CHINA'S *EASTMAN* CASE: A NON-EXCLUSIVE VIEW ON EXCLUSIVE DEALING?

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I. INTRODUCTION

In April 2019, almost a year after the merger of the three former antitrust agencies, China's State Administration for Market Regulation (the "SAMR") published an administrative sanction decision (the "Sanction Decision") against Eastman Chemical (China) Co., Ltd ("Eastman China"), a multinational chemical company (the "*Eastman* Case"). SAMR's local branch in Shanghai (the "SHAMR") imposed a fine of approximately USD 3.5 million (RMB 24.38 million) for abuse of dominance through exclusive dealing measures and other trade restrictions in violation of Article 17.1(4) of PRC's Anti-Monopoly Law (the "AML").

The antitrust agency determined that Eastman China held a dominant position in the relevant market for the supply of CS-12 coalescent (a type of additive used in latex paints) in China from 2013 to 2015. Eastman China implemented two sets of exclusivity arrangements, which effectively forced customers to purchase most or all CS-12 coalescent from Eastman China and therefore restricted these customers from trading with other competitors. Specifically:

- Eastman China entered into long-term contracts with six direct sales customers (collectively referred to as Company A), which included a minimum purchase obligation for two to three years (the "Minimum Quantity Clause"). In order to enforce the Minimum Quantity Clause, Eastman China also included an obligation in the contract requiring Company A to either take the minimum quantities or make payment for such minimum quantities (the "Take-or-Pay Clause").

- Separately, Eastman China entered into a long-term agreement with Company B, pursuant to which Company B would be entitled most favored nation ("MFN") terms in the global sales territories of Eastman if the total amount of coalescent purchased by Company B from Eastman China accounted for more than a certain percentage of its total demand (the "MFN Clause"). In addition, Eastman China reached an ancillary sales incentive agreement with Company B and offered additional sales discounts.

II. MFN CLAUSES AS A MEANS OF ACHIEVING EXCLUSIVITY

Even though the adoption of MFN terms in the *Eastman* Case was heavily scrutinized, the competition assessment clarified that MFN clauses would only attract such scrutiny under specific circumstances. MFNs are often ambivalent and not systematically anticompetitive. In particular, MFN clauses may only raise concerns where there is market power and where such clauses are adopted as part of a wider set of multiple measures to achieve exclusivity. In the *Eastman* Case, MFN clauses were implemented alongside a number of other measures to achieve exclusivity. A clear focus on market power and competitive harm, as articulated in the *Eastman* Case, is a sensible approach to the assessment of MFN clauses.

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A. MFN Clauses will Generally not Attract Scrutiny in China Unless there is Market Power

An MFN clause typically represents an arrangement in vertical agreements between buyers and sellers whereby the seller guarantees that the buyer will receive the best price or terms for a product or service compared to its competitors. In particular circumstances, such clauses may raise antitrust concerns where sellers are prevented from lowering their prices, and where beneficiaries of MFN clauses have little incentive to compete with each other.

In China, MFN clauses are unlikely to raise such concerns where there is a lack of market power by the parties or where markets are not concentrated. So far, other than this case where MFN is viewed as a means for a dominant firm to implement an exclusivity arrangement, there have been no regulations or precedents addressing MFN clauses. The recently promulgated Interim Provisions for Monopolistic Agreements introduced a catch-all provision that could allow China's antitrust agency to look at exclusivity arrangements, including MFN clauses, outside dominance and in the context of anticompetitive agreements. In light of these recent changes, there may be greater scope for enforcement actions against MFN clauses, including on the basis of possible collusion or vertical restraints on pricing in markets adopting MFN clauses as a common practice (i.e. for two-sided or multi-sided markets or oligopoly markets).

In jurisdictions outside China, MFN clauses can still attract horizontal and vertical issues in the absence of dominance:

- MFN clauses may facilitate collusion amongst competitors, as displayed by Apple's *e-book* case in the United States where MFN clauses were found to have been utilized by Apple to facilitate "hub-and-spoke" collusion amongst publishers to raise the price of e-books;

- MFN clauses may also decrease a seller's motivation to reduce prices and damage other undertakings' freedom to determine their own prices, which may generate anticompetitive effects similar to resale price maintenance. Germany's Federal Cartel Office, for instance, found that MFNs could reduce intrabrand price competition. In its online hotel bookings investigation, the Federal Cartel Office considered that hotels would be reluctant to offer lower prices in light of an MFN scheme being in place.[2]

