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Online Hotel Booking

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Online Hotel Booking

Edurne Navarro Varona & Aarón Hernández Canales[1]

I. INTRODUCTION

Online retail has radically changed consumer behavior in recent years. The booking of hotel rooms has been particularly affected by this new trend. Many travellers currently make hotel reservations directly online, and not through travel agents as they used to. A number of specialized platforms have appeared to help identify the different hotel offers available. The way in which these operate, and the conditions that they apply, have led to several investigations from competition authorities in various European countries. This article will analyze the issues in these matters and the various on-going procedures.

II. MOST FAVORED NATION CLAUSES

At stake are the "Most Favored Nation" or "MFN" clauses that the Online Travel Agents ("OTAs") apply, whereby the Agents should benefit from conditions at least as favorable as those offered on the market (both by hotels and other OTAs).[2]

From a competition law perspective, MFNs can be regarded as positive, since they are likely to lead to lower prices and better conditions for customers. Some efficiency advantages have been pointed out in relation with MFNs: (i) they contribute to eliminating opportunism, making it more difficult for free riders to unfairly exploit the investments done by other players; (ii) they reduce transaction costs between the contracting parties; and (iii) they reduce uncertainty about price fluctuations.

But MFNs can also be deemed to harm competition, as they tend to indirectly create equal terms for all operators, thereby ultimately reducing the ability to make competitive offers. In recent years, their common use in certain economic sectors has raised some concerns of competition authorities around the world. Nevertheless, MFNs must not be considered as intrinsically bad for competition. In fact, no competition authority or court has so far found them *per se* illegal.

The characteristics of the market where these clauses are applied, and the contractual forms under which they are established, must be taken into account in order to assess their legality from a competition law perspective. Most concerns regarding MFNs have been related to online retail services. Such has been the case for eBooks[3] or online car insurance distribution,[4] as well as hotel bookings.

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[2] The MFN concept originated in international trade, where they dictated that commercial agreements between States should apply tariffs not less favourable than those granted to other States.

[3] The U.S. judgement, *United States of America v. Apple Inc., et al., 12 Civ. 2862 (DLC),* stated that contracts between Apple and five book publishers containing MFNs with maximum retail price grids and a 30 percent

III. ONLINE HOTEL BOOKING

Currently, hotels can sell their services through several channels: physically, at the hotel's desk or through traditional travel agencies; and online, through the hotel's own web page or through OTAs. It has been estimated that in Europe, during 2015, 34 percent of hotels' turnover will be made through online reservations. OTAs represent 70 percent of these online hotel reservations, the remaining 30 percent being done through hotel websites. Thus, the OTAs channels represent around 24 percent turnover of the hotels. The commissions paid by the hotels to the OTAs amount to almost 5 percent of the formers' turnover.[5]

OTAs are very important for the functioning of the hotel sector. Furthermore, they are essential for independent hotels, as OTAs allow these smaller hotels to compete on equal terms with larger hotel chains, given that their services are shown, rated, and traded in the same conditions as for the chains.

From an economic point of view, most OTAs are mere intermediaries between hotels and customers. They neither buy nor resell services; therefore, they must be considered as hotels' agents. The hotels themselves hold the responsibility of setting the price and selling conditions for their services and assume the business risks. OTAs are remunerated through the payment of a commission by the hotel. This commission is proportional to the price of the reservation and normally ranges between 10 and 30 percent of the final price paid by costumers.

Sometimes, clients pay for the services directly to the hotel; which then pay the commission to the OTA once the client has made use of the service (the "commission-based model"). In other cases, the clients pay the price directly to the OTA when the booking is made and the latter pays it to the hotel, having deducted its commission (the "merchant model").

Meta-search engines also play an important role in the online booking process. They do not allow hotel reservations, but carry out a comparison of the price of the services offered by OTAs and by hotels in their own websites. Meta-search engines are normally remunerated by click: When a surfer is redirected to an OTA or a hotel website by a meta-search engine, the engine receives a fixed amount.

One of the main characteristics of the online hotel reservation sector is its high concentration, with a few OTAs holding substantial shares of the market. As above-said, under the agency model, the principal (hotel) fixes the resale price of its services and the commission to be paid to the agent (the OTA). OTAs having major market shares enjoy higher bargaining power, given that hotel owners will be interested in operating with them. This could lead to a

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commission for Apple were in breach of competition law. Publishers settled the case offering commitments, but Apple refused to do so, went to trial, and was found guilty of conspiracy to restrain trade under Section 1 of the Sherman Act. Before the European Commission, Apple and eBook retailers offered commitments in case COMP/C-2/39.847. As a result, agency agreements between Apple and retailers were terminated and a 5-year ban on MFNs was imposed. Furthermore, retailers would be free to set retail prices during two years (EC Commitments Decision of 25 July 2013).

[4] The UK's Competition and Markets Authority, in its Order of 18 March 2015, banned MFNs between price comparison websites and car insurers.

[5] *European Online Travel View*, Phocuswright (December 2013). This report, among others, was used by the French Competition Authority in its Decision nº 15-D-06 of 21 April 2015.

price being fixed by the OTA that, by virtue of an MFN, would be extended to the rest of the market players. These smaller market players would be prevented by the contracts signed with hotels from introducing lower prices, even with a charge to their commission.

Moreover, MFNs are often combined with other clauses ensuring enforcement. Some of them allow the OTA to suspend or revoke the contract in case of lack of compliance by the hotel. Another common sanction used by OTAs is the degradation of the position occupied by the infringing hotel within the result pages of the online platform.

IV. CASES IN THE EUROPEAN UNION

Since 2010, competition authorities from ten Member States[6] have launched inquiries regarding MFNs in the online booking sector. In view of the transnational scope of the issue, the European Commission ("EC") has intervened; but, given the differences between national markets and divergences regarding the "theory of harm" in each jurisdiction, the cases have been ultimately dealt with at the national levels to date.

However, several meetings have been held within the framework of the European Competition Network ("ECN") between national officers and the EC, where the latter has ensured coordination in order to achieve consistency among national decisions.

Competition authorities from France, Italy, and Sweden started investigations regarding MFNs in the online booking sector between November 2012 and May 2014. These MFNs covered room availability and reservations made at hotels' desks. On account of these similarities, the authorities were appointed by the ECN to jointly lead the European national procedures regarding MFNs.

An OTA presented a first set of commitments simultaneously to these three national competition authorities in December 2014. The commitments excluded MFNs regarding other OTAs, but allowed MFNs in respect to hotels' own sales channels, only excepting loyalty programs and prices negotiated bilaterally with clients and not published. Room availability clauses also remained in force. A market investigation was launched in December 2014. The commitments were discussed within the ECN.

Finally, the authorities involved jointly rejected the offered commitments and the OTA presented new ones in April 2015. Through them, the OTA has engaged not to continue to apply MFNs, except for rooms sold through hotels' direct online channels or sold at hotels' desks but published online. Availability clauses are also excluded. These amended commitments were accepted by the French, Italian, and Swedish authorities through their respective decisions issued on April 21, 2015.

The British national authority has also dealt with MFNs in the hotel booking sector. It was one of the first European competition authorities to launch a formal investigation on the functioning of the hotel-booking sector, doing so in September 2010. Nevertheless, the former Office for Fair Trading ("OFT") inquiry did not intend to assess the lawfulness of MFN. It was mainly focused on the use, in contracts between two important OTAs and a hotel chain, of resale

[6] Austria, Denmark, France, Germany, Hungary, Ireland, Italy, Sweden, Switzerland, and the United Kingdom.

price maintenance restricting discounts and consequently reducing or eliminating competition in prices.

Furthermore, the authority was concerned about the risk that restrictions on discounting could lead to the creation of important barriers to entry in the online hotel booking market. These barriers would result from new entrants being unable to offer lower prices in order to win market share. Additionally, the OFT was concerned about the possibility of generalization of the controversial clauses in the affected market, which would result in major restrictions or even a total prevention of competition therein.

The companies involved offered commitments to the OFT, which were first rejected and subsequently amended. Through the final commitments, hotels would be allowed to set headline room rates. On the other hand, OTAs would be free to offer discounts over headline room rates fixed by the hotels on the basis of their commission revenue, but only to "closed customers." These are costumers already registered in the OTA system, having made a previous booking through it.

Additionally, OTAs would be able to publicize information regarding discounts without any restriction, except for information related to the hotel chain involved in the case. This information should be available only for "closed costumers." Hotels would also be allowed to offer unlimited discounts to their own "closed costumers" and publicize information regarding discounts over a specific hotel room to them. The scope of application of the final commitments would include hotel bookings made by all EU residents concerning hotels located within the EEA.

During the investigation, concerned parties submitted their views about the efficiencies of the system. Unlimited discounts by OTAs over headline rates could damage hotels' reputations; price being an important reputational indicator for clients. Additionally, free discounts offered by OTAs could lead to harmful effects, such as the reduction of hotels' incentives to distribute their services through OTAs. This would harm inter-brand competition in the market and discourage business innovation.

Furthermore, a greater degree of freedom to offer discounts might jeopardize the benefits for hotels, and consequently for costumers, of yield management. Yield management, as explained by the OFT, "involves sophisticated price modelling to enable providers to discriminate between different customer groups based on their willingness to pay" and "has also been adopted by the hotel industry as a means of maximising revenue."[7] An unlimited capacity by OTAs to offer unlimited rebates would distort price models set by hotels, preventing them from an efficient management of reservations.

Finally, the concerned parties claimed that price freedom could result in the cannibalization of direct sales made by hotels and the raising of their distribution costs. It could also undermine OTAs' incentives to invest in their own platforms; taking into account the possibility for hotels or other OTAs to undercut the former's prices by setting lower ones, given

[7] OFT's Notice of intention to accept binding commitments to remove certain discount restrictions for Online Travel Agents and Invitation to comment, of 9 August 2013, p. 31.

the low search costs for customers in the market. The OFT considered that "some of the arguments put forward for the existence of efficiencies [were] likely to have some merit in this sector."[8]

Final commitments were accepted by the OFT on January 31, 2014, putting an end to the investigation. An appeal was filed by a meta-search engine and the Competition Appeal Tribunal annulled the OFT decision on September 26, 2014 on procedural grounds.

In January, 2010, the German Bundeskartellamt also launched an investigation regarding MFNs applied since 2006 by one of the main OTAs operating in Germany. In this case, the MFNs also covered room availability and were extended to reservations made at hotel desks. On December 20, 2013 a decision declared that these MFNs constituted agreements between companies that prevented or restricted competition.

The Bundeskartellamt concluded that no efficiency gains arose from the application of MFNs, thus they could not benefit costumers. The authority also pointed out some alternative business models that could be more suitable for this case, including the introduction of a service fee payable per customer, a cost-per-click payment, a listing fee, or a fixed monthly fee payable by hotels.

An OTA offered commitments during the investigation, but they were not considered suitable to bring the competition infringement to an end. The inquiry was extended to other OTAs. The decision was appealed before the Higher Regional Court of Düsseldorf, which upheld it on January 9, 2015.

V. CONCLUSION

The outcome of ongoing national procedures concerning online hotel booking will be extremely important for the development of a European common digital market. Accordingly, a consistent approach among national jurisdictions will be required. In the light of the procedures mentioned in this article, close coordination between national authorities might be considered as a suitable way towards consistency.

[8] *Id.* at 40.

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Most Favored Nation Clauses: A French Perspective on the *Booking.com* Case

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Most Favored Nation Clauses: A French Perspective on the *Booking.com* Case

Olivier Billard & Pierre Honoré[1]

I. INTRODUCTION

As e-commerce is soaring, competition authorities across Europe are paying increased attention to the commercial practices of companies regarding their online sales. This trend in enforcement priorities is evidenced in particular by the adoption of the European Commission's 2010 revised Guidelines on Vertical Restraints, the European Court of Justice's 2011 ruling in the *Pierre Fabre* case, the European Commission's 2013 *E-books* commitments decision, and the recent announcement of a sector investigation into e-commerce by Competition Commissioner Margrethe Vestager.

Within this context, the practice that has attracted most attention in recent years is undoubtedly the use of Most Favored Nation clauses ("MFN clauses"), also called "parity clauses," in agreements between online booking platforms and hotels. Pursuant to such clauses, hotels are obliged to offer to their online platform partner at least as favorable terms (price, room capacity, booking conditions, and services offered) as those offered to competing platforms and through other distribution channels, both on- and off-line, irrespective of the level of commission charged by the partner platform. Such clauses are widely used in identical terms by all three major online booking platforms in Europe (Booking, Expedia, and HRS).

