

VERTICAL RESTRAINTS IN COMPETITION LAW: THE NEED TO STRIKE THE RIGHT BALANCE BETWEEN REGULATION AND COMPETITION

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The regulation of vertical agreements by competition law is anything but straightforward. Economic theories suggest that if inter brand competition exists, then restrictions on intra brand competition should not be capable of restricting competition and the efficiency enhancing effects of vertical agreements would outweigh any possible risks. Yet experience reveals that vertical agreements can have anticompetitive effects which outweigh their pro-competitive effects, and hence they have to be brought within the purview of antitrust law. Countries are still searching for the perfect way to regulate vertical agreements. This paper undertakes a brief study of the US and EC legal regimes for vertical agreements and analyses the problems faced in these jurisdictions while regulating vertical restraints. The paper then applies this analysis to critique the treatment given to vertical agreements under the Competition Act, 2002 ('the Act'). The Act, which has very recently come into force, has several ambiguities with respect to vertical restraints. The Indian law is similar to the US law inasmuch as there is a clear scope for application of the rule of reason to vertical agreements. As US experience shows, however, there cannot be a uniform application of the rule of reason, since different vertical agreements would call for different standards. The Act is also similar to EC law in the sense that it lays down several criteria which can be taken into account for testing 'adverse effects' on competition. Unlike the EC, however, the competition authority in India is free to take into account all or any of the mentioned criteria. This is a dangerously open ended provision. The paper addresses these and various other loopholes in the present law, and finally aims at suggesting how the regulation of vertical agreements by competition law could be better achieved by the Act.

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I. THE COMMON LAW DOCTRINE OF RESTRAINT OF TRADE AND THE CONCEPT OF ‘REASONABLE RESTRAINT’

There are about a hundred systems of competition law in existence today. Some of the laws are more than a century old like the Sherman Act of the US, whereas some of them are as recent as the Indian Competition Act of 2002, or the Vietnamese or Singaporean Competition Acts of 2004. As more and more countries are shifting to market economies, they have been either adopting or modernising their competition laws. In spite of this recent proliferation of competition laws across the globe, the need to protect the free market from competitive restraints is by no means a recent phenomenon. The Roman Constitution of Zeno, promulgated in 483 A.D. had provisions to restrain monopolies. Though the Sherman Act, 1890 is considered to be the starting point of modern competition law, it was nothing but an application of the old and recognised principles of the common law.¹

The common law doctrine of ‘restraint of trade’ has played a crucial role in the development of modern competition law. The essence of this doctrine is that it is contrary to public policy to enforce contracts that are in the nature of unreasonable restraints of trade. What is unreasonable was to be determined by considering whether the restraint was so large as to interfere with the interests of the general public.² In the US, the common law doctrine of restraint of trade and its relationship with the Sherman Act was explained by Chief Justice White in the landmark case of *Standard Oil Company v. US*.³ It was in this case that the rule of reason approach to interpret the Sherman Act finally triumphed over the literalist approach followed earlier.⁴ In the EC, cases

¹ MARK R. JOELSON, AN INTERNATIONAL ANTITRUST PRIMER- A GUIDE TO THE OPERATION OF UNITED STATES, EUROPEAN UNION AND OTHER KEY COMPETITION LAWS IN THE GLOBAL ECONOMY 1-3 (2006).

² A more recent re-statement of the doctrine of restraint of trade is given in the judgment of Lord Morris of Borth-y-Gest in *Esso Petroleum Ltd. v. Harper’s Garage (Stourport) Ltd.*, [1968] AC 269 – “In general the law recognizes that there is freedom to enter into any contract that can be lawfully made. The law lends its weight to uphold and enforce contracts freely entered into. The law does not allow a man to derogate from his grant. If someone has sold the goodwill of his business, some restraint to enable the purchaser to have that which he has bought may be recognized as reasonable. Some restraints to ensure the protection of confidential information may be similarly regarded...but when all this is fully recognized yet the law, in some circumstances, reserves a right to say that a contract is in restraint of trade and that to be enforceable it must pass a test of reasonableness. In the competition between various possible principles applicable...public policy will give it priority”.

³ 221 US 1 (1911).

⁴ The Court recognized that if the prohibition contained in §1 of the Sherman Act (every contract, combination, conspiracy etc. in restraint of trade is illegal) were to be applied literally even normal trade itself would be in restraint of trade as every business agreement involves some degree of restraint of trade. It responded to this legislative straightjacket by developing an approach known as the ‘rule of reason’ which is derived from the common law principle of restraint of trade, and which like its predecessor, proscribes only unreasonable restraints of trade. For the literalist interpretation of the Sherman Act, see *US v. Trans Missouri Freight*

have considered the close relationship between the common law doctrine of restraint of trade and EC competition law.⁵ Though the analysis to be carried out under the two approaches is somewhat different - in common law, the courts are more focussed on the effect of the restraint between the parties whereas competition law focuses more on the effect on the market; the terminology used in relation to the two approaches is markedly similar, and both use public interest as a touchstone to determine reasonableness of the restraint.⁶