B. MFN Clauses Alone are Unlikely to be Presumed Anticompetitive and Abusive

The adoption of MFN clauses by dominant undertakings is not presumed to be abusive and will be judged under a rule of reason analysis.[3] The Sanction Decision acknowledges that "a global MFN Agreement may not give rise to the effect of restricting transactions." In the *Eastman* Case, the antitrust agency classified the arrangements entered into between Eastman China and its customers as the "MFN Agreement", even though it might be better described as exclusivity arrangements which involved a most-favored nation regime, minimum quantity obligations, and loyalty discounts. Notably, the MFN Clause itself was insufficient to generate the anticompetitive effects of foreclosure and restricting competition. Instead, the Sanction Decision clarifies that it is the combination and aggregation of all the above arrangements in the *Eastman* Case that render the conduct as a whole incompatible with the AML.

Eastman China achieved exclusivity through minimum purchase obligations, take-or-pay arrangements, and incremental purchase discounts above and beyond the MFN regime:

- Minimum quantity forcing and Take-or-Pay. The Take-or-Pay Clause and the Minimum Quantity Clause were considered forms of exclusivity measures in the *Eastman* Case. The antitrust agency pointed out that "the anticompetitive effects in this case are enhanced by the Take-or-Pay Agreement and the MFN Agreement. Considering Eastman China imposed exorbitant minimum quantity requirements in both of the abovementioned exclusivity agreements, which created onerous compulsory obligations in respect of purchase quantity in the long term, and rendered it obviously difficult for transaction counterparties [customers] to change suppliers."

2 Similar MFN clauses have been condemned by other antitrust agencies. In the literature, Fletcher & Hviid suggest that retail price MFC clauses can be seen as equivalent to the worst of RPM and should not be treated any less harshly than RPM. See Amelia Fletcher & Morten Hviid, Retail Price MFNs: Are They RPM "At Its Worst"? 2 (ESRC Ctr. for Competition Pol'y, Working Paper No. 14-5, 2014) at 32.

3 See Taking Eastman Monopoly Case as an example: the investigation and handling of abuse of dominant market position case, China Market Supervision News, July 9, 2019. Senior officials responsible for the *Eastman* Case investigation explained that "… for the same business conduct, when it is implemented by different undertakings, under different market conditions, or in different geographic markets, it may produce completely distinct results. Therefore, the antitrust agencies, when pursuing this type of cases, should conduct their analysis by taking into account various factors and should follow the principles of case-by-case analysis and rule of reason."

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- Incremental purchase discounts. Another exclusivity measure were sales discounts implemented by Eastman China. A supplementary incentive agreement provided that "a sales discount, in addition to the most-favored price, would be offered to Company B, on the condition that certain product purchase quantity had to be reached in a particular regional market." Eastman China offered an incremental purchase discount on the basis of the lowest price level. Under such conditions, no other competitors in China were able to match the price level offered by Eastman China. Company B would only purchase CS-12 coalescent from Eastman China during the term of the agreement alongside a minimum purchase quantity obligation that locked-in 75 percent of the product demand of Company B in China.

III. INCREASED RISK AS A RESULT OF ADDITIONAL LOYALTY DISCOUNTS

The "MFN Agreement" by Eastman China also offered additional sales discounts, which in a broad sense were a type of loyalty rebate program, which raised exclusive dealing concerns in combination with a range of other measures. In terms of the analysis, the *Eastman* Case applied the well-established "as-efficient competitor" test adopted in the *Tetra Pak* Case to determine the possible anticompetitive effects arising from the MFN Agreement. In particular, the Sanction Decision noted that "under such conditions, no other competitors in China were able to match the discount and other favorable conditions under the most-favored-nation treatment." Such "other" favorable conditions were contemplated in a separate incentive agreement which detailed the sales discounts at agreed levels/percentages to be paid to customers on the condition that certain product purchase quantities were met.

A. Narrowly Defined Loyalty Discounts under the Tetra Pak *Case*

In 2016, one of the former antitrust agencies, the State Administration for Industry and Commerce (the "SAIC") imposed a fine of RMB 668 million (USD 96.3 million) on Tetra Pak for conduct involving tying, exclusive dealing, and loyalty discounts that were found to eliminate and restrict competition (the "*Tetra Pak* Case"). This was the first time China's antitrust authorities elaborated on their position on loyalty discounts, finding that Tetra Pak had implemented tens of different types of discounts including retroactive cumulative volume discounts and customized targeted discounts (also known as retroactive discounts with single thresholds).