In recent years, several national competition authorities have launched investigations into these practices. In 2013, the German Federal Cartel Office ("FCO") issued a decision finding that the MFN clauses contained in agreements concluded between HRS and hotels in Germany infringed article 101 TFEU and the corresponding German provisions. The FCO ordered HRS to cease using such clauses in its contracts, but no fine was imposed.[2]

More recently, the French, Swedish, and Italian competition authorities addressed the issue in parallel procedures that led to the adoption of very similar commitment decisions.[3] No infringement of EU or national competition provisions was found, but Booking.com had to offer significant commitments to appease the national competition authorities' competition concerns. The present article will focus on the decision recently adopted by the French competition authority, the *Autorité de la Concurrence* ("ADLC").

[1] Respectively, Partner and Senior associate at Bredin Prat.

[2] Bundeskartellamt, 20 December 2013, dec. B9-66/10 – HRS.

[3] French Competition Authority decision, n° 15-D-06, 21 April 2015; Swedish Competition Authority decision, 15 April 2015, n° 596/2013; Italian Competition Authority decision, 21 April 2015; respective press releases of 21 April 2015.

II. THE COMPETITION CONCERNS RAISED BY MFN CLAUSES IN THE ONLINE HOTEL RESERVATION SECTOR

A. The Effects of MFN Clauses on Competition

From a competition law standpoint, the assessment of MFN clauses is very fact-specific and depends on the exact terms of the clauses, the market positions of the companies, and the actual functioning of the market. In practice, such clauses may have both pro-competitive and anticompetitive effects.

1. Efficiency Gains

According to economic literature, MFN clauses may produce mainly two types of efficiencies.[4] First, they tend to reduce "search costs" for consumers: once customers have found the product they were looking for online, they do not need to visit alternative platforms in search of a better price.

Second, MFN clauses may also help prevent "free riding" problems: online distributors have an incentive to invest in their platform (for example, by improving the use of the interface, providing additional information, etc.) if they have the guarantee that customers will not use their platform to gather information and then purchase the product from another platform offering lower prices.

By ensuring price uniformity, MFN clauses thus arguably tend to benefit consumers in the forms of improved service and reduced search costs.

2. Potential Anticompetitive Effects

However, MFN clauses may also have various types of anticompetitive effects. In its decision, the ADLC first found that the use of parity clauses may restrict competition between Booking.com and competing platforms insofar as that use suppresses the natural link that normally exists between the price charged by an economic operator (i.e. the commission rate charged by Booking.com to hotels) and the amount of demand that accrues to it (i.e. the number of reservations made on Booking.com's platform).

Indeed, given that hotels are obliged to grant Booking.com terms as favorable as those granted to competing platforms (in terms of price and room capacity), Booking.com may charge higher commission rates without losing demand. Conversely, absent the parity clause, a competing platform could gain market share by lowering its commission rates applied to hotels; the latter would then be able to offer lower prices per room on this competing platform, thus attracting additional consumers and, in turn, additional hotels to the platform.

The ADLC also found that parity clauses may have foreclosure effects on competing platforms, especially on potential new entrants. Indeed, such clauses prevent competing platforms from lowering their commission rates charged to hotels, which could enable them to offer lower prices to online consumers in order to try to reach the critical mass where a sufficient number of consumers attract additional hotels to the platform. Given that they cannot compete on price, they have to compete on notoriety for which Booking.com has a historical competitive

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[4] F. Rosati, *MFN for online platforms: Some key economic issues*, n° 1 CONCURRENCES (2015).

advantage, due to significant network effects as well as its size and ability to get referenced by search engines.

Finally, the ADLC found that the use of such clauses by all online booking platforms entailed a cumulative effect on the market, thus reinforcing the anticompetitive effects described above. According to the ADLC, such clauses could normally be imposed only by platforms with significant market power. However, due to (i) the fragmented nature of the hotel sector, (ii) the fact that online platforms act as "gateways" for hotels to reach consumers on a large scale, and (iii) the need for hotels to distribute through various channels in order to fill their capacity, such clauses are applied by almost all online platforms in France. In this respect, it should be noted that the initial complaint lodged by hotel associations alleged that Booking.com, Expedia, and HRS were abusing a collective dominant position.

B. Legal Assessment of MFN Clauses

Whereas the FCO found that such clauses are contrary to article 101 TFEU only,[5] the ADLC addressed the issue under both articles 101 and 102 TFEU,[6] which required the ADLC first to define the relevant market and then to estimate Booking.com's market share.

1. Market Definition

The ADLC considers that online booking platforms, as intermediaries between hotels and consumers, operate on a two-sided market. Upstream, they offer online booking services to hotels in exchange for a commission; downstream, they offer online search and comparison services to consumers for free.

In previous decisions regarding online sales, the ADLC focused on the downstream side of the market, assessing whether online sales were substitutable with other distribution channels from the consumers' point of view.[7] On the contrary, in the present case, given that the practices relate to the contractual arrangements between hotels and online booking platforms, the ADLC decided to focus on the upstream side of the market, and considered that there was a distinct national market for online booking of hotel stays, which excludes the hotels' direct distribution channels (both on- and off-line).

Based on this market definition, the ADLC found that Booking.com is the market leader with a market share of at least 30 percent, and noted the existence of barriers to entry due to significant network effects. As is generally the case in commitment decisions, the ADLC did not reach a final conclusion as to the existence of a dominant position. As explained below, a market share in excess of 30 percent was sufficient for the ADLC to conduct its assessment under both articles 101 and 102 TFEU.

2. Assessment Under Article 101 TFEU

As explained above, parity clauses restrict hotels' freedom to determine their own commercial policy and reduce competition between online platforms. The ADLC thus considers

[5] And the corresponding German law provisions.

[6] And the corresponding French law provisions (articles L. 420-1 and L. 420-2 of the French Commercial Code).

[7] *See*, for example, decision n° 14-D-18 of 28 November 2014.

that they have a potential or actual anticompetitive effect on competition within the meaning of article 101.1 TFEU.

Given that, under Regulation (EC) n° 330/2010, block exemptions are only available where each of the parties to the agreement has a market share of below 30 percent, parity clauses cannot benefit from such block exemptions on account of Booking.com's relatively high market share (in excess of 30 percent). In addition, the existence of parallel restrictions due to the use of such clauses by competing online platforms entails a cumulative effect on the market, which excludes the possibility of a block exemption.

3. Assessment Under Article 102 TFEU

Under article 102 TFEU, the ADLC's analysis is extremely brief. It merely refers to the EU and French provisions prohibiting the abuse of a dominant position and concludes that, in the present case, it cannot be excluded that the use of parity clauses may constitute an abuse of an individual or collective dominant position.

III. THE COMMITMENTS OFFERED BY BOOKING.COM

In order to address the above-described competition concerns, Booking.com offered a series of commitments concerning its parity clauses, *vis-à-vis* both other online booking platforms and hotels' direct channels of distribution.

A. Commitments with Regard to Other Online Booking Platforms

Initially, Booking.com essentially offered to remove the price parity clauses with regard to the other online booking platforms, so that hotels could adapt their offer in order to be in line with online booking platforms' services and commission rates.

However, during the market test, third parties explained that such a commitment would be incomplete, and therefore ineffective, if it did not extend to conditions (breakfast, gym, cancelation policy) and room availability. Booking.com therefore offered an improved commitment package whereby it agreed to remove all price, conditions, and availability parity clauses with regard to other online booking platforms.

As a consequence, hotels should now be entirely free to offer lower prices, more rooms, and better conditions on competing platforms, depending on the quality of service and commission rate applied by each platform. In the ADLC's view, such commitments will thus restore the hotels' commercial freedom and the natural link between the commission rates applied by online booking platforms and their commercial results, thus removing an obstacle to unrestricted competition between them.

B. Commitments Regarding Hotels' Direct Channels

As a result of the commitments offered by Booking.com, hotels will now be free to propose prices lower than those available on Booking.com via their own direct offline channel (telephone, hotel reception, bilateral emails, travel agencies, etc.). These prices offered offline must not be published or marketed online to the public in general, i.e. on the internet (hotel website, comparison sites, etc.) or through mobile phone applications. However, on their website, hotels remain free to display qualitative information concerning the lower prices offered on their

offline channel ("good prices," etc.). They may also offer lower prices to customers belonging to loyalty schemes.

Booking.com also committed not to prohibit hotels from making contact with prior customers, namely customers who have already stayed at the accommodation at least once, whatever the means of booking used for the previous stay, including via Booking.com. The concept of prior customer is defined in the broadest sense since customers who have stayed at one property that is part of a hotel chain or of a community of hotels that have pooled their reservation services are deemed to be prior customers of all the accommodation premises in this chain of hotels or community of hotels.

These commitments are all made for a period of five years. In the ADLC's view, they are sufficient to address the competition concerns identified above and strike the right balance between the preservation of the online platforms' economic model, which provides consumers with a powerful search tool, and the enhancement of hotels' bargaining power, all the while stimulating competition between platforms.

IV. CONCLUSION

The Booking.com decision is highly representative of commitment decisions adopted either by the European Commission or by the ADLC. Indeed, in rapidly evolving markets, especially technology and online markets, competition authorities are keen to address specific competition problems through the settlement route rather than through a more traditional prohibition decision. While this procedure enables the ADLC to swiftly tackle competition problems and to find custom-made solutions thereto, using the settlement route can come at the expense of a detailed and sound reasoning of the decisions.

In the present case, while the competition concerns are explained in detail, many questions spring to mind that are not precisely addressed by the decision: Shouldn't the market definition focus on the downstream side of the market, where Booking.com may be competing not only with other online platforms to attract consumers, but also with other on- and off-line channels of distribution? Does Booking.com really hold an individual dominant position with a market share that is mainly described as in excess of 30 percent or is there instead a collective dominant position, as initially alleged by the plaintiffs? What exactly is the nature of the abuse that may fall within the scope of article 102 TFEU? Irrespective of the final response to these questions, the reasoning of the decision could be improved by addressing them in further detail.

The Booking.com decision is also representative of the challenges faced by competition authorities in Europe in order to ensure consistency, and uniformity in the application of competition law throughout the common market. In this case, while the German competition authority issued a prohibition decision (regarding HRS' practices), the French, Swedish, and Italian competition authorities preferred the commitment route (regarding Booking.com's practices), in an unprecedented case of close cooperation under the supervision of the European Commission.

It should also be noted that the German competition authority, who is currently conducting a parallel investigation into Booking.com's parity clauses, has recently announced that it intends to reject Booking.com's commitments, even if these have been accepted by three other national competition authorities, thus reinforcing the risk of divergent application of EU

competition law. Against this background, it remains to be seen whether the Commission will use its—exceptional—powers under article 11.6 of (EC) Regulation 1/2003 to take jurisdiction away from the German competition authority, in an effort to ensure a uniform application of competition law to this specific issue.

In our view, collaboration between competition authorities should be welcomed because diverging decisions in different Member States would tend to prevent online platforms from adopting European-wide commercial policies, which runs contrary to the objective of a common digital market. In addition, a unified legal framework would provide internet companies more legal certainty and would thus improve the investment conditions throughout Europe for e-commerce.

Finally, it should be noted that the risk of legal uncertainty does not only relate to diverging opinions between national competition authorities, but may also arise from the application of different sets of provisions within the same Member State. Indeed, a few days after the adoption of the ADLC's decision, the Paris Commercial Court issued a decision declaring Expedia's price parity clauses null and void on the basis of article L. 442-6, I, 2° of the French commercial code, which prohibits clauses that create a significant imbalance in the contractual relationships between two parties.

This decision contrasts with the ADLC's in two respects: first, it sets a general prohibition of price parity clauses, while the ADLC made a distinction between price parity clauses that apply with respect to other online platforms (which are prohibited) and price parity clauses that apply with respect to hotels (which may still offer lower prices off-line); second, it considers that availability parity clauses are valid, while the ADLC specifically objected to these clauses as a result of the market test.