II. RESTRAINTS IN COMPETITION LAW: HORIZONTAL AND VERTICAL

In competition law, restraints have been broadly categorised into horizontal and vertical. Horizontal agreements are agreements between firms which operate at the same market level. Vertical agreements are between firms that are in some supply relationship.⁷ Horizontal agreements are almost always of concern to competition authorities, as these agreements tend to increase the chances of monopoly.⁸ Even where the purpose of such agreements is apparently benign, like agreements on standards, or harmonisation of technology, the underlying purpose may be anticompetitive.⁹

Vertical agreements are those between undertakings operating at different levels of the production chain. In case of most goods or services, there is a chain of production before the product reaches the customer - from gathering of the raw material to processing and creating the final product, distributing and selling of the product etc. Therefore, vertical agreements are an essential

Association, 166 US 290; *US v. Joint Traffic Association*, 171 US 505; *US v. Addyson Pipe and Steel Co.*, 175 US 211; *Northern Securities Company v. US*, 193 US 197. (It must be noted however that these cases clearly marked a movement towards the rule of reason approach).

⁵ See *W.W.F. v. World Wrestling Federation Entertainment Inc.*, EWCA Civ 196 [2002], (Carnworth, LJ at ¶¶ 64-66); *Apple Computer Inc. (No Challenge Interlocutory)*, RPC 70 Ch D [1992], (Nicholls, LJ at ¶ 109-113).

⁶ ALEXANDRA KAMERLING & CHRISTOPHER OSMAN, *RESTRICTIVE COVENANTS UNDER COMMON AND COMPETITION LAW* 1-13 (2007).

⁷ For example in a steel market which has two firms that supply steel to two car manufacturers, an agreement between the two steel suppliers would be a horizontal agreement, as would an agreement between the two car manufacturers. But an agreement between the steel supplier and the car manufacturer would be a vertical agreement, like the agreement between the car manufacturer and say its distributor.

⁸ See MARK FURSE, *COMPETITION LAW OF THE EC AND UK* 133-134 (2004).

⁹ Horizontal agreements to fix prices, divide markets, restrict output and fix tenders are more or less prohibited by competition laws the world over. Not all horizontal agreements are, however, deemed to be bad. Hard core cartels may be detrimental to consumer welfare, but other horizontal agreements, like research and development agreements, joint ventures etc. may be beneficial. Such agreements are not *per se* illegal but are brought within the folds of the rule of reason. In the EC, Art. 81(3) of the EC Treaty provides that agreements that restrict competition under Art. 81(1) may nevertheless be legal in cases where the agreement contributes to an improvement in the production or distribution of goods, or in technical or economic progress, provided that certain conditions are satisfied.

feature of commercial life, and in one sense a substitute for vertical integration.¹⁰ Vertical restraints exert mixed effects on the competitive process and have to be judged on the basis of the reasonableness of the restraint. The regulation of vertical agreements by competition law has evoked much controversy.¹¹

Unlike horizontal agreements, vertical agreements do not involve a combination of market power. On the other hand, vertical agreements affect competition in the market only when the firm imposing a vertical restraint already has market power. In such cases, competition from other firms' products (inter brand competition) is limited, hence it is desirable that there is enough competition between distributors and retailers of the products of the firm which has market power. Conversely, if the firm exercising the vertical restraint does not have sufficient market power, or in other words, if there is sufficient inter brand competition, then the restriction on competition between the distributors and retailers of the same brand (intra brand competition) may not have any effect on the market.

Economic theories support the view that if inter brand competition exists, then restrictions on intra brand competition through vertical restraints should not be capable of restricting competition, and the efficiency enhancing effects of vertical agreements would outweigh any possible risks. The Chicago School virtually argues for the legality of vertical agreements.¹² Although under the new industrial economics, some of the radical views of this

¹⁰ Ideally a supplier organising its distribution chain would prefer a system of vertical integration. This is because restrictions imposed in distribution of products by vertically integrated firms may escape the scope of competition law, as for an agreement to exist it needs two or more firms, whereas a parent and its wholly owned subsidiary constitute one economic actor. See the intra-enterprise conspiracy theory developed in the US in the case of *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752. See the cases of *Beguelin Import v. GL Import Export*, CMLR 81 [1972] and *Viho v. Commission*, 4 CMLR 299 [1995], in the EC for the 'single economic entity' doctrine.

¹¹ Debates surrounding vertical restraints are heavily influenced by both the theoretical approach to them that is adopted and the specific market conditions within which the vertical restraint operates, both upstream (at the level of the supplier) and downstream (at the level of the acquirer). Chicago School economists generally emphasise that, since the output of the supplier and the output of the acquirer are complementary (rather than being substitutes for each other, as are the goods or services affected by horizontal restraints), the supplier and the acquirer have a common interest in maximising, rather than restricting output. So, in the view of Chicago School economists, vertical restraints generally enhance welfare. See Silke Neubauer & Jeremy Lever, *Vertical Restraints, Their Motivation And Justification*, 21(1) ECLR 7-23 (2000).

