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Managing Distribution and Antitrust Compliance Issues in China: Post Medtronic & GM

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Abstract

According to article 14 of the AML, NDRC and its delegated local authorities investigated several major cases concerning RPM in 2016, including Medtronic Case and GM case, which indicates that enterprises in China face relatively high antitrust compliance risk in distribution practices. Ever since the AML came into effect, RPM has drawn attention from the perspectives of public and private antitrust enforcement. There are 13 cases investigated and fined by NDRC and its delegated local authorities, covering different sectors such as healthcare, autos and premium liquor. Regarding private enforcement, Johnson & Johnson case and Gree case imply that courts in China tend to adopt the rule of reason to determine the legality of RPM. In order to embody the article 14 of the AML, SAIC and NDRC is drafting a series of provisions and guidelines to provide a clearer standards for antitrust enforcement and compliance. Although no cases involving non-pricing vertical restraints has been released so far, there are signs that enforcement authorities have realized the potential adverse effect of such agreements on competition. They may take steps to regulate non-pricing vertical restraints in the near future. In regard of legislations stipulating vertical restraints, apart from article 14 and 15 of the AML, a number of guidelines will probably come into effect in 2017. In brief, antitrust risks enterprises face in China post Medtronic & GM may be increased, which reminds enterprises better to strengthen management level of antitrust compliance and ability to cope with investigations and lawsuits.

Keywords: vertical restraints, Medtronic Case, China antitrust enforcement

I. Introduction

With the release of the Medtronic case and the GM case, the curtain of National Development and Reform Commission's "NDRC antitrust enforcement in 2016 has been dropped. NDRC's last two heavy punches in 2016 were laid respectively in healthcare industry and auto industry, which are two hottest industries targeted by antitrust investigations of NDRC in recent years. These two cases, together with other cases involving vertical monopoly agreements this year, signal a heightened antitrust risk of distribution restrictions once again.

Distribution agreements between an enterprise and its upstream or downstream trading counterparts which have the effect of restricting or excluding competition in relevant market are prohibited under Article 14 of the *Anti-Monopoly Law* ("AML").¹ Furthermore, Article 15 indicates that monopoly agreements which satisfy certain requirements can be exempt from regulation of AML.² This article aims to outline the antitrust risk enterprises may face when managing their distribution, as well as provide practical advice by analyzing the enforcement of authorities and court decisions.

II. Vigorous Enforcement against RPM

Resale Price Maintenance "RPM" includes fixing the price of commodities resold to a third party or limiting the minimum resale price of commodities resold to a third party, both of which are expressly prohibited by Article 14 of the AML. Moreover, RPM could also be achieved through certain indirect means, such as fixing the distribution margin, fixing the maximum level of discount the distributor can grant from a prescribed price level, making the grant of

¹ Article 14 of the AML: "The following monopoly agreements between business operators and trading counterparts shall be prohibited:

- 1) fixing the price of commodities for resale to third party;
- 2) fixing the lowest price for resale of commodities to third party; and
- 3) any other monopoly agreements as defined by the anti-monopoly enforcement agency of the State Council."

² Article 15 of AML: "The provisions of Article 13 and 14 of this Law shall not be applicable to the agreements between undertakings which they can prove to be concluded for one of the following purposes : (1) improving technologies, or engaging in research and development of new products ; or (2) improving product quality, reducing cost, and enhancing efficiency, unifying specifications and standards of products, or implementing specialized division of production ; (3) increasing the efficiency and competitiveness of small and medium- sized undertakings ; (4) serving public interests in energy conservation, environmental protection and disaster relief ; (5) mitigating sharp decrease in sales volumes or obvious overproduction caused by economic depression; (6) safeguarding legitimate interests in foreign trade and in economic cooperation with foreign counterparts ; or (7) other purposes as prescribed by law or the State Council.

rebates or reimbursement of promotional costs by the supplier subject to the observance of given price level, linking the prescribed resale price to the resale prices of competitors, or threats, intimidation, warning, penalties, delay or suspension of deliveries or contract termination in relation to observance of a given price level.

A. Public Enforcement: NDRC's Actively Investigations against RPM

a. Significant Actions against RPM before the Cases of Medtronic and GM

Price restraint has long been the red line in distribution management. In 2016, the NDRC and its delegated local counterparts, authorities in charge of the price-related monopoly agreements, had investigated and penalized on 6 cases involving RPM, making the total number of RPM cases penalized to 13. Enforcement against RPM involves different sectors, including infant powder, glasses, premium liquors, autos, healthcare, household electrical appliances and food logistics, among which the auto and healthcare sector are mostly concerned.