While this decision is based on legal grounds other than competition provisions, the adoption of diverging legal decisions may have significant practical consequences for on-line operators, which adds to the risks identified above in terms of legal certainty and investment conditions.

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Online Price Restraints Under U.S. Antitrust Law

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Online Price Restraints Under U.S. Antitrust Law

Richard M. Steuer[1]

I. INTRODUCTION

Restraints on electronic commerce have become a burning hot topic in Europe. The European Commission has opened a sector inquiry into barriers limiting e-commerce between countries, while national competition authorities, particularly Germany's Bundeskartellamt, have been combating restraints on discount pricing and the use of online marketplaces. Within the European Union, there is an overarching objective to eliminate barriers to commerce between Member States. There also is greater concern for intrabrand competition, greater attention to the distinction between passive order taking and active selling, and a different set of rules against minimum resale price maintenance.

In the United States, the application of the antitrust laws to electronic commerce has progressed incrementally over the years. At first, the conventional wisdom was that electronic commerce was too new a phenomenon to expect the antitrust laws to keep up, but electronic commerce has existed now for some three decades and that rationalization no longer rings true.

For the most part, the rules applicable to restraints limiting, or indirectly influencing, prices in electronic commerce reflect the rules that apply to such restraints in every type of commerce. To the extent there is still uncertainty, it usually reflects the difficulty of applying principles originally established in the bricks-and-mortar world to virtual resellers delivering a combination of tangible and intangible products.

Generally, resale restraints other than restraints on resale prices themselves have been found to be reasonable and lawful, even if they may inhibit discounting to some degree. To illustrate:

- U.S. antitrust law normally permits a manufacturer or other supplier to prohibit dealers from reselling through particular means—such as mail order, telephone, or electronic commerce.
- A supplier may enter into agreements with dealers limiting the territories into which retailers may deliver products, including products ordered through electronic commerce, and/or the territories in which retailers may advertise and promote to attract customers.
- A supplier may enter into agreements with dealers limiting the types of customers to which those dealers may resell through electronic commerce or otherwise, such as permitting sales to contractors but not to consumers, or permitting sales to consumers but not to other retailers or resellers of any kind.

[1] Partner in the New York office of Mayer Brown LLP. © Copyright 2015, Richard M. Steuer/All Rights Reserved.

- A supplier may exercise control over the appearance of dealers' outlets and dealers' displays, including the appearance of dealers' websites.

Price restraints are trickier. Suppliers may suggest the minimum prices at which dealers may resell their products on the internet without violating the antitrust laws. Suppliers of most products also may announce unilaterally that they will stop doing business with dealers that resell for less than the prices that the supplier specifies, so long as the supplier does not enter into bilateral agreements with the dealers limiting the minimum price at which the dealer may resell.

But the law on bilateral agreements is in flux. Bilateral agreements setting minimum resale prices were considered *per se* illegal under federal antitrust law until 2007, when the Supreme Court made them subject to the rule of reason.[2] Nevertheless, such agreements have not been widely adopted because the Court indicated that they may continue to violate federal antitrust law in some circumstances, and because certain states continue to consider minimum resale pricing agreements *per se* unlawful under state antitrust law.

In contrast, bilateral agreements limiting the ***maximum*** price at which the dealer may resell generally are considered reasonable and lawful under both state and federal law, and—with one exception—suppliers' policies against dealing with dealers that resell for less than recommended prices do not violate state or federal law either, if they are genuinely unilateral. The exception is a new Utah contact lens statute, enacted in March 2015 and effective on May 12, 2015, that prohibits both agreements ***and*** unilateral policies restricting minimum resale prices for contact lenses. Similar legislation has been introduced in a number of other states, but the Utah statute almost immediately was challenged in federal court as unconstitutional and the outcome of that case is likely to control any comparable statutes from other states as well.

In this context, three significant questions have arisen in the United States with respect to restraining prices in electronic commerce generally:

1. May a supplier use agency or consignment arrangements, particularly for intangible products that are not inventoried, to set online prices?
2. May a supplier restrict the prices that resellers are permitted to display on their websites or otherwise offer in electronic commerce?
3. May a supplier prohibit resellers from engaging in electronic commerce altogether, or from selling through certain online platforms such as auction sites or marketplaces?

II. AGENCY

Consignment arrangements fell out of favor after the Supreme Court's 1964 decision in *Simpson v. Union Oil Co.,*[3] holding that a sham consignment amounts to resale price maintenance. However, even though minimum resale price maintenance agreements remain *per se* unlawful in some states today, in *genuine* consignment situations (under which the agent earns a commission for distributing the goods but does not take title to them) the consignor always has been permitted to set the price at which its product is sold by the consignee (which is acting as

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[2] *Leegin Creative Leather Prods. v. PSKS, Inc.*, 551 U.S. 877 (2007).

[3] *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964).

the consignor's agent) even where minimum resale price maintenance is considered to be *per se* unlawful.[4] Of course, where tangible products are involved, genuine consignment arrangements impose additional costs (for insurance, etc.) on the supplier, which retains title and risk of loss until a sale is made.

But more and more, popular products today are not tangible and intermediaries do not need to stock inventory or take title. Downloads of music, books, games, and programs (including programs for "printing" tangible products on 3D printers) are all examples of intangible products sold through electronic commerce. Although the rights to such products may be sold and resold, they also may be distributed through agency agreements, with title never passing to the intermediary, which serves as an agent and charges whatever price the principal sets. There can be no resale price maintenance because there is no resale.[5]

Nevertheless, the Justice Department's recent case against Apple over the pricing of e-books left many wondering whether agency agreements were dead.[6] That case involved some very unique arrangements in the context of allegations of a hub-and-spokes conspiracy among suppliers (*i.e.,* publishers), orchestrated by an intermediary (Apple). The Court's decision—which is being appealed by Apple—is instructive but does not mark the death of agency agreements.

The case concerned a so-called "price parity provision"—by which a supplier and an agent agree that whatever price the supplier sets, it will adjust that price to match the lowest price charged by any reseller that takes title and resells the same product in competition against the agent. Plainly, this was no ordinary arrangement, since it involved an intangible product that was being sold ***both*** by agents and through resellers.

The Court held that the defendant publishers all adopted agency agreements with Apple at the same time and then forced agency agreements on Amazon—the largest retailer of e-books—in order to raise retail prices collectively. However, the Court was careful to point out that agency agreements themselves are not inherently illegal. Agency agreements can be especially attractive for intangible products such as digital publications, because many of the obstacles that historically have discouraged agency—*e.g.,* retained risk of loss, cost of insurance, UCC filings, monitoring, etc.—simply don't exist. Under an agency model the principal is able to set the retail price, and so long as that price is not being set or raised pursuant to an agreement among competitors, the *Apple* decision does not weaken the legality of these arrangements.

The Court further held that the price parity provision—which the parties and the Court sometimes referred to as a most favored nation ("MFN") clause—provided the means to force the publishers to require Amazon to switch to agency agreements and charge the same higher retail prices as Apple, but the Court was quick to add that MFN clauses themselves are neither improper nor illegal.

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[4] *See, e.g., Ryko Mfg. Co. v. Eden Servs.*, 823 F.2d 1215 (8th Cir. 1987), *cert. denied*, 484 U.S. 1026 (1988) (genuine consignments are not resales).

[5] *Cf. LucasArts Entm't v. Humongous Entm't,* 870 F. Supp. 285 (N.D. Cal. 1993)(no resale in licensing and royalty sharing arrangement).

[6] *United States v. Apple Inc.,* 952 F. Supp. 2d 638 (S.D.N.Y. 2013), *appeal pending.*

At the same time, it is important to understand that Apple's "price parity provision" was markedly different from what MFN clauses usually are understood to be. Ordinarily, an MFN clause appears in a sales agreement, binds either the seller or the buyer, and provides either (a) "I promise to sell to you at the lowest price that I charge any customer," or (b) "I promise to buy from you at the highest price that I pay any supplier. "In contrast, the "MFN" clauses that the publishers entered into with Apple were part of agency agreements, not sales agreements. The publishers were not selling to Apple, although initially they were still selling to Amazon, which resold e-books to consumers at prices that Amazon set. Consequently, each publisher's "MFN" agreement with Apple essentially provided, "I promise to sell to ***consumers*** through Apple's electronic bookstore, which is acting as my agent, at the lowest retail price that any of my ***customers*** (*e.g.,* Amazon) charges consumers."

This meant that if Amazon resold e-books to consumers for less than the retail price at which the publishers were selling through the Apple bookstore, which allegedly is exactly what Amazon was doing, Apple, as the publisher's agent, automatically could reduce the retail price at the Apple store to the same amount in order to remain competitive and continue to earn commissions. Since the publishers were not eager for their prices to drop, the Court found that they were forcing Amazon to switch to the agency model and, as the publishers' agent, begin charging the same higher prices as Apple.

In short, there was nothing typical about the *Apple* case. Because the MFN was so unique, and was found to be part of a price-fixing conspiracy among the publishers, the Court's condemnation should not be expected to apply to ordinary MFN clauses, regardless of the outcome of Apple's appeal. Although the Justice Department has expressed hostility toward MFNs for years, and has attacked them in the health care industry, such clauses repeatedly have been upheld by courts in a variety of contexts. They must be approached with caution but they are not defunct. If an agency agreement or ordinary MFN clause is needed to serve a legitimate purpose, it should be possible to adopt it without violating the antitrust laws, notwithstanding the *Apple* decision.

III. MAP PROGRAMS

The next issue that has been attracting attention in the United States is how to recognize a bilateral minimum resale price maintenance agreement in electronic commerce. Although minimum RPM is no longer *per se* illegal under federal law after the Supreme Court's decision in *Leegin,*[7] it has been understood to remain *per se* illegal under the laws of California and Maryland.[8]

Do restrictions on the display of discount prices on websites merely amount to the restriction of price *advertising*—which has long been considered reasonable and lawful in

[7] *Leegin Creative Leather Prods. v. PSKS, Inc.,* 551 U.S. 877 (2007).

[8] *See* Maryland Code Ann., Comm. Law § 11-204(b) (eff. Oct. 1, 2009) ("For purposes of subsection (a)(1) of this section, a contract, combination, or conspiracy that establishes a minimum price below which a retailer, wholesaler, or distributor may not sell a commodity or service is an unreasonable restraint of trade or commerce."); *Mailand v. Burckle,* 20 Cal.3d 367 (1978); *Alan Darush MD APC v. Revision LP,* 2013 WL 1749539 (C.D. Cal. 2013); *Alsheikh v. Superior Court of Los Angeles County,* No. B249822, 2013 BL 275295 (Cal. App. 2d Dist.) (unpublished opinion).

virtually every case—or the restriction of resale prices themselves, *i.e.,* minimum resale price maintenance. In 2011, the District Court for the Southern District of New York held—contrary to indications in some earlier cases—that enforcement of a minimum *advertised price* ("MAP") agreement against internet retailers does not amount to minimum resale price maintenance, notwithstanding the contention often made by such retailers that prices appearing on websites really amount to selling prices rather than advertised prices.[9] The Court in that case also reaffirmed that minimum resale price maintenance is not *per se* illegal under New York's antitrust law, in accord with an earlier holding of a New York state court.

Franke, a manufacturer of sinks and faucets, had instituted a MAP policy applicable to all of its dealers, including internet retailers. It provided that (a) retailers were not permitted to publish prices below a specified range anywhere on any website; (b) Franke could cease doing business temporarily or permanently with violators; (c) internet retailers could, however, advertise that consumers could call or email to obtain the retailer's lowest price; and (d) internet retailers also could advertise the availability of coupons for lower sales prices at checkout.

WorldHomecenter.com, an internet retailer, violated the policy and thereafter signed a bilateral reinstatement agreement, promising to adhere to the MAP policy. The agreement provided that further violation would result in permanent termination. After Worldhomecenter.com violated the policy again, Franke allegedly stopped shipping, demanded that its wholesalers stop shipping, and posted a "warranty disclaimer" on its own website announcing that it would not honor warranties for Worldhomecenter.com customers.

Worldhomecenter sued, claiming that because it was being prevented from displaying lower prices anywhere on its website, the MAP policy amounted to minimum resale price maintenance in violation of New York's antitrust law.