¹² Broadly, the Chicago School economists argue for a non-interventionist approach. They argue for a general acceptance of vertical restraints, as any firm with market power could also have easier means of restricting competition, than through vertical restraints. According to them not only non-price vertical restraints, even vertical price restraints can be pro-competitive. See A. Tor, *Developing a Behavioral Approach to Antitrust Law and Economics: An Executive Summary*, 2004, available at www.luc.edu/law/academics/special/center/antitrust/pdf/tor-sumry.pdf, 2. (Last visited on April 25, 2010).

school have been proven to be inaccurate,¹³ the influence of the Chicago School continues to be felt, particularly in the US.

Generally vertical agreements may be of the following kinds:¹⁴

1. Exclusive Distribution Agreements – Where a manufacturer sells his products to a limited number of traders, who are usually granted exclusive right to sell the products within a defined territory or to a specific group of customers.¹⁵
2. Selective Distribution Agreements – Where dealers are required to meet certain criteria before becoming part of the distribution network.¹⁶ Selective distribution is frequently used for the distribution of luxury goods.

The major anticompetitive concern that arises with these two kinds of agreements is that they might foreclose the market to competitors and thereby impair inter-brand competition, or in some cases, even eliminate inter brand competition.

3. Exclusive Supply Agreements – An extreme form of limited distribution agreement where the purchaser is prevented from dealing in/acquiring products from any other person apart from the manufacturer.
4. Tying Agreements – Where the supplier makes the supply of one product (the tying product) conditional upon the buyer buying a distinct, separate product (the tied product).¹⁷

¹³ Experience and evidence has shown us that government regulation is necessary in markets where there are market failures, and that unfettered competition has the potential to sow seeds for the destruction of the market economy.

¹⁴ See RICHARD WHISH, *COMPETITION LAW* 626-638 (2009). The Act in §3(4) mentions five kinds of vertical agreements namely tie-in arrangements, exclusive supply agreements, exclusive distribution agreements, refusal to deal and resale price maintenance. The list is, however, not exhaustive.

¹⁵ Such agreements to sell to a particular class of customers are also known as customer allocation agreements.

¹⁶ In *Metro v. Commission*, 2 CMLR 44 [1978], the European Court of Justice held that “selective distribution systems constituted, together with others, an aspect of competition which accords with Article 81 (1) provided that resellers are chosen on the basis of objective criteria of a qualitative nature relating to the technical qualifications of the reseller and its staff and the suitability of its trading premises and that such conditions are laid down uniformly for all potential resellers and are not applied in a discriminatory fashion.”

¹⁷ Two products are distinct if in the absence of the tie, the products can be purchased from two different markets. For example, a printer and its cartridge would constitute distinct products, belonging to different markets, as there could be separate printer suppliers and cartridge suppliers. Whereas, if the buyer is forced to buy all his cartridges from a particular printer supplier, (as a result of a tie) this will limit his available options of buying cartridges sold by other cartridge suppliers.

Tying and exclusive supply, both belong to the 'single branding' group of agreements, where the buyer is basically induced to buy products from one supplier. The major anticompetitive concern with these agreements is that they may foreclose access to the market and facilitate collusion. Tying might allow a firm to leverage its market power in one market and cause anticompetitive effects in another.

5. Resale Price Maintenance Agreements – Where price restraints are imposed on the buyer as to the price at which he may sell the product.¹⁸

The main anticompetitive concern with such agreements is reduction in intra brand competition and increased transparency of prices, which may lead to collusion at different levels of the supply chain.

III. BENEFITS AND DETRIMENTS OF VERTICAL AGREEMENTS

There are two types of problems that a manufacturer may wish to control through vertical agreements. The first type of problem is where a manufacturer is confronted with undesirable actions from its distributors intended to maximise their own profit, but to the detriment of the manufacturer's interest. These problems are called intra brand problems. The second set of problems that a manufacturer may encounter relate to competition from other manufacturers. These are called inter brand problems.¹⁹

¹⁸ One way of classifying restraints (as is done in the US) would be into 'price' and 'non-price' restraints. Price restraints usually are in the form of minimum resale price maintenance, where the buyer is forced to observe a minimum price threshold below which he cannot sell, or maximum resale price maintenance, where the buyer cannot go above a certain price threshold while selling his goods. For a detailed economic analysis of such restraints see Y. Spiegel & Y. Yehezkel, *Price and Non-Price Restraints when Retailers are Vertically Differentiated*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236024 (Last visited on April 25, 2010).

¹⁹ As identified by Dobson and Waterson, intra brand problems may be of four kinds. *First*, a manufacturer may be concerned that its distributors tend to set prices too high (or sell too low a volume), which results in a final price to end-users that is higher (or quantities that are lower) than the level which would maximise their joint profits. *Second*, particularly in markets where there is little differentiation between distributors, there may be concerns about destructive competition between distributors. *Third*, there may be a tendency of some distributors to be reluctant to engage in advertising and promotion and to attempt to 'free ride' on the promotional investments and efforts of others, offering products for lower or discount prices once customers have seen a product demonstrated elsewhere. This creates a problem for the manufacturer who wants to ensure that his goods maintain high quality and reputation yet are also distributed widely. *Fourth*, a manufacturer may face problems in achieving the optimal number and density of distributors, with dealers wishing to establish themselves sufficiently distant from their competitors. On the other hand, inter brand problems occur, for example, if the distributor carries competing brands, a manufacturer who invests in sales, training, outlet equipment, customer information etc. for his distributor may in effect be subsidising the promotion of his competitor's products, to the extent that the distributor uses those investments for the sale of other, competing brands. This may lead to manufacturer free-riding