Tetra Pak's retroactive discount scheme offered customers discounts in accordance with preset thresholds based on the total volume of packaging material purchased from Tetra Pak in a given year. SAIC noted that the anticompetitive effects of the retroactive discounts stem from their ability to lock-in the purchases of a specific customer and convert this previously contestable demand into non-contestable demand. A critical feature of the retroactive discount is the lack of incentive to switch to alternative suppliers before qualifying for the rebate. Therefore, "the setting of intervals between different thresholds and ranges of discounts are of critical importance to the inducing effect." In other jurisdictions such as EU and US, loyalty discounts imposed by dominant undertakings are not presumed illegal. This includes the recent *Intel* decision[4] in 2017 where the European Court of Justice applied the rule of reason to set aside the General Court's quasi-per-se test for loyalty rebates. The US antitrust regime treats loyalty discounts in a more lenient manner based on rules that govern predatory pricing.

In China, there is no doubt that the retroactive and customized targeted discounts carry higher risks than basic incremental discounts. However, not all rebate/discount schemes that meet the basic characteristics of these retroactive cumulative discounts are automatically prohibited by the AML. To determine their competitive harm, the effects of the discounts need to be assessed in light of factors including the size of the non-contestable demand, the design of the discount, the market conditions, etc.

B. A Broader Take on Loyalty Discounts in the Eastman *Case*

The Sanction Decision does not characterize the sales discounts included in the arrangements of Eastman China. They could be similar to the retroactive cumulative volume discounts in the *Tetra Pak* Case or simply incremental discounts. Regardless, SHAMR may at least consider them to be "loyalty discounts in a wide sense" by inducing customers to purchase more products through discounts or preferential trading conditions, the outcome of which is to lock-in purchase quantities and demand.

4 T-286/09, *Intel v. Commission.*

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IV. ANALYZING MFN CLAUSES AND LOYALTY DISCOUNTS IN THE CONTEXT OF EXCLUSIVE DEALING

China's antitrust agency found that Eastman China sought to implement exclusive dealing arrangements by way of a range of measures including the MFN Clause, Take-or-Pay Clause, and the loyalty discounts. Their purpose was to lock in customers' demand which had the effect of foreclosing its competitors. Regardless of the apparent competitive harm that could arise from these arrangements, it is still necessary to analyze their substance and potential effects, in isolation and in aggregation.

Notably, the Sanction Decision precedes the recent promulgation of the Interim Provisions on the Prohibition of Abuse of Dominant Market Position (the "Provisions on Abusive Conduct"). Article 17 not only refers to exclusive dealing in terms of the "direct restrictions" explicitly noted in the Provisions, but also refers to restrictions "in disguised form by imposing [unreasonable] trading conditions." There is a possibility that the antitrust agency may further expand the scope of law enforcement of exclusive dealing and challenge atypical forms (such as the MFN Clause plus minimum quantity purchase obligations in the current case against Eastman China).

In addition, the Provisions on Abusive Conduct detail a number of potential reasons that may justify exclusive dealing, such as "ensuring product quality and safety or protecting intellectual property and specific investments." Although the list of reasons is primarily geared towards establishing a proper purpose for the conduct in question, the broader effects of the conduct need to be taken into account as well. This includes the benefits to counterparties and consumers as well as the broader impact on economic efficiencies. Accordingly, the list of justifiable reasons set out in the Provisions on Abusive Conduct does not operate in isolation and cannot be applied in a formalistic manner. Undertakings may also need to consider the competitive effects of the conduct in question in addition to their purpose based on the list of justifiable reasons.

The Sanction Decision fails to elaborate on any justifications or efficiencies that could have motivated the exclusivity arrangements Eastman China entered into with customers in this case. The Sanction Decision does note that the long-term contracts and exclusivity agreements "can reduce the negotiation costs of the seller and the purchaser to a certain extent" and "make it easier for both parties to transactions to plan purchases and production." However, the antitrust agency held that "they have also brought about the obvious result of restricting transactions and anti-competitive effects, and their negative effects are greater than economic efficiency." Therefore, from the perspective of antitrust compliance, when formulating specific business policies the undertaking should not only refer to the "justifiable reasons" listed in the Provisions on Abusive Conduct, but also engage in a balancing exercise to determine whether any benefits outweigh any possible anticompetitive harms.

V. KEY TAKEAWAYS FROM THE *EASTMAN* CASE

The *Eastman* Case demonstrates that certain trading restrictions will not fall foul of the AML in isolation but may raise concerns in aggregation and on a case-by-case basis, where they can be classified together as measures intended to achieve exclusivity.