Franke moved to dismiss and the judge granted the motion. First, she held that New York law merely renders minimum resale price maintenance agreements unenforceable, not illegal. Next, she held:

> Unlike the prior cases cited by Plaintiff where an advertising policy was held to restrain prices, the [MAP] policy here provides internet retailers with more than one way to communicate lower prices to clients, either by allowing customers to call or email for a price quote or by offering a coupon to be applied at checkout.

These methods afford internet retailers "viable strategies to provide online customers with reduced prices." On this basis, the Court concluded that Franke's restriction was "regulating advertised prices, not the resale prices themselves," and therefore could not be subject to *per se* illegality even if the *per se* standard continued to apply to minimum resale price maintenance in New York.

Would the Court have ruled the same way if Franke had not allowed internet retailers to invite consumers to call or email for a lower price quote, or had not allowed internet retailers to advertise the availability of coupons providing lower prices at checkout? Arguably, even without these exceptions, the supplier still would have been "regulating advertised prices, not the resale

[9] *Worldhomecenter.com, Inc. v. Franke Consumer Products, Inc.,* No. 10 Civ. 3205 (S.D.N.Y. June 22, 2011), *accord, Worldhomecenter v. KWC America, Inc.,* No. 10 Civ. 7781 (S.D.N.Y. 2011) (adopting same reasoning).

prices themselves," although it might have been more difficult for the Court to distinguish certain earlier *Worldhomecenter.com* cases. At the same time, distinguishing those earlier decisions was not essential, because they were only denials of motions to dismiss, not determinations of liability, and there already were other cases pointing the opposite way.[10] Further clarification must await further developments in the case law.

In any event, this decision, in combination with such cases as *Campbell* and *Blind Doctor*, provides a significant marker for any supplier applying MAP policies to dealers that market their products on the internet. This may prove to be particularly important to makers of contact lenses and any other products that might become subject to statutes of the type adopted in Utah, prohibiting both bilateral minimum resale price agreements ***and*** unilateral minimum resale price policies—assuming that such statutes survive constitutional challenge.

IV. RESTRICTING SALES THROUGH SPECIFIED CHANNELS

A third issue that has been recurring with some frequency is the right of a supplier to restrict customers from reselling their products through online marketplaces or auction sites. In contrast to the rules that have been developing in Europe, U.S. antitrust law has afforded suppliers greater discretion to limit where and how resellers may distribute products online.

In the United States, suppliers have been allowed to prohibit customers from reselling their products through electronic commerce, either reserving electronic commerce to the supplier itself or eliminating electronic commerce for its products altogether.[11] This is consistent with earlier cases permitting suppliers to refuse to permit dealers to resell products by mail order or telephone.[12]

Even where a supplier permits dealers to resell through electronic commerce, an issue still can arise as to whether the supplier may prohibit dealers from reselling through a third-party marketplace or auction site. There is a dearth of case law directly addressing the right to sell through an online marketplace or auction site. Nevertheless, if a supplier may prohibit a dealer from reselling its products through e-commerce entirely, it presumably may prohibit reselling through specified means of e-commerce, such as a marketplace—just as it may prohibit reselling through flea markets in the bricks-and-mortar world.

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[10] *Campbell v. Austin Air Systems, Ltd.*, 423 F. Supp.2d 61, 69-70 n. 6 (W.D.N.Y. 2005) (agreement on minimum price advertised on the internet); *Blind Doctor, Inc. v. Hunter Douglas, Inc.*, 2004 U.S. Dist. Lexis 18480 (N.D. Cal. 2004)(unilateral policy; restraint on posting prices on a website is not price-fixing).

[11] *MD Products, Inc. v. Callaway Golf Sales Co.*, 459 F. Supp. 2d 434 (W.D.N.C. 2006) (no concerted action found where defendant unilaterally instituted policy); *Blind Doctor, Inc. v. Hunter Douglas, Inc.*, 2004 U.S. Dist. Lexis 18480 (N.D. Cal. 2004)(prohibition on internet or toll-free telephone sales); *Credit Chequers Information Servs. v. CBA, Inc.*, 1999 WL 253600 (S.D.N.Y. 1999), *aff'd*, 205 F.3d 1322 (2d Cir. 2000).

[12] *See H.L. Hayden Co. of New York, Inc., v. Siemens Med. Sys.*, 879 F.2d 1005, 1014 (2d Cir. 1989); *O.S.C. Corp. v. Apple Computer, Inc.*, 792 F.2d 1464, 1468 (9th Cir. 1986); *Parkway Gallery Furniture, Inc. v. Kittinger/Pennsylvania House Group, Inc.*, 878 F.2d 801, 802 (4th Cir. 1989) ("prohibit[ing] dealers from soliciting or selling its furniture by mail or telephones order to consumers residing outside specified sales areas"); *National Marine Elec. Distribs., Inc. v. Raytheon Co.*, 778 F.2d 190 (4th Cir. 1985) (prohibiting dealers from engaging in mail order sales).

Likewise, a supplier may prohibit dealers from supplying other resellers that offer products through online marketplaces and auction sites, just as a supplier ordinarily may prohibit dealers from selling to any transshipper or other third-party reseller. Such restrictions may impact the prices that consumers ultimately pay online but fall within the rule generally permitting suppliers to limit intrabrand competition in order to strengthen interbrand competition.

Of course, if sellers that do participate in an online marketplace conspire with one another to fix the prices they offer, this would amount to horizontal price-fixing. Lest this seem unlikely, the U.S. Department of Justice recently obtained a guilty plea from an online seller to a felony charge for conspiring with competing online sellers to adopt pricing algorithms that surreptitiously coordinated changes in the prices that each of them charged through an online marketplace. Even an online marketplace can become an axis for collusion, and price-fixing by means of software is still price-fixing.

V. EUROPE

As noted at the outset, the rules are different in Europe. Suppliers in the European Union may not prevent consumers in one Member State from buying online at lower prices from dealers operating in other Member States. Once a supplier authorizes a dealer, it must allow the dealer to have a website and sell its products online. Restraints designed to divide the market geographically, such as an obligation to re-route consumers to another dealer's website, or to reject transactions if the credit card address is in another dealer's area, are prohibited. In an exclusive distribution network, the supplier may prohibit a dealer from actively targeting customers in another dealer's area but the dealer must be permitted to sell to customers from another dealer's area that make contact on their own (called "passive" sales).

Also, minimum resale price maintenance is a "hardcore" restraint under EU law. EU law broadly prohibits vertical agreements that, directly or indirectly, in isolation or in combination with other factors, have as their objective restricting a dealer's ability to determine its minimum resale price. Thus, unlike the United States, forbidding dealers from displaying discount prices in Europe is more likely to be treated as tantamount to minimum resale price maintenance.

In short, suppliers should not attempt to restrict pricing in electronic commerce in Europe without first consulting long and hard with European counsel.

VI. CONCLUSION

Restraints on prices in electronic commerce in the United States are just like price restraints in the bricks-and-mortar world—except when they're not. Agency arrangements can succeed online, but require special attention if both agency sales and conventional resales of the same product exist side-by-side. Restraints on the display of resale prices by dealers online require close attention to avoid slipping into bilateral minimum resale price maintenance agreements. Restraints on resales through online marketplaces and auction sites are generally permissible, although they can be hard to police.

Electronic commerce is becoming the predominant form of commerce in many sectors of the economy today, and it is important that the law on pricing keep pace. Inevitably, there will be more disputes in the future, and with them will come more issues and, hopefully, more guidance.

Whether this will result in eventual harmonization between the rules in the United States and the rules in Europe or a widening of the gap between the two, only time will tell.

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Most Favored Customer Clauses in Online Retail: Best Price or Bad Deal?

Samir R. Gandhi, Rahul Rai, & Hemangini Dadwal

AZB & Partners

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Most Favored Customer Clauses in Online Retail: Best Price or Bad Deal?

Samir R. Gandhi, Rahul Rai, & Hemangini Dadwal[1]

I. INTRODUCTION

Most favored customer ("MFC")[2] clauses are emerging as an important tool through which purchasers ensure that suppliers match the best offer they make to any other purchaser of their goods and services. Although MFC conditions may afford greater bargaining power to purchasers, they have the ability to promote price uniformity, which in turn reduces the incentive to compete. In certain instances independently negotiated MFC conditions may reflect legitimate commercial interest. In certain others, MFC conditions have the ability to prejudice consumer interest, which forms the cornerstone of most antitrust laws, including the [Indian] Competition Act, 2002 ("CA02").

Typically, by insisting on an MFC condition, a purchaser seeks to secure a guarantee from a supplier that it has been offered the best price (and other terms of sale) when compared to offers made to other customers. If the purchaser were the end customer—for example, a bank purchasing a software solution on the guarantee that the software vendor has offered it the best price and terms of service that it may have offered to similar customers—the customer would not have to incur the transaction costs for ascertaining the best price. In this situation, the MFC condition may have certain pro-competitive benefits.

If the purchaser of a product/service insisting on an MFC condition is not the end consumer but a retailer, by securing products on MFC terms, it may be able to resell the products at prices more competitive than its peers who do not benefit from access to the same products on MFC terms. If the purchaser-retailer insisting on MFC conditions is not in a dominant position, and the resale market for the relevant product is competitive, then an individual purchaser-retailer's insistence on MFC conditions is unlikely to raise competition concerns.

However, the tables turn in online retail where it is possible that the online platform operators, which primarily serve to provide a platform for manufacturers/suppliers to meet with potential customers, may insist that the manufacturers/suppliers list their products on the platform at the best price/term they may have offered to some other platform. In this situation, the online platform operator does not act like a retailer engaging in purchase and resale transactions. Thus it does not necessarily fix the retail price of the goods that are listed on its platform for sale.

In this case, the platform operator may be said to act like an "agent" that allows manufacturers/suppliers to use its platform in return for a commission linked to the volume of

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[2] Also called "Most Favored Nation" ("MFN") clauses.

goods sold through the platform. The platform operator, by insisting on the MFC condition, ensures that the goods are listed on its platform at the best price that the manufacturer/supplier may have offered to others. This would help the platform operator route customer traffic to its platform. This business model is popularly referred to as "agency" model. In an agency model, the manufacturer/supplier retains the ability to set prices and pocket the proceeds of the sales. The quantum of an agents' (platform operators') revenue is linked to the volume of sales made on its platform. Sales would naturally increase if the agent were confident that the retail prices on its platform are the lowest, when compared to other platforms.

Unlike brick and mortar retailers, or traditional individual purchasers, online trading platforms have the inherent ability to monitor and ensure compliance with MFC conditions. The rather prohibitive cost of monitoring compliance for traditional physical retailers has meant that MFC conditions, even if negotiated, might not necessarily have been complied with. In contrast, monitoring prices for online retail sales is easier and perhaps much cheaper. Accordingly, MFC conditions are gaining currency in the field of online retail sales. In this article, we seek to examine the applicability of antitrust rules to MFC conditions, specifically in the context of online retail and its implications in India.

II. ANTITRUST APPLICABILITY IN THE UNITED STATES AND EUROPEAN UNION

Retail price MFC conditions inhibit the suppliers' incentive to reduce prices. A reduction in price for one online platform would mean a corresponding reduction on all other platforms, which may have tied the supplier with MFC conditions. This may lead to price uniformity across various online platforms and perhaps at higher levels. Despite potential competition concerns, at some level retail MFC conditions help align the interest of manufacturers/suppliers and online trading platform operators.

The manufacturers/suppliers would like to maximize their profits by charging higher prices, and online platform operators would like to ensure that their platform offers the products at a price no higher than the price at which rival platforms offer the products. This is easily achieved if the online platforms do not act as retailers of products but as agents that facilitate the interaction between manufacturers/suppliers and customers. In such situations, the manufacturers/suppliers do not have to mandate the retailer to necessarily sell the goods at a certain price—a practice that is generally known as resale price maintenance and attracts scrutiny if the manufacturers/supplier enjoys some degree of market power. Rather the manufacturer/supplier itself fixes the retail price at which its goods will be offered for sale on an online platform.

In other words, switching to an agency model allows manufacturers/suppliers the opportunity to determine retail prices without the risk of being scrutinized for imposing resale price maintenance conditions. However, antitrust agencies have been quick to notice this shift and acknowledge potential competition concerns in the agency model, which facilitates the acceptance of MFC conditions.