Vertical restraints may control both intra and inter brand problems. For instance, resale price maintenance or minimum purchase obligations on the distributor may induce him to set lower prices. In the case of destructive competition between distributors, a manufacturer may alleviate the problem by imposing resale price maintenance, or by allocating exclusive territories. Free-rider problems may be addressed by exclusive purchasing agreements. On the other hand, inter brand competition problems, notably free-riding effects and price competition, may be resolved through exclusive dealing arrangements - prohibiting a distributor from selling competing products, or a less direct method such as an obligation to purchase a substantial minimum quantity.²⁰

Vertical agreements, however, also have many negative effects, such as foreclosure of other suppliers or buyers by raising barriers to entry, reduction of inter brand competition, reduction of intra brand competition between distributors of the same brand, and creation of obstacles to market integration.²¹ Practices such as exclusive dealing may be harmful where it gives rise to switching costs.²² Similarly, consumers may be disadvantaged by the inability to make side-by-side, in-store comparisons and may be liable to make purchases on the basis of inadequate information about the alternatives on offer. Exclusive dealing may thus reduce inter-brand competition. Again, even where there is sufficient inter-brand competition, exclusive territories may weaken intra-brand competition and may lead to higher prices in the downstream market. Resale price maintenance also may be a way to facilitate dealer cartels as price-cutting can be policed more easily.

Vertical agreements, thus, can be beneficial or harmful to competition, depending on the circumstances.

effects. Another inter brand problem may occur when a distributor, by raising the price of the manufacturer's products, diverts sales away towards competing brands. This problem becomes more severe when the competing manufacturers' products are highly substitutable. See Dobson & Waterson, *Vertical Restraints and Competition Policy* (1995)- A report prepared for the Office of Fair Trading, (which provides an instructive overview of the economic theory of vertical restraints, retailer market power and an analysis of the economic effects of vertical restraints on inter- and intra-brand competition).

²⁰ H. H. Paul Lugard, *Vertical Restraints under EC Competition Law: A Horizontal Approach*, 17(3) ECLR, 166, 170-171 (1996).

²¹ The last is of crucial importance in the EC, as market integration is one of the goals of the EC treaty. For the negative effects of vertical agreements see European Commission's Guidelines on Vertical Restraints, ¶107.

²² For example, if the store that a buyer visits sells only Pepsi and he happens to want Coca-Cola, he must either incur the cost of visiting another outlet or make do with what he regards as second-best.

IV. THE US AND THE EC LAW ON VERTICAL RESTRAINTS

In the US, vertical agreements have been held to fall within §1 of the Sherman Act²³ since the *Dr. Miles case*.²⁴ For many years, the US Supreme Court considered these agreements to be *per se* illegal.²⁵ The Supreme Court's *GTE Sylvania*²⁶ decision, however, brought about a change with respect to the treatment given to non-price vertical restraints. In *Sylvania*, the Court determined that a vertical restraint imposed by a seller on his customers, other than resale price maintenance, would be tested under the rule of reason. The Court, however, remained hesitant in applying the rule of reason to vertical price restraints. Finally, after two decades in 1997, maximum resale price maintenance was declared to be subject to the rule of reason analysis in *Khan*,²⁷ and more recently the *per se* illegality rule was removed from minimum price maintenance in the *Leegin case*.²⁸

In the EC, vertical agreements have been held to fall within Art. 81(1) of the EC Treaty.²⁹ Art. 81(1) prohibits agreements that have, either as their object or as their effect, the prevention, restriction or distortion of competition in the common market. Art. 81(1) may, however, be declared inapplicable and the agreement exempted where the criteria set out in Art. 81(3) are satisfied, *i.e.*, when the agreement contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the benefit.

Earlier, Art. 81(1) of the EC Treaty was also interpreted in its broadest sense, and vertical agreements, particularly those which involved allocation of territories to distributors, were considered to be violative of Art.

²³ Sherman Act, §1: Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal...

²⁴ *Dr. Miles Medical Co. v. John D. Park and Sons*, 220 US 373.

²⁵ *Per se* violations are those that meet the strict characterization of §1 ("agreements, conspiracies or trusts in restraint of trade"). A *per se* violation requires no further inquiry into the practice's actual effect on the market or the intentions of those individuals who engaged in the practice. The *per se* rule means that certain agreements are presumed to have adverse effects on competition, and are declared illegal without applying the rule of reason. In other words, if a practice is declared *per se* illegal, in a subsequent occurrence of such practice, what is required is just to prove that such practice has taken place, and the argument in defence can at best be that such practice has never taken place. *See* *US v. General Motors Corp.*, 384 US 127 and *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (though *Schwinn* came as something of a surprise establishing a *per se* illegal rule for vertical restraints despite earlier contrary suggestions in *White Motor Co. v. United States*, 372 US 253).

²⁶ *Continental T.V. Inc. v. GTE Sylvania, Inc.*, 433 US 36.

²⁷ *State Oil Co. v. Khan*, 522 US 3.

²⁸ *Leegin Creative Leather Products Inc. v. PSKS Inc.*, 127 U.S. 2705.