From September 2014 to September 2015, continuous enforcement on RPM in auto sector has been well known by the public. NDRC's delegated local counterparts in Hubei, Shanghai, Jiangsu and Guangdong respectively investigated on FAW-Volkswagen, Chrysler, Benz and Dongfeng-Nissan, with fines equivalent to 3% to 7% of the turnover in the previous year of such automobile manufacturers. In April 2016, the target has been turned to auto parts sector, in which the Hankook Tire was penalized for its RPM on tires for trucks by Shanghai DRC.

b. Noteworthy Highlights of the Cases of Medtronic and GM

1) NDRC vs. Medtronic

In December 7, 2016, NDRC released a case in which it imposed a fine of CNY 118.5 million (approximately USD 17.2 million) on Medtronic (Shanghai) Management Co., Ltd ("Medtronic") for reaching and implementing price monopoly agreements with trading counterparts. In the Medtronic case, Medtronic entered into vertical monopoly agreements to fix resale prices and restrict minimum resale prices as well as bidding prices with its trading

counterparts through distribution agreements, e-mail notifications, and oral discussions from no later than 2014. NDRC determined its several arrangements in distribution as RPM, includes not only directly fixing resale prices, and restricting distributors' minimum bidding price but also fixing platform vendor's gross margin. Medtronic fixed prices by setting price system of the whole distribution chain for distributors and platform vendors to implement. In Medtronic's distribution contracts, distributors are required to strictly observe suppliers' guidance prices on bidding, and the bidding prices offered by distributors shall also be restricted and reviewed by Medtronic's relevant business division. Moreover, the punitive measures were adopted, such as refusing to supply products to distributors who won bids with low prices to ensure the implementation of monopoly agreements. On this basis, Medtronic established internal value chain, which is prevalence in healthcare industry.

The Medtronic case might be a milestone in the application of exemption under Article 15 of the AML as well. Among previous penalty decisions, there was no obvious evidence for us to find out whether Article 15 of the AML has been applied in the practice of the authorities. However, in Medtronic case, NDRC explicitly expressed that Medtronic had not apply for exemption or provided evidence for exemption under the Article 15 of the AML. By clarifying this in its decision, NDRC may show its attitude towards the exemption procedure - exemption could be sought for with sufficient evidence presented.

2) Shanghai Municipal Price Bureau vs. GM

Also in the last month of 2016, another case in auto sector was released by Shanghai Municipal Price Bureau, in which SAIC-General Motors Corporation ("GM") was fined for its fixing the minimum resale price of relevant auto models by issuing several commercial documents to distributors, including *Regional Price Notice*, *Market Competition Dynamics* and *Price Guidance Notice*. GM also adopted punitive measures including suspending the supply of well-sold models, imposing fines and deducting sales rebates. A similar case in auto industry had been published in 2015, in which NDRC found Dongfeng Nissan fixed the price of automobiles by issuing price management measures and other documents to its distributors, accompanied by punitive measures.

c. RPM under Auto Antitrust Guidelines

In addition to RPM cases released by now, NDRC intends to provide specific guidance to auto companies by drafting *Anti-Monopoly Guidelines for Auto Industry (Draft for Comments)* (“Auto Guidelines”), the only antitrust guidelines for a specific industry. Pursuant to Auto Guidelines, the provision of a list of recommendation prices or maximum prices by the supplier to the buyer is not considered itself as leading to RPM. However, if the recommended price, guided price and maximum price have been adopted by all or most of the distributors due to one party’s pressure or incentive, which substantially constitutes fixed price or minimum resale price, such conduct may be defined as RPM on a case-by-case basis. Auto Guidelines is expected to be issued in 2017, which may have some reference for companies in other industries.

B. Private Enforcement: Detailed Analysis to Determine RPM

a. General Proposition

Although NDRC and its local counterparts determined in a number of different investigations that involving parties had excluded and restricted competition in relevant market by reaching into vertical restraints, they barely provided specific analysis in any published administrative decisions. On the contrary, courts in China tend to provide a relatively detailed analysis in its findings, where the rule of reason has been adopted in the determination of illegal RPM. From this perspective, standards and principles adopted by courts of China are more predictable.

b. The Case of Johnson & Johnson in Shanghai

As the first civil litigation involving vertical monopoly agreement, Beijing Ruibang Yonghe Science and Technology Trade Company v. Johnson & Johnson Medical Companies (“J&J”)³ in 2013 is a landmark in this regards. In such case, Shanghai Higher People's Court adopted the rule of reason. It found that only if a RPM agreement has the effect to exclude or restrict competition can it be determined as a monopoly agreement under Article 14 of the AML.