For example, in December 2011, the European Commission ("EC") initiated antitrust investigations against Apple, Inc. ("Apple") and four publishers, including Harper Collins (News Corp.) and Macmillan, for suspected concerted practices aimed at raising the retail prices for eBooks in the European Union. Similarly in April 2012, the United States Department of Justice

("DOJ") filed a suit against Apple and five publishers, alleging a conspiracy to raise the price of eBooks on Apple's iBookstore. Both competition authorities took note of what appeared to be a collusive switchover to the "agency" model agreement[3] by the publishers, leaving the publishers in charge of the sale price of eBooks. In both the European Union and the United States, the publishers reached a settlement with the antitrust agencies upon the acceptance of certain commitments offered by publishers.[4] However, Apple has preferred an appeal in the United States against the decision holding Apple's agreements with the publishers to be anticompetitive.[5]

The EC and the DOJ were concerned about the anticompetitive effects of the concerted switchover to the "agency" model by the publishers. Earlier each publisher let the online portals determine the sale price. Competition among the portals ensured that customers got the books at the most competitive price. The shift to an "agency" model meant that the online portals lost the ability to determine the retail price. The inclusion of MFC conditions led to uniform increases in prices across all portals—an outcome inimical to consumer interest. Essentially, by shifting to the "agency" model, the publishers took away the online retailers' ability to determine the price at which eBooks would be sold on their platforms.

III. ANTITRUST APPLICABILITY IN INDIA

While the motivation for the shift to the "agency" model in the United States and European Union could be strategic, the reasons for online platforms adopting the "agency" model in India may, to a large extent, be attributable to the government's foreign direct investment ("FDI") policy.

Although online trading platforms have existed in India for close to a decade, it is only in the recent past that they have gained in popularity. Increased consumer interest, as a result of greater internet penetration (that is expected to only grow further), has attracted foreign investment in companies operating online trading platforms. The infusion of foreign capital has necessitated a fundamental shift in the business model followed by most companies operating online trading platforms.

[3] In an agency model, the publishers (suppliers) determine the price and list it for purchase on the online portal, which would retain a commission on the sale. In a reseller model, however, the online portal would purchase the books from the publishers and set the price (and other terms, including discounts and promotions) in respect of the sale of the book.

[4] The commitments included (i) the termination of agency agreements that were allegedly the result of collusive conduct; (ii) allowing e-retailers the ability to determine retail prices, including discounts and promotions; and (iii) preventing Apple and the publishers from entering into agreements with price MFC clauses for a period of five, years.

[5] On July 10, 2013, the United States District Court for the Southern District of New York found Apple to have violated Section 1 of the Sherman Act by conspiring with the Publishers to eliminate retail price competition and raise the price of eBooks. Apple entered into a conditional settlement with the Court according to which it will be required to pay damages if it loses in appeal before the Court of Appeals, along with other settlement terms including doing away with MFN clauses in its agreements with publishers. The hearings before the appellate court took place in December 2014 and the judgment is presently reserved.

Until November 2011, multi-brand retail in India was not open to foreign participation. While the 2012 FDI Policy[6] approved FDI in multi-brand retail up to a 51 percent cap on foreign shareholding in Indian companies, it has been made subject to fairly onerous local procurement requirements[7] that are difficult to comply with.

However, for online portals, it is possible that to work around the onerous conditions attached to FDI in multi-brand retail and yet benefit from foreign investment. Online portals do not engage in purchase and resale activity. Rather, these companies only provide an online market place, which facilitates the meeting of independent customers and sellers. By doing so, these companies operate as online market places that do not strictly engage in retail sale of goods or multi-brand retail.[8] Further, suppliers retain the flexibility to determine the price at which they wish to offer their products for sale.

However, in a rapidly crowding space, online portals may seek to distinguish themselves by offering a market place where goods are made available at the best possible price. To do so, some may goad the suppliers to offer their products at a certain price. In this process, a few online portals may insist, as a pre-condition to offering a supplier's products for sale on their platforms, that suppliers list their products at the same prices at which they may have listed their products on a competing platform. In doing so, they would risk antitrust scrutiny for the same reasons that the EC and the DOJ scrutinized MFC conditions in agency models adopted by eBook publishers in the European Union and United States, respectively.

Absent an agreement among companies operating online portals wherein they would all insist on MFC conditions in their dealings with suppliers interested in listing their products, an individual online portal's insistence on MFC condition is unlikely to be viewed as a cartel under Section 3(3)[9] of the CA02. However, an individual online portal's insistence that a supplier must agree to an MFC condition could potentially be examined under Section 3(4)[10] of the CA02 as a vertical restraint or under Section 4[11] of the CA02 as an abusive unilateral conduct.

Vertical restrictions under the CA02 are examined under the rule of reason. Therefore, absent market power, vertical restraints or unilateral conducts are unlikely to raise suspicion under the CA02. In addition, the Competition Commission of India ("CCI") has acknowledged

[6] Press note no. 5 of 2012, issued by Department for Industrial Policy and Promotion, Ministry of Commerce and Industries, Government of India

[7] *Supra*, onerous conditions include a minimum necessary investment of U.S $100 Million and a requirement that at least 50 percent of total FDI brought in should be invested in 'backend infrastructure' within three years, etc.

[8] http://archive.financialexpress.com/news/ecommerce-major-flipkart-gets-clean-chit-from-ed-over-fdi-violation/1298837

[9] The Competition Act prohibits any agreement, arrangement, or action in concert between enterprises that are engaged in the same level of trade which results in (i) directly or indirectly fixing prices, (ii) limiting or restricting production, (iii) allocating markets or consumers, and (iv) bid-rigging, as they are presumed to cause an appreciable adverse effect on competition ("AAEC").

[10] Arrangements or agreements between entities engaged in different levels of the production or supply chain are prohibited if they result in an AAEC in India.

[11] Section 4 of the Competition Act prohibits an enterprise in a dominant position from abusing its dominant position by, *interalia,* (i) imposing unfair or discriminatory conditions with respect to the sale or purchase of goods and services or prices, (ii) limiting or restricting production or sale of goods, (iii) denial of market access, or (iv) using its position in one market to enter into or protect another market.

that there is ample competition among companies operating online platforms and no one platform may be said to be in a dominant position.[12] By acknowledging that online platforms lack market power, the CCI would find it difficult to examine an MFC condition as a vertical anticompetitive agreement or an abusive conduct by a dominant enterprise.

The CCI, however, is not shy of examining issues that its global peers may be grappling with. The CCI has also shown the propensity to both examine and, if appropriate in the Indian context, accept antitrust best practices and principles from across the globe, particularly in mature antitrust jurisdictions like the European Union and the United States. The ongoing churn in the Indian retail industry has seen brick and mortar retailers face-off with online trading platforms on several occasions. Moreover, with the growing popularity of a handful of online platforms, it is only a matter of time before their actions are subjected to antitrust scrutiny by the CCI and it would hardly be surprising if MFC conditions imposed by online trading platforms were to be scrutinized by the CCI.

However, given the CCI's recent decisions wherein it has recognized the competitiveness of online trading platforms, it remains to be seen how the CCI would deal with MFC conditions. It is possible that, with time, the landscape of online retail may change resulting in one or two online platforms enjoying sufficient market power to attract attention. This would enable the CCI to examine a MFC condition either as an anticompetitive vertical restraint under Section 3(4)[13] of the CA02 or as an unfair condition under Section 4 of the CA02[14]. On the other hand, if several online platforms **together** agree to insist on MFC conditions, the CCI is likely to construe such a conduct as a cartel under Section 3(3) of the CA02 and prohibit it.

[12] Mr. Ashish Ahuja vs Snapdeal.com through Mr. Kunal Bahl, CEO & Ors., Case no. 17/2014 and Mr. Mohit Manglani vs M/s Flipkart India Private Limited & Ors., Case no. 80 of 2014.

[13] The CCI has held in the past (*Automobiles Dealers Association, Hathras, U.P v. Global Automobiles Limited & Anr. [Case no. 33 of 2011]*) that in order for a vertical restraint to result in an AAEC, the concerned entities are required to possess sufficient market power.

[14] Section 4 of the CA02 deals with abuse of dominant position, for which, again, market power is essential.

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Vertical Restraints and the Forgotten Function of Prices in Brand Management

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Vertical Restraints and the Forgotten Function of Prices in Brand Management

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I. INTRODUCTION

Vertical restraints remain high on the policy agenda, in particular in the European Union where the European Commission ("EC") is about to re-appear on the scene. The EC had left the field to Member States such as Germany, France, and the United Kingdom, who have brought a wide range of vertical cases since the publication of Regulation No 330/2010 of 20 April 2010 and the Guidelines on Vertical Restraint.[2]

The underlying reason for the return of the EC in the vertical restraints arena is driven by concerns about policy coherence within the European Competition Network and arguably, also, the European dimension of most of the practices considered in the cases brought on a national level. Nevertheless, the continued interest in how to properly assess vertical restraints such as RPM is also due to an increasing growth of e-commerce that is triggering specific debates not only about dual pricing but also platform competition—to name only two areas covered by recent vertical cases. These developments have not only brought old topics on vertical restraints back to the fore but have also triggered new practices given the new business opportunities presented by the internet.

While vertical restraints cannot be reduced to questions of price, the ultimate control over who sets prices is one of the core aspects in the debate. Fundamentally, the question is how much control non-dominant manufacturers are allowed to have over their products' prices and price-setting policies. In the following, two separate functions that prices fulfill in the context of vertical restraints are isolated. Focusing only on one of these functions to the detriment of the other leads to an inappropriate assessment and balancing of possible pro- and anticompetitive effects of vertical restraints. It also threatens to reduce or eliminate the possibility of manufacturers to manage and develop their brands, with corresponding potential negative effects not only for product quality and innovation but also for consumers.

The current discussion among scholars and practitioners already stresses various rationales for an effects-based approach to judging potential harm from vertical restraints, but misses two related issues: the role of price as, first, a core attribute of branded products and, second, as a core strategy variable in the vertical competition between retailers and manufacturers. Even if a given vertical restraint had the potential to raise the price, at least in the

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[2] *See* Commission Regulation (EU) No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, OJ L 102, 23.4.2010 and Commission notice - Guidelines on Vertical Restraints, Official Journal C 130, 19.05.2010.

short run, or to prevent a price cut, though this need not necessarily be the case, the somewhat simplistic view equating low prices with high consumer welfare and high prices with low consumer welfare is certainly at odds with a more nuanced understanding of what have to be considered two important roles of prices in the assessment of vertical effects. Neglecting the function that prices have for branded products amounts to restricting the manufacturers' control over the retail price and therefore ultimately the positioning and development of its brand. This may lead to substantial inefficiencies.

In standard economic theory, a good is described as a bundle of characteristics—such as its quality or the time and place of its availability. Price, however, is traditionally not seen as one of a product's or brand's characteristics.[3] Based on this view, economic theory has primarily considered only the allocative role of prices, i.e., their role as a mere transfer or means of exchange between economic actors. This is also the role of prices that competition economics has almost exclusively focused on. It is therefore not surprising that the canonical competition policy view identifies price primarily as a cost to consumers and high prices as typically associated with competition law infringements.

This article emphasizes that the role of price as a cost to consumers is but one relevant role that prices play in the context of vertical restraints of branded products. In addition to being costs and signals of relative scarcity, prices also convey information, such as on the quality of the product or service. This has been widely acknowledged not only by marketing practitioners but also in the academic marketing literature that is briefly reviewed below. The arguments developed in the following are built directly on the recognition of this wider role that prices can play.[4]

To demonstrate the role of prices as a quality indicator, and the role that vertical restraints can play in this context, consider a potential free-riding problem among retailers. A retailer that lowers its price essentially free-rides on the positive quality image that has been created by the higher prices set by other retailers. This argument builds directly on a link between higher prices at other retailers and a higher quality perception of consumers.[5] While an individual retailer will want to free-ride and boost sales at its own outlets through setting a lower price, the manufacturer fully internalizes the effect that price choice has on quality and quality perception across all outlets and all sales.

In addition, retailers and manufacturers may have different and often conflicting preferences. Retailers may sometimes prefer a lower price level than the respective manufacturer, but this may not always lead to greater efficiency. In fact, the retailer's preference for a lower

[3] This characteristics-based approach goes back to K. Lancaster, *A New Approach to Consumer Theory*, J. POL. ECON. 132: 132–157 (1966).