²⁹ *See* *Etablissements Consten SARL and Grundig-Verkaufs-GmbH v. Commission*, 1 CMLR 418 [1996].

81(1).³⁰ They were permitted only if they could qualify for exemption under Art. 81(3). A process of reform started in the 1990s which resulted in the adoption of Regulation 2790/1999,³¹ a general block exemption for vertical agreements which would prevent them from being prohibited under Art. 81(1) when certain conditions are met.³²

On April 20, 2010, the EC adopted the new Exemption Regulation No. 330/2010, which replaced Regulation No. 2790/1999 and will remain in force until May, 2022. As did Regulation 2790/1999, Regulation 330/2010 also provides a safe harbour for vertical restraints if the market share of the supplier does not exceed 30 percent in the market in which it sells the contract goods or services. For this to apply, however, the market share of the buyer should also not exceed 30 percent in the 'relevant' market. The relevant market share of the buyer relates to the market on which it purchases the contract goods or services.³³

A. EC LAW: HARDCORE RESTRAINTS

According to Art. 4 of Regulation 330/2010, the safe harbour benefit cannot be extended to agreements containing 'hard core' restraints. Hard core restraints include- resale price maintenance, territorial and customer restrictions (with certain exceptions), restrictions imposed on authorised dealers within selective distribution systems on selling to end-users, restrictions on cross supplies within a selective distribution system and restrictions on component suppliers to sell the components they produce to independent repairers or service providers. The emphasis on the aim to foster a more competitive market

³⁰ EC law's focus on market integration sometimes conflicts with principles like efficiency of distribution and promotion of inter brand competition. The cardinal rule of EC law is that distributors should not enjoy absolute territorial protection since this leads to the isolation of national markets contrary to the common market philosophy. See Fiona M. Carlin, *Vertical Restraints: Time For Change?*, 17(5) ECLR 283-288 (1996). See also *Establissemments Consten SARL and Grundig-Verkaufs-GmbH v. Commission*, 1 CMLR 418 [1996] (which shows the Commission's inflexible approach towards exclusive distribution agreements and its emphasis on intra brand competition. As a result of paying too much attention to intra brand competition, the Commission sometimes fails to focus on restrictions of inter brand competition, which are arguably more harmful).

³¹ Regulation 2790/99 entered into force on June 1, 2000 and is to be read in conjunction with the accompanying Guidelines on Vertical Restraints. The regulation expired in May, 2010.

³² For instance, vertical agreements where the suppliers' market share is below 30 percent will be exempted under this regulation, provided the agreement does not contain any of the hard core black listed provisions in Art. 4 of the regulation.

³³ Art. 3(1). Based on the 2009 draft version of the Regulation, the market share of the buyer would have had to be calculated in relation to "any of the relevant markets affected by the agreement." Business and the legal community raised the concern that this provision would have resulted in a significant loss of legal certainty and would have been inconsistent with other EU instruments. Therefore, the final text of the new Regulation was changed to its current position.

through the new guidelines is evident from the harsher approach taken towards hard core restraints than in the previous guidelines.³⁴

More important is the inclusion of internet sales within the ambit of the guidelines. With regard to this, the new guidelines confirm that an outright prohibition on selling or advertising a product over the internet is a hard core restraint that would not qualify for the safe harbour granted by the Regulation.³⁵ On the other hand, a balance is sought to be struck by permitting an outright ban on internet sales where they can be objectively justified, such as when there exists a public ban on selling dangerous substances to certain customers for reasons of safety or health.³⁶

The recent case of *Pierre Fabre v. Autorité de la Concurrence*³⁷ provides an example of the strict approach of the Court of Justice of the European Union ('CJEU') on internet sales of products through selective agreements. The CJEU ruled that an absolute ban on internet sales to end users in the context of a selective distribution network constitutes a restriction of competition 'by object', unless objectively justified.³⁸ The CJEU further stated that a ban on internet sales is not covered by the Vertical Restraints Block Exemption Regulation (No 2790/1999). The CJEU did not go so far as to state that a distribution agreement that provides for such a ban may not benefit, on an individual basis, from the exemption provided for in Art. 101(3), Treaty on the Functioning of the European Union (TFEU) [formerly Art. 81(3)]. Indeed, the Court did not have sufficient information before it to assess whether the conditions for an individual exemption were met in the case at hand.

V. PROBLEMS THAT ARISE WHILE EVALUATING VERTICAL AGREEMENTS

A. THE US POSITION

In the US, cases have established beyond doubt that vertical agreements are subject to the rule of reason. Due to the different kinds of vertical agreements which courts have to deal with, however, the rule of reason analysis has become far more complex, and the courts in the US are faced with

³⁴ Guidelines, ¶47 and ¶223.

³⁵ Guidelines, ¶52.

³⁶ Guidelines, ¶60.

³⁷ Case C-439/09, judgment delivered on October 13, 2011.