³(2012) Hu Gao Min San Zhong Zi No. 63, (2012) 沪高民三(知)终字第63号

When determining whether a RPM would exclude or restrict competition, the court may consider several aspects includes 1) whether there is sufficient competition in relevant market; 2) whether the business operator enjoys superior power in areas of market share, supply of raw materials, key technologies, distribution channel, or brand influence; 3) whether the business operator has the incentive to restrict competition; 4) whether such price restraint shall pose adverse effect on competition. Also, the court clarified that the plaintiff should bear the burden to prove that RPM may exclude or restrict competition.

As a result, the court held that RPM of J&J did exclude intra-brand competition and therefore constituted illegal RPM. However, it is worth noting that the plaintiff could seek for compensation under the AML instead of the Contract Law, leading to the amount of compensation as the normal profit loss. Also, J&J did not apply for exemption under Article 15 of the AML so that the court showed no comment on such provision.

c. The Case of Gree in Guangdong

In a more recent trial released in August 2016⁴, Guangzhou Intellectual Property Court also adopted the rule of reason in its determination in illegal RPM in the first instance. The court found that although Gree Electric fixed the minimum resale price in Dongguan, the competition in relevant market remains sufficient rather than being excluded. The court decided that the agreement to fix resale price in this case is not to exclude or restrict competition in relevant market. Thus, the court found that the RPM implemented by Gree Electric had no adverse effect on competition in relevant market and shall not be penalized under Article 14 of the AML.

III. Non-Pricing Vertical Restraints: Certainty vs. Uncertainty

Due to the continual enforcement on RPM, an increasing number of companies realized the high risk of RPM may try to seek for non-pricing vertical restraints with their trading counterparts. Under Article 14 of the AML, there is also a catch-all provision to regulate the non-pricing vertical monopoly agreement; therefore the risk of non-pricing restraints shall not

⁴ (2015) Yue Zhi Fa Shang Min Chu Zi No.33, (2015) 粤知法商民初字第33号

be undermined. In practice, such non-pricing vertical restraints normally include but not limited to territorial allocation, customer allocation, exclusive dealing and most-favored nation clause.

Territorial allocation refers to the situation where a supplier intends to exclusively allocate territories to a single distributor, or where a distributor is prevented from selling to customers outside of its allocated territory. Customer allocation refers to the situation where a supplier intends exclusively allocate secondary distributors or customers to a single distributor, or where a distributor is prevented from selling to secondary distributors and customers other than the ones allocated to it. Referring to practice in other jurisdictions, territorial or customer allocation is normally a typical one of vertical restraints. Territorial or customer allocation mostly happens in auto, medical devices, electric alliance and other industries with high scientific and technological character and in great need of pre-sale and after-sale services.

Besides, exclusive dealing includes exclusive supply where the supplier is required by the distributor to provide products exclusively to the distributor, and exclusive purchasing where the distributor is required by the supplier to purchase products exclusively from the supplier or any third party specified by the supplier.

Most-favored nation clause (or “parity clause”) is a kind of arrangement between the supplier and the distributor whereby the supplier grants the distributor conditions that will not be less favorable than those granted to the other distributors, in terms of price, after-sale services and other trading conditions.

A. Potential Practice of Enforcement Authorities

State Administration for Industry and Commerce “**SAIC**” is responsible for investigation of non-pricing restraints in China. So far, no administrative penalty or court decision on non-pricing vertical restraints has been released. However, the Medtronic case investigated by NDRC shows that antitrust authorities have noticed possible adverse effects on competition caused by non-pricing vertical restraints. In such case, NDRC determined that in addition to RPM, Medtronic also imposed non-pricing restraints on its counterparties, including consumer allocation, territorial allocation and restriction on sales of competing products, which further reinforced the restrictive effects of vertical monopoly agreements on market competition.

Since NDRC is only in charge of price-related monopolistic conducts, non-pricing related restraints therein are considered as supplementary factors rather than decisive ones. Given there was a case where the suspected company was fined by NDRC and a local counterpart delegated by SAIC respectively for price-related and non-pricing related monopolistic conduct,⁵ it is possible that relevant conduct of Medtronic may be investigated and fined by SAIC in the future.

Besides, the State Council published *Opinions on Developing E-Commerce Economy and Fostering New Economic Driving Force* (“**Opinions**”) in May 2015, which stressed to regulate competition behaviors in e-commerce market, including investigation against monopoly agreements. In this context, despite enforcement authorities in China have not released official viewpoints on MFN which is common to see in e-commerce industry, antitrust concerns involving vertical restraints are likely to be triggered in the future.

