors) within a vertical relationship possibly precluded and limited intra-brand competition, meaning the competition among distributors of the same producer, such an agreement might not extend to harm inter-brand competition of the entire market. Thus a horizontal agreement within a vertical relationship may not be such a kind of horizontal monopoly agreement prohibited in Article 13 of the AML. He further went on to state that only competing parties owning different brands and forming a horizontal agreement could possibly preclude and limit competition, and Article 13 of the AML should only apply to those circumstances.

It might be arguable in the judge's position that horizontal monopoly agreements meeting Article 13's definition could only exist among competing parties owning different brands. Moreover, the court's position might be pointedly in conflict with the approach taken by the NDRC. For example, in 2013 the local branch of the NDRC in Hubei Province found that FAW Volkswagen, which is an automobile joint venture company in China, organized ten local dealers in the city of Wuhan, Hubei Province, to jointly sign an agreement in writing that essentially fixed prices for new Audi cars, auto parts and components and car repairs.[6] The Hubei branch of the NDRC ruled that FAW Volkswagen violated Article 13 of the AML and fined FAW Volkswagen and all the signatory dealer parties. Certainly this is not the first time in China that the judicial and the administrative antitrust law enforcement entities took inconsistent legal positions.

IV. CONCLUSION

The core matter in this case is that the End Customer Management Charter in no way qualifies as a horizontal monopoly agreement, for various reasons we have articulated above. Thus, Article 13 of the AML simply should not apply. Even though the court reached the same conclusion as ours, the reasoning behind it however was quite different. The court clearly accepted it as a horizontal monopoly agreement, but stated such an agreement was within a vertical relationship and within the same brand, and is thus not the same kind of horizontal monopoly agreement that Article 13 is intended to outlaw.

The ruling in this case begs the question as to how a manufacturer-distributor conflict shall be handled by courts in the future as to whether it should be resolved under the framework of Article 13 or Article 14 of the AML. This question probably applies to the competition agencies as well. This ruling appears to leave the impression that any manufacturer-initiated restraint to manage its distributors falls in danger of becoming a horizontal monopoly agreement, albeit within a vertical relationship.

In our opinion, conflicts arising from manufacturer-distributor relationships could be complex, and may not always fall into the realm of a vertical relationship, and do not always have to be necessarily regulated by Article 14 of the AML. In the *Panasonic* case, we take the position that Article 14 should apply, while Article 13 should apply in the *FAW Volkswagen* case. But the four-point analytic framework established in the *Beijing Rainbow v. Johnson & Johnson* case[7] is decidedly fundamental to determine the legality of a vertical monopoly agreement.

6 Decision of Administrative Penalty (*FAW Volkswagen*), E JIA JIAN CHU [2014] No. 14, Hubei Province Price Bureau, August 18, 2014, http://www.hbpic.gov.cn/zwgk/gfwj/xzxkhcf/201701/t20170110_23774.html.

7 *Beijing Rainbow v. Johnson & Johnson*, Civil Decision of Shanghai Higher People's Court, (2012) HU GAO MIN SAN (ZHI) ZHONG ZI No. 63, August 1, 2013, available at: http://ipr.court.gov.cn/sh/ld/201309/t20130927_157023.html.