³⁸ Where, based on the purpose and economic context of the agreement, it is established that an agreement has an anticompetitive object, it can be characterised as a restriction of competition by object, in which case it is not necessary to examine the effects of the agreement on competition. In determining whether a contractual provision constitutes a restriction of competition by object, the context of the clause, its objectives and the economic and legal background are all taken into account.

the burdensome task of assessing each agreement before deciding upon its validity. Coupled with this is the problem of discharging the burden of proof. In a rule of reason analysis, the initial burden lies on the plaintiff to show that the agreement in question is anticompetitive. Then the burden shifts on the defendant to show the pro-competitive effects. It would also need to be proven that the pro-competitive effects could not have been achieved by using less restrictive means. In some cases, like those of resale price maintenance, however, this is problematic, as proving the benefits could be very difficult.³⁹ Therefore, different criteria need to be set for evaluating different categories of agreements and so far there seems to be no uniformity among scholars as to how the rule of reason should be applied in the US with respect to different kinds of vertical agreements.⁴⁰

B. THE EC POSITION

The EC law on vertical restraints appears to be more methodical at first blush. In the EC, it is first necessary to determine whether an agreement falls within the ambit of Art. 81(1), *i.e.*, whether the agreement has the 'object' or 'effect' of preventing, restricting or distorting competition.⁴¹ The burden of proof here lies on the competition authority. Some of the agreements which are regarded to fall within the 'object box' are horizontal agreements to fix prices, to exchange price information, to share markets, to limit output, to limit sales, for collective exclusive dealing, and vertical agreements to fix minimum resale prices and to impose export bans.⁴² When it is not possible to ascertain whether an agreement has the 'object' of harming competition, it becomes necessary to conduct an extensive analysis of the market before it can be concluded that the agreement has the 'effect' of harming competition. EC law thus places a lot of weightage on the appropriate definition of the relevant market. In particular, it requires that the correct relevant market be easily and unambiguously defined. This by itself is no simple task.⁴³

³⁹ T.A. Lambert, *Dr. Miles Dead. Now What?: Structuring a Rule of Reason for Evaluating Resale Price Maintenance* 26 (University of Missouri Legal Studies Research Paper 2008-25, 2008).

⁴⁰ SANDRA MARCO COLINO, VERTICAL AGREEMENTS AND COMPETITION LAW - A COMPARATIVE STUDY OF THE EU AND US REGIMES 83-87 (2010).

⁴¹ The words 'object' or 'effect' are to be read disjunctively. It is first necessary to consider the object of the agreement. If it is not clear whether the object of the agreement is to harm competition, it becomes necessary to consider the effect. See *Société Technique Minière v. Maschinenbau Ulm*, CMLR 357, 375 [1996].

⁴² In such cases, if the parties wish to assert that the agreement has any efficiency enhancing effects, they have to do so under Art. 81(3). This 'object box' is somewhat similar to §1 of the Sherman Act which characterizes some agreements as *per se* infringements of the Act. The distinction in EC law, however, is that even in the above mentioned cases, where an agreement is known to *per se* infringe Art. 81(1) the parties can still argue that the agreement satisfies the requirements of Art. 81(3). See RICHARD WHISH, *supra* note 14, 120.

⁴³ In many cases the available evidence will be inconclusive as to which plausible relevant market definition is most appropriate, often due to the existence of the so-called cellophane

Art. 81(3) then provides an exception to Art. 81(1) to agreements which satisfy four conditions, two positive and two negative.⁴⁴ All these conditions are mandatory, and the burden of proof lies on the undertaking concerned to show that it satisfies the four conditions. Therefore, it is under Art. 81(3) that a rule of reason type analysis is conducted, whereby the undertaking concerned has to demonstrate the pro-competitive effects of an agreement which is hit by the Art. 81(1) prohibition.⁴⁵ Some authors, however, criticise this approach saying that some degree of economic analysis is inevitable under Art. 81(1), when the competition authority demonstrates whether an agreement is within the former's prohibition. Therefore, the possibility of importing the rule of reason into Art. 81(1) should not be excluded.⁴⁶

Further, the block exemptions devised by the EC for excluding certain categories of vertical agreements suffer from certain limitations like over emphasis on market shares.⁴⁷ The EC law is also constrained by its goal of market integration, which may conflict with efficiency objectives.

VI. THE INDIAN LAW ON VERTICAL AGREEMENTS

In India, §3 of the Act deals with anti-competitive agreements. It prohibits any agreement with respect to production, supply, distribution, storage, and acquisition or control of goods or services, which causes or is likely to cause, appreciable adverse effects on competition within India. Under §3, any such agreement is considered void. Though the Act does not use the words horizontal or vertical agreements,⁴⁸ it treats certain kinds of horizontal

fallacy. See Baker S. & Wu L., *Applying the Market Definition Guidelines of the European Commission*, ECLR 273 [1998].

⁴⁴ The agreement must contribute to improving the production or distribution of goods, or to promoting technical progress, while allowing consumers a fair share of the resulting benefit (the positive conditions), and the agreement must not impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives, nor afford such undertakings the possibility of eliminating competition in a substantial part of the products in question (the negative conditions).

⁴⁵ See *Metropole Television v. Commission*, 5 CMLR 1236 [2001], where the Court clearly rejects that a rule of reason exists under Art. 81(1) and says that a rule of reason type of analysis is only possible under Art. 81(3).