B. Legislation Regulating Non-pricing Vertical Restraints

By now, SAIC has issued *Provisions on Prohibition of Monopolistic Agreements* “*Provisions*” to regulate monopoly agreements. Unfortunately, the *Provisions* mainly focus on horizontal agreements and rarely mention vertical restraints. Besides, in its *Provisions on the Prohibition of the Abuse of Intellectual Property Rights to Eliminate or Restrict Competition*, SAIC forbids members of a patent pool use the patent pool to exchange sensitive information in relation to competition, such as production quantity or market division, so as to reach any monopoly agreement prohibited by Articles 14 of the AML.

IV. Exemption Rules under Current Legislations

One marked feature needs to be noticed in Medtronic case is that NDRC explicitly expressed its opinion on the application of exemption rules for the first time. It can be construed as a signal of enforcement authorities’ endeavor to investigate vertical restraints on a case-by-case basis.

⁵ NDRC’s Administrative Decision on Chongqing Qingyang and 4 other Allopurinol Sales Companies. See http://jjs.ndrc.gov.cn/fjgld/201601/t20160128_772982.html; Yu Gong Shang Jing Chu Zi (2015) No.15渝工商经处字 (2015) 15号, See http://www.saic.gov.cn/zwgk/gggs/jzzf/cfjd/201512/t20151221_165120.html

a. General Rules

According to article 15 of the AML, vertical restraints satisfying certain requirements shall not be applicable by AML, such as those which have not substantially restricted competition in the relevant market and can enable the consumers to share the benefits derived therefrom. Besides, *Guidelines on General Conditions and Procedures for the Exemption of Monopoly Agreements ("Exemption Guidelines")*, which is probably to come into effect in 2017, also provide the major factors in determining whether an agreement can be exempted. Such factors include, 1) detailed forms and effects of the agreement's fulfillment of exemption requirements listed in Article 15 of the AML; 2) whether the agreement and the fulfillment of exemption requirements establish cause and effect; 3) importance of the agreement in fulfilling the exemption requirements; and 4) other factors which may prove the agreement meets the relevant exemption requirements.

b. SAIC's Efforts on Legislation

SAIC tends to accept the safe harbor threshold in regulating the vertical restraints and in practice vertical agreement containing the aforesaid non-pricing restraints may not be necessarily regarded as a breach of the AML.

Provisions on Prohibition of Abuse of Intellectual Property Rights to Exclude and Restrict Competition, issued by SAIC, provides that if the market share of an undertaking and its trading counterparts in the relevant markets does not exceed 30%, the agreements between them may not be deemed as monopoly agreement under Article 14(3) of the AML, unless there is persuasive evidence to show such agreement has the effect of elimination and restriction on competition.

c. Proposed Regulatory Approach under Auto Guidelines

Auto Guidelines drafted by the NDRC also introduce a concept of "significant market power", and some non-pricing restraints reached by undertakings which hold less than 25%-30% market share in relevant market is likely to be determined as not holding the significant market power, thus being exempted from Article 14(3) of the AML. Auto Guidelines exempted

some customer or territorial restraints reached by enterprises without a significant market power, including restricting distributors selling in a specific territory without restricting their passive sale or cross supplies, restricting distributors' proactive sales in other territories, restricting distributors selling auto parts to customer for the reason that such auto parts would be used for producing same products, and restricting wholesalers selling to end customers. However, Auto Guidelines also points out four kinds of customer or territorial restraints which shall seek exemption on a case-to-case basis, including restricting distributors' passive sales, restricting cross supply between distributors, restricting distributors and maintainers selling auto parts and restricting the suppliers of auto parts selling to distributors, maintainers and end customers. Although such guidelines were drafted for auto industry, enterprises in other industries may also find out the standards adopted by the authorities in their enforcement, therefore adjusting its own distribution mode and commercial policy.

V. Conclusion and Looking Forward

It can be predicted that RPM would remain to be the target of NDRC's enforcement in 2017, while the authorities start to keep an eye on non-pricing restraints in distribution arrangement. Relevant laws and regulations, antitrust guidelines (including Auto Guidelines and Exemption Guidelines), as well as more cases are expected to be published in 2017, therefore would providing a clearer standard for enterprises.

Antitrust compliance management focusing on the business operation terminal should be emphasized. It is highly recommended for enterprises to go through daily operations, identify and mitigate possible antitrust risks. Note that any formats of documents including, but not limited to, business letters, inside notifications and e-mail exchange records can be presented as evidence of implementing vertical restraints. Moreover, non-pricing vertical restraints are raising concerns from antitrust enforcement authorities, which alert enterprises to avoid implementing territory allocation clauses, customer allocation clauses or MFN without justification, especially for those with market power. Once an enterprise is under investigation or lawsuit, it is advised to actively present evidences to seek for exemption according to article 15 of the AML and other regulations.