A. Capturing Substantial Proportion of Demand will Suffice to be Classified "Exclusive"

Article 17 of the AML describes exclusive dealing as "an undertaking with a dominant market position restricting trade of the counterparties with it or its designated undertakings only." It has so far not been immediately apparent whether an arrangement by a dominant firm to lock-in less than the total market demand could be classified as "exclusive dealing" in violation of the AML. The application of exclusive dealing prohibition by China's antitrust agencies over the last decade prior to the *Eastman* case arose only in the context of obligations that required counterparties to deal with the dominant firm *solely* rather than predominantly or partially. The *Eastman* Case now confirms (although not surprisingly) that the exclusive dealing prohibition under the AML does not require customers to deal entirely with the dominant firm – a substantial proportion of demand can suffice.

Separately, exclusive dealing is condemned where dominant firms lock-in demand of customers in order to maintain or increase their market share and consolidate or strengthen their market power. Eastman China's market share was above 50 percent while the demand of customers locked-in through its exclusivity arrangements accounted for about 20 percent of the total sales volume in the market. In other words, the market demand locked-in by Eastman China's "exclusive dealing" (i.e. 20 percent) was significantly lower than its own market share (i.e. more than 50 percent), which arguably could not have enabled Eastman China to maintain or increase its market share or market power.

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B. Relative Market Power of Other Competitors to Determine Extent of Exclusivity

The structure and specific characteristics of the market are of vital importance. In this case, the specific structure of the relevant market can be divided into two parts: large direct clients with stable demand, and small and medium-sized clients with unstable and scattered demand (mainly supplied through distributors and agents). The antitrust agency determined that Eastman China had locked-in "most demand" (between 60-80 percent) from large direct clients through "exclusive dealing." For small and medium-sized clients, who account for nearly 80 percent of total market demand, Eastman China did not engage in any restrictive dealing arrangements. In that regard, with the characteristics of scattered demand and low orders from individual customers, the other two major competitors active in the relevant market should in principle be able to effectively compete, given the remaining 80 percent of market demand. The Sanction Decision fails to address this point sufficiently. Together, the three undertakings including Eastman China account for about 95 percent of the total market size, demonstrating that Eastman China's competitors had at least relative market power and could have possibly competed for the demand of small and medium-sized customers irrespective of the exclusive dealing arrangements entered into by Eastman China in respect of large direct clients.

C. Risks of Quantity Forcing

As for the type of the minimum quantity clause, it will generally be riskier to agree on the purchase proportion (such as requiring the customer to source 90 percent of its estimated annual demand from the dominant firm) than to agree on the specific purchase volume or purchase value. A minimum quantity clause linked to the customer's overall demand is a more direct restriction on the customers who cannot purchase from dominant firm's competitors (may be similar to the non-contestable demand, the antitrust agency held that "the entry barrier for the locked-in portion of demand is extremely high" in the *Eastman* Case). Further, in case the customer has new and additional demand on top of the original estimate, it may not be able to switch to a new supplier competing with the dominant firm for such new demand when the proportion of total demand (rather than specific volume) is locked. The proportion requirement therefore may further exclude competitors and reduce competition in the relevant market.

D. A Note on the Economic Analysis

The authority in the *Eastman* Case applied econometric tools to help define relevant markets and assess possible anticompetitive effects. This included Critical Loss Analysis to determine the amount of substitution necessary to expand a provisional market definition and the Lerner Index to measure market power by relating price to marginal cost. To a degree, this has increased the predictability, transparency, and sophistication of the authority's enforcement practice, providing an invaluable self-assessment tool in responding to antitrust investigations. Still, the agency took a potentially narrow approach in its economic analysis. For instance, in analyzing the exclusivity arrangements, the agency found it apparent that the absence of the Take-or-Pay Clause would have effectively diminished the level of market power of Eastman China as determined by the Lerner Index, therefore suggesting that the Take-or-Pay Clause itself (rather than the combination of all exclusive arrangements including the MFN Clause) had the effect of eliminating and restricting competition. However, the agency seemed to fail to consider other factors that could have also been relevant here when construing the counterfactual situation. For instance, the systematic impact of the fluctuations of international prices of crude oil on the raw material prices of the relevant products in this case also has a significant influence on the level of competition in the whole market. Further, as marginal costs form the basis of calculating market power under the Lerner Index, it would have also been necessary to compile and compare marginal costs data of comparable homogenous goods of major suppliers in the market. In that regard, the use of econometric models, and their results, will continue to depend on the nature, credibility, and comprehensiveness of the underlying data.

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