⁴⁶ SANDRA MARCO COLINO, *VERTICAL AGREEMENTS AND COMPETITION LAW - A COMPARATIVE STUDY OF THE EU AND US REGIMES* 93 (2010).

⁴⁷ For example, the benefit of the Block Exemptions cannot be enjoyed by those agreements where the supplier has more than 30 percent market share of the relevant market. See Art. 3 of Regulation 2790/99. This is, however, problematic as economic theory shows that unless a firm possesses significant market power, vertical restraints cannot have adverse consequences for competition, and market shares cannot be the sole (or most significant criteria) for exemption. See Derek Ridyard & Simon Bishop, *E.C., Vertical Restraints Guidelines: Effects Based Or Per Se Policy?*, 23(1) ECLR 35-38 (2002).

⁴⁸ The Act does not specifically use the terms 'horizontal' or 'vertical' but the agreements referred to in §3(3) are horizontal agreements and those referred to in §3(4) are vertical

agreements more severely, by presuming them to have adverse effects on competition. According to §3(3), agreements between parties (including cartels) that: (1) directly or indirectly determine purchase or sales prices; (2) limit or control production, supply, markets, technical development, investment or the provision of services; (3) share the market or source of production or provision of services by way of allocation of the geographical area of the market, type of goods or services, or number of customers in the market or any other similar way; and (4) directly or indirectly result in bid rigging or collusive bidding are “presumed to have appreciable adverse effects on competition.”

§3(4) of the Act deals with vertical agreements. It lists, in particular, five types of vertical agreements - tying, exclusive supply, exclusive distribution, refusal to deal, and resale price maintenance,⁴⁹ which would be in contravention of §3(1), only if they cause or are likely to cause appreciable adverse effects on competition in India. The term “appreciable adverse effect on competition” used in §3 is not defined in the Act. The Act, however, specifies a number of factors which the Commission should take into account when determining whether an agreement has an appreciable adverse effect on competition, including whether the agreement creates barriers or forecloses competition by creating impediments to entry, or drives existing competitors out of the market. The Commission should also take into account the possible pro-competitive effects of an agreement, *viz.*, benefits to consumers, improvements in the production or distribution of goods or the provision of services, and the promotion of technical, scientific and economic development by means of production or distribution of goods or provision of services.⁵⁰ Thus, a balanced assessment is required to be done of the beneficial and harmful effects on competition. This balancing approach is similar to the ‘rule of reason’ that prevails in the US⁵¹ and therefore it is said that in India vertical agreements are

agreements.

⁴⁹ Each of these categories has been explained in the Explanations below §3(4). These practices were also considered to be restrictive trade practices under the Monopolies and Restrictive Trade Practices Act, 1969. *See* *Telco v. Registrar of Restrictive Trade Practices*, (1977) 2 SCC 55 : (1977) 47 CompCas 520 SC.

⁵⁰ §19(3): The Commission shall, while determining whether an agreement has an appreciable adverse effect on competition under §3, have due regard to all or any of the following factors, namely:

- (a) creation of barriers to new entrants in the market;
- (b) driving existing competitors out of the market;
- (c) foreclosure of competition by hindering entry into the market;
- (d) accrual of benefits to consumers;
- (e) improvements in production or distribution of goods or provision of services;
- (f) promotion of technical, scientific and economic development by means of production or distribution of goods or provision of services. a

While criteria (a)-(c) help to determine whether an agreement has an appreciable adverse effect on competition, criteria (d)-(f) provide various arguments that can be used to justify such agreements.

⁵¹ *See* Vinod Dhall, *Essays on Competition Law and Policy*, available at www.cci.gov.in/.../essay_articles_compilation_text29042008new_20080714135044.pdf - (Last visited on

subject to the 'rule of reason' and are not presumed to have adverse effects, as in the case of horizontal agreements.⁵²

The Indian Law on vertical restraints suffers from several drawbacks.

Firstly, in India, there are no separate rules governing any specific category of vertical agreement and all of them are required to be tested for adverse effects under §19(3). All vertical agreements cannot be evaluated by the same standard. For example, the US experience tells us that in case of agreements like resale price maintenance proving benefits could be more difficult than proving detriments. So, if we do not lay down standards for evaluating different kinds of vertical agreements and decide to generally follow the rule of reason approach of the US, then the Competition Commission of India would face problems similar to those being faced by the US courts, *i.e.*, a coherent application of the rule of reason to different kinds of vertical agreements.

Secondly, the Act also is similar to the EC law in the sense that it lays down criteria which are to be taken into account for testing adverse effects. This adverse effects test, however, is an incomplete adaptation of Art. 81(3) of the EC. The EC laws impose certain compulsory conditions for exempting vertical agreements- they require that the agreement allow consumers to share in the benefits, does not impose restrictions that are unnecessary to attaining the efficiency objective, and does not substantially eliminate competition. All of these conditions are mandatory, whereas those in the Act are merely permissive.⁵³ This is dangerous and could create considerable complications in future, when cases come up before the Competition Commission.

Thirdly, we do not have exemptions given to vertical agreements on the basis of threshold levels (like the *de minimis* exemption, or block exemptions given in the EC) and all vertical agreements are to be tested on the basis of 'adverse effects' on competition. This would create unnecessary burden on the competition authority.