[4] The focus here is on price but the analysis is easily extended also to the wider role that, for instance, a (restricted) choice of distribution channels can play beyond its possible anticompetitive effects that are typically emphasized.

[5] It can easily be imagined that retail price setting in brick-and-mortar stores versus online stores creates such distinct pricing patterns.

price may not be aligned with wider consumer preferences.[6] This observation relates to a much broader theme, namely that of vertical competition. This theme captures the notion that retailers' and manufacturers' interests are not always aligned, and that these interests are in conflict even beyond the question of how to distribute a given level of channel profits through the respective wholesale and retail margins. Retailers may prefer a particular level of retail price specifically because it influences their competitive position vis-á-vis the manufacturer and thus the way future profits are shared in the vertical relationship. More precisely, this may be used to strategically influence bargaining power in the vertical relationship. Retailers have fewer incentives than the manufacturer to uphold the quality image of the manufacturer's product, as this may shift future bargaining power away from the retailer and towards the manufacturer. When retailers are given control over the price, brand manufacturers are no longer able to use price as an additional instrument to control brand image and, notably, to make their brand "stand out" among potential substitutes.[7]

The rest of the paper is organized as follows. Section II provides a brief review of what is known about the link between price and quality from the literature. Section III establishes the central argument of the dual role of prices of particular relevance in the context of vertical restraints, and Section IV concludes.

II. PRICES, QUALITY, AND BRANDS

In economics, a good can be described as a bundle of characteristics such as its quality or the time and place of its availability. Price, however, is traditionally not seen as one of a product's or a brand's characteristics. Economic theory has considered the role of prices in the allocation of resources and competition policy has followed this lead.

Businesses and business scholars are, however, very much aware of the wider role of prices. The marketing literature considers price not only as a means of exchange between buyer and seller, so that a higher price is merely a higher sacrifice for the consumer. It also recognizes the key role of prices in the context of a firm's optimal marketing mix.[8] In this context, prices can serve as a cue for the quality of a product.[9]

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[6] From a narrow point of view, that is *ceteris paribus*, consumers will of course always prefer to pay a lower price, especially if they are the only ones paying the lower price and if this has no impact on the characteristics of the product they purchase.

[7] Incidentally, note that the two arguments may apply to a different degree depending on whether there are large and powerful retailers or whether the retailer landscape is dispersed. In the former case, the argument of vertical competition may be particularly applicable. In the latter case, free-riding may potentially be more likely to apply.

[8] The term marketing mix usually refers to the "4 Ps of marketing", which stand for **P**roduct (quality, design, functions, etc.), **P**rice (unit price, discounts, credit policy, etc.), **P**romotion (advertisement, etc.), and **P**lace (sources of selling, inventory control, etc.). *See*, for instance, E.J. MCCARTHY, BASIC MARKETING (1964).

[9] For instance, Erickson & Johansson acknowledge that "the role price plays in a consumer's evaluation of product alternatives is very possibly not a unidimensional one ", and stress both that price determines (for the consumer) the reduction in wealth necessary to purchase a product ("price as a constraint"), and that it at the same time conveys information about the product quality ("price as a product attribute"). G.M. Erickson & J.K. Johansson, *The Role of Price in Multi–Attribute Product Evaluations*, J. CONSUMER RESEARCH 12: 195–99 (1985). Because of this dual role, prices are the most immediate and easiest to communicate marketing-mix variable, V.R.

More generally, the marketing literature typically embeds the role of prices in a wider framework. So-called "extrinsic quality cues" such as price, brand name, or store name are not directly related to the physical attributes of the product and can be changed without changing the product itself. By contrast, cues that can only be changed by changing the product itself—such as the nutritional content of a breakfast cereal—are called "intrinsic quality cues."[10]

Prices can serve as an extrinsic quality cue when consumers view a high price level as more indicative of a product's or brand's high quality.[11] That price can signal quality is also a key message that marketing scholars communicate to business practitioners, cautioning them about price reductions.[12] The role that higher prices can play in sustaining, for example, market outcomes exhibiting higher product quality should not be confused with the trivial fact that consumers interested in such a higher quality product would nevertheless attempt to purchase this higher quality product at the lowest possible price. This is, however, in no way a contradiction with the possibility that an overall high price range does benefit consumers or that conduct by manufacturers bringing such higher quality about is not benign.

While the present discussion focuses on the relationship between price, quality, and quality perception, it should be noted that apart from being a transfer between firms and consumers, price can play a much wider role—as was, for example, discussed in Veblen's & Leibenstein's theory of conspicuous consumption which argued for a willingness to pay a price above the intrinsic value to achieve a certain level of uniqueness and exclusivity.[13]

Rao, *Pricing Research in Marketing: The State of the Art*, J. BUSINESS 57: 39–60 (1984). More literature, including on the subsequently discussed issues, is reviewed in R. Inderst, *An Economic Analysis of Price Ownership by Branded Goods* Manufacturers, mimeo (2013), which was sponsored by the German Brands Association (Markenverband).

[10] *Cf.* A.R. Rao & K.B. Monroe, *The Effect of Price, Brand Name, and Store Name on Buyers' Perceptions of Product Quality: An Integrative Review*, J. MARKETING RESEARCH 26: 351–357 (1989).

[11] *Cf.* F. Völckner, *The Dual Role of Price: Decomposing Consumers' Reactions to Price*, J. ACAD. OF MARKETING SCIENCE 36: 359–377 (2008).

[12] For instance, Völckner & Hofmann warn "managers must be aware that price-quality inferences remain important aspects of consumers' behavior and consider them when setting prices. For example, setting a low selling price or lowering a price with a discount not only lowers consumer costs but also threatens to lower their perceptions of product quality through negative signaling effects. Managers should therefore be cautious when using discounts or pure penetration pricing to induce consumers to try new products or switch to less familiar brands and retailers. In these cases, consumers likely make negative price-quality inferences and begin to doubt the quality of the promoted product". F. Völckner & J. Hofmann, *The Price–Perceived Quality Relationship: A Meta–Analytic Review and Assessment of Its Determinants*, MARKETING LETTERS 18: 181–196 (2007).

[13] *Cf.* T. VEBLEN, THE THEORY OF THE LEISURE CLASS: AN ECONOMIC STUDY IN THE EVOLUTION OF INSTITUTIONS (1899); H. Leibenstein, *Bandwagon, Snob, and Veblen Effects in the Theory of Consumers' Demand*, Q.J. ECON. 64: 183–207 (1950); or, more recently, L.S. Bagwell & D. Bernheim, *Veblen Effects in a Theory of Conspicuous Consumption*, AMER. ECON. REV. 86: 349–373 (1996). It is noteworthy that at least one legal scholar has based a defence of RPM on these theories; Orbach calls this the "image theory." B. Orbach, *Antitrust Vertical Myopia: The Allure of High Prices*, ARIZONA L. REV. 50: 261–287 (2008) and B. Orbach, *The Image Theory: RPM and the Allure of High Prices*, ARIZONA LEGAL STUDIES: 09–39 (2010). *See also* Andrés Font-Galarza, Frank P. Maier-Rigaud, & Pablo Figueroa, *2013 RPM Under EU Competition Law: Some Considerations From a Business and Economic Perspective* 11(1) CPI ANTITRUST CHRON. (November 2013) for a discussion of RPM in a Veblen context and what that would imply in the context of the weighing of effects under Article 101(3) TFEU.

Based on the literature reviewed, an important question is what theoretical rationale can underpin the observed link between price, quality, and quality perception. The existence of such a link was introduced at an early stage into the academic literature, in fact both in economics and marketing. In a 1944 publication,[14] Scitovszky lucidly expressed one important link between price and quality. He argued that price is informative precisely for those consumers who do not directly observe quality. Then, for an uninformed consumer to judge the quality of a product by its price "implies a belief that price is determined by the competitive interplay of the rational forces of supply and demand." That is, if enough other consumer "experts" are able to directly observe a brand's quality, this belief is in fact justified since the "differences in price can be trusted to reflect differences in quality as appraised by experts." In this case, the uninformed consumer "can assume that the prices facing him are what they are because others found them reasonable and justified." A high price thus reflects high quality because if quality was not sufficiently high, informed consumers would refuse to buy the brand at that price.

If the quality of a product cannot be evaluated before purchasing, and there is no way for the seller to credibly signal the quality of his product, then this may well lead to a situation where only sellers of goods with poor quality remain in the market, at least when products are relatively indistinguishable.[15] This is, however, no longer the case when the manufacturer can credibly and convincingly use the aforementioned cues to communicate superior quality. How such a separation between high-quality and low-quality products can be achieved through prices is further discussed below.[16]

In the case of goods where quality can change quickly in production and distribution, e.g. where it depends critically on care and hygienic standards, past experience may, however, provide little information about present (or future) quality of a product. The manufacturer can, however, still be incentivized to maintain high quality, and higher prices can still serve to further increase these incentives. If a manufacturer does not take sufficient care to continuously monitor and maintain the high quality of its products—for instance, by ensuring the necessary hygienic standards in processing dairy products—its reputation may be seriously and permanently damaged if a severe decline in quality becomes public—in the context of food scandals as cases of

[14] In his original article Scitovszky discusses the phenomenon mostly based on anecdotal evidence and notes *inter alia* that "in the United States 'expensive' is in the process of losing its original meaning and becoming a synonym for superior quality. Worse still, one of the largest American breweries uses the advertising slogan: 'Michelob, America's highest-priced beer!'" T. Scitovszky, *Some Consequences of the Habit of Judging Quality by Price*, REV. ECON STUDIES 12: 100–105 (1944).

[15] Following Akerlof, this is called the lemons problem in economics. A classic example is the market for used cars. Someone who considers selling his car, which he knows to be in good shape, will find it very hard to convince a potential buyer that he in fact never had an accident with the car. Hence, the potential buyer will take into account the risk of ending up with a "lemon" and is therefore only willing to pay a price that is less than the value of a car in good shape. At such a low price, however, the owner of a car in good shape would not be willing to sell. Hence, only someone who knows that his car is a "lemon" would be willing to sell at this price, so that the fact that a particular car is up for sale in such a "lemons" market indicates that it must have poor quality. G.A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, Q. J. ECON. 84: 488–500 (1970).

[16] Related arguments have been made, for instance, by A. Wolinsky, *Prices as Signals of Product Quality*, REV. ECON. STUDIES 50: 647–58 (1983) and M.H. Riordan, *Monopolistic Competition with Experience Goods*, Q. J. ECON. 101: 265–279 (1986).

safety or health hazards. In this case, consumers often may continue to shun the manufacturer's products in the future although his quality issues may be long gone. The higher the prices, and therefore the higher the margins of the manufacturer, the more expensive this will be.[17]

While there is the need to preserve incentives for the manufacturer to ensure high quality as well as a corresponding perception of high quality for already established products, with new products the issue of quality perceptions is arguably particularly relevant. This is the case even when some aspects of quality are relatively persistent, as early in the lifetime of a product only very few consumers will be able to evaluate its true quality. In particular, in such circumstances it seems that the proper choice of price, as a means of communicating information about quality to those consumers who had no or only limited experience of the product, is of particular importance.[18]

The link between price and perceived quality was put to empirical testing very early on in the marketing literature.[19] Some of the respective findings are singled out below. While evaluating and comparing the positive and negative attributes of different products represents a difficult task for consumers, price—by contrast—is relatively easy to compare. This would suggest, as has been documented in the literature, that price is of particular relevance as a cue for quality when consumers have to decide quickly.[20] Further, an individual quality cue such as price should be more relevant if consumers have few alternative cues to infer a product's quality. This can be the case for new products or brands that are still little known. So there can also be a complementary role of price and other quality cues in the optimal marketing mix.[21]

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[17] *Cf.* B. Klein & K.B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, J. POL. ECON. 89: 615–641 (1981) or C. Shapiro, *Premiums for High Quality Products as Returns to Reputations*, Q. J. ECON. 98: 659–679 (1983). Adjusting the price over time, depending on perceived quality, may not be feasible as this not only confuses consumers or involves high costs for manufacturers and retailers, but also because a reduction in the price may itself be seen as an indication of low quality provision in the future.