Further, any effects based test at the outset, would face the problem of precise market definition. Market definition by itself and subsequent testing for adverse effects is no easy task and requires complicated economic analysis. To add to the irony, the term 'relevant market' finds no place in §3 of the Act. Thus, the adjudication of vertical agreements by the Commission

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⁵² It is argued that in India even horizontal agreements are not really subject to any '*per se*' prohibition as the words 'shall presume' mean a rebuttable presumption. See the cases of *Sodhi Transport Company v. State of Uttar Pradesh*, (1986) 2 SCC 486 : AIR 1986 SC 1099 and *R.S. Nayak v. A.R. Antulay*, (1986) 2 SCC 716 :AIR 1986 SC 2045.

⁵³ See Aditya Bhattacharjya, *India's New Competition Act: A Comparative Assessment*, 4 J. COMPETITION L. & ECON. 609.

becomes all the more sticky due to the flawed understanding of concepts like relevant market and analysis of appreciable adverse effects on Competition during investigation.⁵⁴

VII. POSSIBLE SOLUTIONS FOR INDIA?

The regulation of vertical agreements by Indian competition law has perceptible loopholes and could be strengthened further. The law is heavily borrowed from the EC law but without some of the safeguards present in the EC which at the outset identify and eliminate some agreements from being examined by competition law. Moreover, in the EC, the test for adverse effects is also much stronger. The Indian law has also borrowed the rule of reason approach of the US and along with it is likely to have imported the problems which are being faced presently in the US regarding application of the rule. Therefore, in order to improve upon its existing regime on vertical agreements, India could consider:

1. Introducing the term 'relevant market' in §3 for the sake of clarity. The test for adverse effects becomes all the more complicated if there is any ambiguity with respect to the market involved.
2. Creating a system of *de minimis* exemptions and block exemptions. This would reduce unnecessary burden on the Competition Commission. In the absence of market power vertical agreements are not likely to affect competition anyway.
3. Strengthening the test for adverse effects, *i.e.*, making provisions like accrual of benefits to consumers and improvement in production and

⁵⁴ For instance, in *Neeraj Malhotra v. Deutsche Post Bank Home Finance Limited*, Case 5/2009, it was argued in ¶13.5 (iv & v) that "Under §3(3) law permits the Commission to presume violation without further enquiry only and only if any trade practice tested on the parameters laid down in clauses (a) to (d) of §3(3) in relation to *relevant market* falls foul of any of those parameters. Therefore, evidence gathered and documents collected during the investigation shall be evaluated from the perspective of presence or otherwise of the parameters laid down clauses (a) to (d) of § 3(3) in relation to *relevant market*. Neither the Director General nor the Deputy Director General had gathered any evidence or data in this regard." Another case which reveals the flawed understanding of relevant market is *Consumer Guidance Society v. Hindustan Coca Cola Beverages Ltd.*, Case UTPE 99/2009, a case concerning exclusive supply agreements. Here the Commission observed in ¶12.7 "Considering the fact that there are about 900 multi-screen theatres out of which HCCBPL is having exclusive supply agreement with multiplexes having 214 screens and PEPSICO with multiplexes having 600 screens, the relevant geographical market cannot be confined to the closed market inside the premises of multiplexes owned by ILPL who is only operating 38 multiplexes in India. If the relevant geographical market is taken as defined by the DG it would certainly lead to illogical conclusion and in that case every retail outlet, restaurant or store having exclusive supply agreement with a supplier will be deemed dominant within the boundaries of its premises and at the same time because of such agreements supplier will also be deemed dominant within the closed premises of that retailer."

distribution of goods and services mandatory factors for the Commission to consider while evaluating a vertical restraint, or, in the alternative,

4. Lay down guidelines for evaluating the different kinds of vertical agreements mentioned in the Act, instead of subjecting all of them to a general rule of reason approach.
5. Keeping in mind its developing country requirements, laying down exemptions for some vertical agreements entered into by certain industries. Since vertical agreements are far less harmful than horizontal cartel arrangements such exemptions could also be considered.⁵⁵

There is ample scope for strengthening the existing regime governing vertical agreements. Such agreements are a part of day-to-day commercial life and if there are loopholes in their regulation, considerable problems are likely to arise in future. Since vertical agreements may or may not be benign, the key lies in striking the right balance between competition and regulation. Wherever possible enterprises should be able to enter into such agreements without being unnecessarily hauled up by the authorities and at the same time, the Competition Commission should be freed from the task of probing into each and every vertical agreement. Finally, for the ones that require to be evaluated, there should be more clarity in the law so that cases can be decided coherently and speedily, and competition is fostered in the market.

⁵⁵ India being a developing country has its own problems like higher entry barriers which lead to higher concentration ratios, marked asymmetries of information and greater instances of dominance by erstwhile public sector companies. These characteristics often call for a modified approach to the enforcement of competition law, e.g. more protection to domestic industries so that they are able to compete with multinationals, and other such exemptions. Keeping this perspective in mind, exceptions can also be made in case of some vertical agreements entered into by certain industries. For example, local firms with cheap access to free labour may not be restrained from cooperating with multinational firms which are large enough to invest heavily in research development and have cheaper access to capital.