[18] When high quality is more costly to produce than low quality, a low-quality firm's profit margin is higher, so that the immediate reduction in demand that is induced by a price increase is more costly for a low-quality firm than for a high-quality firm. As discussed above, this channel, which links price to quality perception, is present both here and when products are more mature but quality must be continuously upheld. *Cf.* K. Bagwell & M.H. Riordan, *Equilibrium Price Dynamics for an Experience Good*, Discussion Paper, Northwestern University, Center for Mathematical Studies in Economics and Management Science (1986); K. Bagwell & M.H. Riordan, *High and Declining Prices Signal Product Quality*, AMER. ECON. REV. 81: 224–239 (1991); K. Bagwell, *Pricing To Signal Product Line Quality*, J. ECON. & MGMT. STRATEGY 1: 151–174 (1992); or M.C.W. Janssen & S. Roy, *Signaling Quality through Prices in an Oligopoly*, GAMES & ECON. BEHAVIOR 68: 192–207 (2010). Focusing, in particular, on pricing over time, *see,* in the marketing literature, D.J. Curry & P.C. Riesz, *Prices and Price/Quality Relationships: A Longitudinal Analysis*, J. MARKETING 52: 36–51 (1988) or D.R. Lichtenstein & S. Burton, *The Relationship between Perceived and Objective Price–Quality,* J. MARKETING RESEARCH 26: 429–443 (1989).

[19] *Cf.* H.J. Leavitt, *A Note on Some Experimental Findings About the Meanings of Price*. J. BUSINESS 27: 205–210 (1954).

[20] *Cf.* R. Suri & K.B. Monroe, *The Effects of Time Constraints on Consumers' Judgments of Prices and Products*, J. CONSUMER RESEARCH 30: 92–104 (2003).

[21] There exist numerous meta-studies that systematically analyze the results from other studies. For instance, despite differences in the respective findings, Völckner & Hofmann conclude that consumers seem to apply simple heuristics, such as "you get what you pay for," which underpins such a link between price and quality perception, Vöockner & Hofmann, *supra* note 10. *See* for instance also V.A. Zeithaml, *Consumer Perceptions of Price, Quality,*

Taken together, the role of price as an important signal of quality, or, more generally, an important, sometimes constitutive part of a brands' image, is well established in the academic literature and even more so among practitioners. In what follows, we further add to the argument and then apply this concept to the respective antitrust question.

III. THE LINK BETWEEN PRICES AND QUALITY

In the previous section some of the marketing and economics literature establishing a link between prices and quality or quality perception was discussed. Based on the formal analysis developed in Inderst & Pfeil (2012),[22] three related channels establishing a link between price and quality can be isolated. Illustrating these channels in detail provides a sound background for our subsequent discussion of free-riding and vertical competition that demonstrates that both rely on the established link between price and quality.

When a higher price is chosen, there is more to be gained by sustaining demand through upholding higher quality. Conversely, when true and perceived quality drop off, e.g. as a consequence of a lowering of hygienic standards, the resulting loss in demand proves to be more costly when the margin that would otherwise be earned on a higher volume is itself higher. This can be termed a margin effect.

In addition, there is also a cost effect: keeping quality perceptions unchanged, a higher price would in itself reduce demand. Then, an increase in the per-unit costs—when this is associated with higher quality—has a smaller negative impact on overall firm profits.

Finally, an elasticity effect is identified. This effect arises, in particular, when not all consumers have the same marginal valuation for quality but when, instead, those consumers who value the product more also have a higher valuation for quality. As the price increases, the critical consumer type, i.e. the type of consumer who is just indifferent to purchasing or not purchasing, now values quality more and, consequently, reacts more strongly to a perceived change in quality. In other words, as the price increases, this renders the product's demand more responsive to changes in quality, which then increases the firm's incentives to indeed provide high quality.

Based on this link between price, quality, and quality perception, manufacturer price ownership could lead to higher equilibrium quality and quality perception than retailer price ownership. This is the case because only the manufacturer fully takes into account the implications that individual retail prices have on the product's overall quality perception. From the manufacturer's perspective individual retailers place too much emphasis on the sales in their individual store, ultimately resulting in free-riding on consumers' quality perception.

Further, when there is retail competition, what matters in negotiations between the manufacturer and individual retailers is how easily they can substitute for the counterparty, i.e. by stocking another product or relying solely on other outlets. When one retailer decides not to stock the respective product any longer, then the manufacturer will be able to attract more

and Value: A Means–End Model and Synthesis of Evidence, J. MARKETING 52: 2–22 (1988) or Rao & Monroe, *supra* note 8.

[22] R. Inderst & S. Pfeil, *Branding, Quality, and Price Ownership through RPM*, mimeo (2012).

consumers and sales at other outlets when the product's quality perception is higher. In turn, the share of consumers that the retailer that delists this product attracts, and the respective profits, are then strictly lower. In essence, a higher quality perception, as sustained (credibly) through a higher price thus puts the manufacturer in a better—and the retailer in a worse—position when the two parties do not come to an agreement.

Taken together, the preceding discussion thus isolates two rationales for why control over the price matters for branded products in light of the established link between price, quality, and quality perception. Both rationales derive from a conflict of interest between retailers and manufacturers: first, manufacturers typically fully internalize the implications that prices have on consumers' overall perception of quality, whereas individual retailers will tend to free-ride; second, as consumers' perception of high quality enhances a manufacturer's bargaining power but may decrease that of retailers, the latter have less incentives to uphold high quality perception through the corresponding choice of the retail price.[23]

IV. CONCLUDING REMARKS

Competition law and economics has traditionally come to view high prices as a direct result of various forms of anticompetitive conduct. The nexus between higher prices and consumer harm is similarly ingrained in the minds of competition lawyers and economists alike. This also holds true for vertical effects, where efforts to control prices by manufacturers are easily interpreted as eliminating other sources of competition in an effort to maintain artificially high prices. This focus on low prices is also reflected in the weighing in of inter-brand competition as a counterbalancing force to eliminated or reduced intra-brand competition.

While vertical restraints can be used in an anticompetitive way, we have attempted to demonstrate that competition law risks overshooting the mark if no account is taken of both the fundamental use of price as a signal of quality and of the important role prices play for manufacturers in their overall "marketing mix" decisions. As set out above, there is a well-established link in both theoretical and empirical work between price and quality. More generally, price is recognized by both practitioners and (notably marketing) scholars as a key part of a product's brand image and, as such, as a key "cue" for consumers. It is thus far more than a simple transfer between consumers and firms, implying that a lower price is not always beneficial for efficiency and consumer welfare. While in a narrow sense, that is *ceteris paribus*, a lower price will always be better for a consumer than a higher price, especially if that consumer is the only one in the position to benefit from the reduced price, it has been shown in this article that the choice of price may have fundamental repercussions for the product itself, thereby rendering the required competition analysis in assessing the effects of vertical restraints much less straightforward.

Overall, ignoring these wider functions of prices when restricting manufacturers' practices, including the use of vertical restraints, may thus come at a cost. Ignoring these functions risks curtailing the possibilities available to brand manufacturers to successfully

[23] In both instances it is immediate that the retailers' preferred price may not coincide with the price level that maximizes efficiency and welfare. Competition law and policy that rigidly allocates control over the retail price to retailers may thus cause a reduction of consumer welfare.

develop a high quality brand and experiment with different distribution approaches in a changing market place.

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On the Utility of Surrogates for Rule of Reason Cases

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On the Utility of Surrogates for Rule of Reason Cases

Kevin Caves & Hal Singer[1]

We need directions. Without them, we would be lost. Ditto for rules on how firms with market power may behave in the marketplace. How can I set prices inside and outside this bundle without running afoul of the antitrust laws? How can I settle a lawsuit with a generic firm that potentially infringed on my patent? Under what conditions may I establish a minimum retail price for my distributors?

In some circumstances, the law provides a "surrogate"[2] to be used in conjunction with a full-blown rule-of-reason analysis: If *A* is greater than *B*, then, all else equal, the likelihood of an antitrust violation increases—at least relative to a world in which *A* does not exceed *B*. As the name suggests, a surrogate allows the fact finder to make an inference about market power or anticompetitive effects based on the results of the test.

Most (if not all) surrogates generate at least some false positives and some false negatives. But so long as a surrogate merely shifts the needle—as opposed to triggering automatic violations (or safe harbors)—it provides utility to courts (by separating meritless cases from meritorious ones), to industry participants (by providing general guidance on how to behave), and to attorneys general and antitrust agencies (by offering guidance on the evidence necessary to prosecute a case). No surrogate will get it right all the time, but such instruments remain useful as long as the outcome of the test is sufficiently correlated with the economically correct answer.

Consider two surrogates: In *Actavis*, the Supreme Court rejected the FTC's "quick-look" approach, under which *any* reverse payment settlement was "presumptively unlawful,"[3] and ruled instead that the likelihood of finding an antitrust violation increases if the payment[4] from a branded firm to a generic (*A*) exceeds the avoided litigation costs and/or the value of services

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[2] A surrogate that is incorporated into a rule of reason analysis is different from a truncated, "quick-look" case, which deprives defendants of the opportunity to challenge the initial inference of an anticompetitive effect. *See* Aaron Edlin, Scott Hemphill, Herbert Hovenkamp, & Carl Shapiro, *Actavis and Error Costs: A Reply to Critics*, ANTITRUST SOURCE 3 (Oct. 2014), *available at* http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/oct14_edlin_10_21f.authcheckdam.pdf.

[3] *Actavis*, 133 S. Ct. at 2237; *see also* Reply Brief for Petitioner at 7–8, *FTC v. Actavis* (No. 12-416), 2013 WL 1099171.

[4] Some district courts have interpreted payments from *Actavis* to include non-cash payments, including "lucrative manufacturing and distribution agreements and prospective future revenue under an exclusive marketing privilege." *See, e.g.*, Summary Judgment Opinion, In re Nexium (Esomeprazole) Antitrust Litig., (D. Mass. 2013), Sept. 4, 2014, at 20 [hereafter *Nexium Summary Judgment*].

rendered (*B*).[5] For brevity, we refer to this *Actavis* surrogate as the "avoided-litigation benchmark." In *Cascade*, the Ninth Circuit ruled that exclusionary bundled discounting claims, in addition to the usual requirements for proving liability under §2 of the Sherman Act, also require plaintiffs to prove that the imputed price of the tied product (*A*) is less than the defendant's incremental cost of producing the tied product (*B*).[6] We refer to this *Cascade* surrogate as the "discount-attribution test."

In other instances, the law provides a fuzzy standard based on a host of factors that do not neatly map into a formula. For example, in *Leegin*,[7] the Supreme Court articulated an exclusionary theory for establishing liability of a retail-price-maintenance ("RPM") program, but did not set out any surrogate. Because certain retailers enjoy the shared benefit of a vertical practice such as RPM, the Court reasoned, a manufacturer with market power may provide the incentive for retailers to foreclose small manufacturers or new rivals. It was not until two economists formalized this theory a few years later, however, that any litigant would know that the two key factors for establishing anticompetitive effects from RPM under this exclusionary theory are (1) that the manufacturer imposing the vertical pricing scheme has market power, and (2) that entry requires accommodation by retailers.[8]

Fuzzy standards like these leave litigants with the "I'll-know-exclusionary-conduct-when-I-see-it" standard. In principle, this could favor either plaintiffs (who might rationalize more fact patterns as being consistent with a fuzzy standard), or defendants (how can a plaintiff marshal evidence of a violation when the initial evidentiary burden is so nebulous?) Fuzzy standards also leave firms scratching their heads as to how best to conduct their business.

But surrogates have their warts too; the major demerit is the possibility that some bad conduct will not trigger the test (a "false negative"), and that some good conduct will be presumptively condemned (a "false positive"). Yet these error costs can be mitigated so long as the parties have an opportunity to offer evidence that the test has given the wrong answer.

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[5] The Supreme Court initially identified two benchmarks (or "traditional settlement considerations") against which to compare the size of the reverse payment: (1) the patent holder's anticipated litigation costs; and/or (2) the value of other services that the payment might reflect. A reverse payment in excess of these benchmarks may suggest anticompetitive harm because it constitutes a signal that the patentee may be "using its monopoly profits to avoid the risk of patent invalidation or a finding of non-infringement." Conversely, a reverse payment below these benchmarks does not imply the same degree of "concern that a patentee is using its monopoly profits to avoid the risk of patent invalidation or a finding of non-infringement." *Actavis*, 133 S. Ct. at 2236 ("Where a reverse payment reflects traditional settlement considerations, such as avoided litigation costs or fair value for services, there is not the same concern that a patentee is using its monopoly profits to avoid the risk of patent invalidation or a finding of non-infringement.").

[6] *Cascade Health Solutions (f/k/a McKenzie-Willamette Hospital)* v. *PeaceHealth*, No. 05-35627, (9th Cir. Sept. 4, 2007), 11221, n. 13 ("[E]ven if the exclusionary conduct element is satisfied by bundled discounts at price levels that yield a conclusion of below-cost sales, under the appropriate measure, there cannot be Sherman Act § 2 liability for attempted monopolization unless the other elements of a specific intent to monopolize and dangerous probability of success are satisfied.").

[7] *Leegin Creative Leather Products, Inc.* v. *PSKS, Inc.*, 551 U.S. 877 (2007).

[8] *See* John Asker & Heski Bar-Isaac, *Raising Retailers' Profits: On Vertical Practices and the Exclusion of Rivals,* 104(2) AMER. ECON. REV. 672-686 (2014).

Another potential weakness is that many surrogates are based on an underlying economic model, whose policy implications critically depend on certain simplifying assumptions. Relax those assumptions and the test is not as reliable. In other cases, the policy implications are sound only when the proxy for consumer welfare is accurate. For example, because the discount-attribution test uses the welfare of an equally efficient rival as a proxy for consumer welfare, it is straightforward to construct a hypothetical bundle that improves consumer welfare by expanding the choice set of consumers yet forecloses an equally efficient rival from competing in the tied market—a false positive.[9] It is equally straightforward to construct a bundle that degrades consumer choices yet permits entry in the tied market—also a false positive.[10] To be fair, competitor welfare often provides a proxy for competition, and is therefore often correlated with consumer welfare.

Of course, there are other surrogate tests for exclusionary bundling. For example, we would prefer an alternative surrogate based on a squeezing-surplus model that focuses on consumer welfare.[11] For multi-product bundled rebates, the test would work as follows: If the stand-alone price of the tying product (A) exceeds in the independent monopoly price (B), then the likelihood of finding an antitrust violation would increase.[12] As in other models, this crisp policy implication breaks down to the extent that the key assumption of the underlying model (homogenous tied products) gives a poor approximation of the real world.[13]

Despite these obvious drawbacks, surrogates such as the discount-attribution test provide utility to a court so long as the test results (1) correlate with changes in consumer welfare, and (2) merely alter the *likelihood* of finding a violation—that is, so long as the story does not end there. If forced to choose between the discount-attribution test and no surrogate—for example, a nebulous exclusive-dealing framework[14]—we would begrudgingly prefer the discount-attribution test, if only because it provides some guidance (however imperfect) to firms and courts.

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[9] Before a bundle, a firm charges $10 (the monopoly price) for A and $5 (the competitive price and marginal cost) for B. After the bundle, a firm continues to charge $10 for A when purchased on a standalone base, but charges $14 for the bundle. Because the imputed price of the tied product is $4 (equal to $14 less $10), the equally efficient rival is foreclosed, and *Cascade* would condemn this pro-competitive offer.

[10] Before a bundle, a firm charges $10 (the monopoly price) for A and $5 (the competitive price) for B. After the bundle, a firm raises the standalone price for $A to $12, and charges $17 for the bundle. Because the imputed price of the tied product is $5 (equal to $17 less $12), the equally efficient rival may compete, and *Cascade* would condone this anticompetitive offer.

[11] *See* Patrick Greenlee, David Reitman, & David S. Sibley, *An Antitrust Analysis of Bundled Loyalty Discounts*, 26 INT'L J. IND. ORG. (2008).

[12] In the case of single-product loyalty rebates, the analogous test would be: If the standalone price of the non-contestable portion of the buyer's demand (A) exceeds the independent monopoly price (B), then a rebuttable presumption of anticompetitive harm would be established.

[13] Greenlee et al., *supra, note 11*. ("If products in the tied market are homogeneous, simple price comparison tests exist that can distinguish bundled rebates that raise consumer surplus from those that do not.").

[14] *See, e.g.,* Joshua D. Wright, Simple but Wrong or Complex but More Accurate? The Case for an Exclusive Dealing-Based Approach to Evaluating Loyalty Discounts, Remarks at the Bates White 10th Annual Antitrust Conference (June 3, 2013), *available at* http://www.ftc.gov/sites/default/files/documents/public_statements/simple-wrong-or- complex-more-accurate-case-exclusive-dealing-based-approach-evaluating-loyalty/130603bateswhite.pdf.

In contrast, the avoided-litigation benchmark adopted in *Actavis* does not use rival welfare as a proxy for consumer welfare; in this sense it is less prone to false positives than the discount-attribution test. It can also prevent anticompetitive settlements that might occur if courts could not infer a higher likelihood of an antitrust violation from unexplained payments. Borrowing on the scholarship of Edlin, Hemphill, Hovenkamp, & Shapiro ("EHHS"),[15] the Supreme Court set out a simple yet elegant model that mapped payments to generics onto but-for generic entry dates. The central logic of the model is that a brand would not make payments to a generic in excess of the avoided litigation costs *unless* entry were postponed relative to the expected entry date in the absence of a settlement. Thus, one may infer from any otherwise unexplained payment that the purpose of the payment was to extend the brand's monopoly at the expense of consumers. To mitigate the risk of false positives, defendants can present compelling efficiency justifications to provide a procompetitive rationale for the payment.

By tweaking the underlying assumptions of a model, clever economists can construct counterexamples in which a surrogate condemns pro-competitive conduct (a false positive).[16] These circumstances permit settlements that involve payments in excess of litigation costs that nevertheless expedite generic entry (or at least do not delay entry, relative to the expected entry date under litigation).

It should also be noted that a strict application of the avoided-litigation benchmark (which the Court does not appear to call for) could produce a false negative whenever the profits to generics under competition are small relative to the brand's litigation costs. Under these circumstances, the brand can, in theory, delay entry indefinitely, and without violating the avoided-litigation benchmark, by offering to share a relatively small portion of its monopoly rents with the generic, which is still made better off than it would have been under competitive entry.

To illustrate, consider the following example, which adopts notation analogous to that of EHHS: Suppose that, absent entry, the brand will earn monopoly profits M_B per unit of time. If

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[15] *Actavis*, 133 S. Ct. at 2235 (citing Brief for 118 Law, Economics, and Business Professors as Amici Curiae, signed by, among others, Carl Shapiro and Aaron Edlin) (for the proposition that "patentees sometimes pay a generic challenger a sum even larger than what the generic would gain in profits if it won the paragraph IV litigation and entered the market"). *Id*. at 2237 (citing AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶2046, p. 338 (3d ed. 2012)) (for the proposition that "the size of the unexplained reverse payment can provide a workable surrogate for a patent's weakness"). These views were distilled into an article that appeared after the *Actavis* decision. *See* Aaron Edlin, Scott Hemphill, Herbert Hovenkamp, & Carl Shapiro, *Activating Actavis*, ANTITRUST, 16 (Fall 2013).

[16] Barry C. Harris, Kevin M. Murphy, Robert D. Willig, & Matthew B. Wright, *Activating Actavis: A More Complete Story*, ANTITRUST, 83 (Spring 2014). The authors construct two such examples: (1) when the brand is risk averse; and (2) when the brand is risk averse *and* the generic is more optimistic about its chances in litigation than the brand. *See* also Joshua D. Wright, Antitrust Analysis of Reverse Payment Settlements After Actavis: Three Questions and Proposed Answers, *available at* http://www.ftc.gov/system/files/documents/public_statements/591131/141010actavisspeech.pdf. Wright observes that the EHHS model presumes that the generic can earn duopoly profits after entry (in the absence of a settlement), when its duopoly profits are protected via Hatch Waxman for only 180 days. This, combined with another institutional detail (collateral estoppel), results in a significantly broader settlement range than under the simply monopoly-to-duopoly model. Wright concludes that this "broad settlement range renders attempts to regulate the size of patent settlements, or infer anticompetitive effects based upon payment size ineffective." Instead, he advocates for a "more full-blown rule of reason inquiry." *Id*.

entry occurs, then both the brand and the generic earn duopoly profits D. If competition under duopoly is Bertrand in price (or close to it), then $M_B >> 2*D$.[17] Under litigation, the most that the entrant could expect to gain is $(1-P)*T*D$, where T is the remaining patent lifetime, and P is the probability that the patent will be found valid and infringed. Accordingly, the generic is made better off by any reverse payment X, so long as $X > (1-P)*T*D$. (If the generic is risk averse, or if the generic would incur infringement fees in the event that the patent were upheld, then the generic would also accept a range of payments below this amount.) Let C_B denote the brand's litigation cost. As long as $C_B > (1-P)*T*D$, then there exists a range of reverse payments that would not trigger the avoided-litigation benchmark, but would still make the generic better off staying out of the market altogether than it would have been under competitive entry. Moreover, as competition approaches Bertrand (as $D \rightarrow 0$), the inequality is guaranteed to hold for any positive value of C_B.

Unlike Cascade,[18] failure to trigger the avoided-litigation benchmark in *Actavis* does not appear to create a safe harbor.[19] To mitigate the risk of false negatives—which could occur when the reverse payment is approximately equal to the avoided litigation costs or the fair market value of services rendered—the Court invites plaintiffs to bring forward supplemental evidence, including direct evidence, as to why the settlement (with reverse payment) was secured in the first instance.[20] Because there are other paths to proving a violation under *Actavis*, the avoided-litigation benchmark is best understood as a sufficient, but not necessary, condition to moving the needle in favor of finding an antitrust violation.

The avoided-litigation benchmark, like any stylized model, is not immune to prediction error. So long as it merely moves the needle, however, we do not have to worry as much about whether the test is ideal. Without a surrogate to narrow the focus, "there would be many false negatives, as antitrust plaintiffs struggled in every case to compare the settlement to a reconstructed measure of the expected litigation outcome."[21] Stated differently, without the surrogate, plaintiffs would have to pinpoint the but-for entry date using other tools.

Which brings us full circle to the question advanced at the beginning of this essay: Should we prefer surrogates for antitrust violations that permit errors, or should we instead rely on a

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[17] The notation "$X >> Y$" implies that the first quantity is much greater than the second.

[18] *See, e.g.*, Einer Elhauge, *Tying, Bundled Discounts, and The Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397, 461–75 (Dec. 2009) (criticizing the safe harbor for effectively immunizing conduct that may harm consumer welfare).

[19] In contrast to *Cascade,* there is no discussion of safe harbors in *Actavis*.

[20] *Actavis*, 133 S. Ct, at 2237 ("Although the parties may have reasons to prefer settlements that include reverse payments, the relevant antitrust question is: What are those reasons? If the basic reason is a desire to maintain and to share patent-generated monopoly profits, then, in the absence of some other justification, the antitrust laws are likely to forbid the arrangement."). *See also Nexium Summary Judgment* at 60 ("The Court does not agree, however, that Actavis counsels such a narrow view of fair market value as a dispositive issue. The Actavis opinion makes it clear that evidence of a fair value exchange can "redeem[]" an otherwise suspicious reverse payment. 133 S. Ct. at 2236. The Court understands this to mean that establishing fair market value is just one of many possible defenses available to a Defendant seeking to demonstrate procompetitive justifications for a reverse payment.").

[21] *See* Aaron Edlin, Scott Hemphill, Herbert Hovenkamp, & Carl Shapiro, *Actavis and Error Costs: A Reply to Critics*, ANTITRUST SOURCE 7 (Oct. 2014), *available at* http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/oct14_edlin_10_21f.authcheckdam.pdf.

more nebulous rule-of-reason inquiry? It turns out that question presents a false choice: We can use both. Certain benchmarks reveal meaningful economic information regarding likely anticompetitive effects in the first instance, without forfeiting the chance for plaintiffs and defendants to argue their respective theories of the case under the rule of reason.

While a comprehensive assessment of any particular surrogate is outside the scope of this brief essay, it bears emphasis that some tests are more closely tethered to consumer welfare than others, at least when their assumptions provide a reasonable representation of the market in question. Conditional on satisfying that initial burden, the likelihood of finding a violation increases. Because the story does not end there, plausible efficiency justifications can be incorporated into this second stage of the inquiry.