

# Legal Commentary

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## The “Grey Rhino” of Anti-Monopoly Compliance – Examining the Risks of Vertical Monopoly Agreements from the Latest Fine of RMB290 Million

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On September 27, 2021, the Zhejiang Provincial Administration for Market Regulation (“ZAMR”) released on its website an administrative penalty decision against a manufacturer of civil electrical products for implementing a vertical monopoly agreement to fix or restrict prices when it resold civil electrical products. The penalty fine imposed was RMB290 million, equal to 3% of the manufacturer’s 2020 product sales in mainland China of RMB9.827 billion.

The manufacturer issued an announcement on May 13, 2021, disclosing that it had been subject to an investigation by ZAMR on suspicion of reaching and implementing a monopoly agreement with its trading counterparts. According to ZAMR, the manufacturer violated Article 14 of the *Anti-Monopoly Law of the People’s Republic of China* (the “AML”), which prohibits vertical monopoly agreements and states in part that “[c]ompeting undertakings are prohibited from concluding the following monopoly agreements: (1) on fixing or changing commodity prices resold to a third party; (2) on restricting the lowest prices for commodities resold to a third party...”. ZAMR found that the manufacturer violated Article 14 by engaging in a series of price control behaviors that resulted in implementing a vertical monopoly agreement to fix and restrict product prices (resale price maintenance, or “RPM”).

Vertical price monopoly, a common monopolistic behavior in the sales of tangible products, is a focus for anti-monopoly enforcement. This case further demonstrates the determination of the anti-monopoly enforcement authorities to crack down on vertical price monopolies and serves as a warning for enterprises in industries prone to vertical price controls.

### Analysis of basic case information

ZAMR issued the administrative penalty decision by following the framework for analyzing resale pricing behavior. Specifically:

## I Existence of RPM

In this case, the manufacturer implemented a primarily distribution-based sales model supplemented with direct sales. In the distribution process, the parties formulated “market operating standards” and other documents that contained provisions on fixing product resale prices and restricting minimum resale prices, and controlled product resale prices through various means, including the release of pricing policies, execution of distribution contracts and letters of commitment with distributors, etc. The details of these methods are as follows:

- **Execution of distribution agreements.** The agreements stipulated that the distributor would “recognize and comply with the market management system agreed upon by both parties”, and “the distributor shall strictly implement the markup rates filed with the company or required by the company”.
- **Issuance of pricing policies.** The manufacturer released pricing policies to various distributors, stipulating that “for the final retail price, a 25% discount is the guide price, floating between a 15% discount and 35% discount”; “as of today, for final retail price of G06 (white), the guide price will be adjusted to a 35% discount that is recorded in the company’s price list; a 40% discount is accepted in retail end and promotional activities”. In addition, the manufacturer also released price lists of products on QQ and DingTalk talk groups, etc., requiring distributors within the talk groups to sell products at the “sales price” marked in the price list.
- **Execution of distributor commitment letters.** Distributors were required to sign commitment letters to comply with the price control system of the manufacturer, which stipulated that “the retail price of the wall switches and socket series products shall not be lower than 35% discount of that recorded in the price list maintained by the company”; distributors must “comply with the recommended pricing system maintained by the company (including but not limited to daily retail prices, prices in general promotional activities, and large price promotions)”.

The manufacturer successfully exercised price controls over both its online and offline distributors by fixing and restricting product prices and further strengthened pricing controls by establishing an assessment and supervision team (establishing a market supervision department, inspecting market prices openly or secretly and open channels to receive tip-offs of other distributors), entrusting intermediaries to monitor prices (appointing a number of third party companies to supervise the retail prices of its distributors), and punishing distributors who deviated (deducting points, requesting payment of liquidated damages, banning their distributor qualifications, etc.).

## II Existence of anticompetitive effect

In this case, by analyzing the dominant position of the manufacturer’s products in the market and the distributors’ dependence on key products, ZAMR determined that the manufacturer’s behavior of fixing and restricting prices eliminated or restricted competition among distributors and end retailers, thus harming the legitimate rights and interests of consumers and social and public interests.

## Market share and safe harbors in vertical monopoly agreements

Notably, there are no requirements as to a manufacturer's or distributor's minimum market share or market power for them to be found to engage in RPM, neither in provisions of the AML nor in administrative enforcement. In another word, manufacturers and distributors may still be regarded as having reached vertical monopoly agreement to restrict resale prices even if the manufacturer and the distributor have relatively low market shares. This is particularly true in administrative enforcement that adopts the illegal per se approach, "prohibited in principle, exempted individually".

However, some guidelines or guiding opinions have stipulated conditions for exempting certain agreements from being identified as monopoly agreements, certain of which have even attempted to set out market share-based safe harbors for monopoly agreement. Specifically:

- In accordance with the *Guiding Opinions on the Exemption for Monopoly Agreements Signed by Small and Medium-sized Enterprises in the China (Shanghai) Pilot Free Trade Zone*, one exemption condition is that the agreement "will not significantly restrict competition in the relevant market". Small and medium-sized enterprises may satisfy this condition by arguing that they have relatively small market share in the relevant market.
- The *Anti-Monopoly Guidelines in the Automobile Industry* advance the concept of "presumed exemption", which means that in evaluating competition in vertical agreements, undertakings with less than 30% market share may be presumed to have no significant market power, which is a principle that has been recognized both in the law enforcement practice and theoretical studies. However, these guidelines also stipulate that the presumed exemption mainly applies to vertical monopoly agreements signed by undertakings without significant market power to impose vertical geographic restrictions and customer restrictions, but fail to clarify whether the principle also applies to vertical monopoly agreements involving resale price restrictions. With respect to the exemption for RPM, these guidelines enumerate four situations where RPM will be exempted, including the short-term resale price restrictions for new energy vehicles, in sales by the dealers acting only as intermediaries, in government procurement, and in e-commerce sales by auto suppliers.
- The *Anti-Monopoly Guidelines in the Field of Intellectual Property Rights* establish a safe harbor regime for IP rights-related agreements by reference to international practices and law enforcement in China. For example, the combined market share of the undertakings in competition does not exceed 20%, the market share of the undertaking and its trading counterparts in any relevant market does not exceed 30%, etc. These rules provide clearer guidance for undertakings to achieve anti-monopoly compliance when reaching horizontal or vertical IP rights-related agreements.
- The *Anti-Monopoly Guidelines in Active Pharmaceutical Ingredients ("API") (Draft for Comment)* are relatively conservative in this respect, stipulating that an API manufacturer or distributor needs to prove satisfaction of statutory conditions set forth in Article 15 of the AML if it asserts that its agreements are entitled to an exemption.

However, none of the above guidelines and guiding opinions have been incorporated into formal laws or regulations, and we have not seen any public announcements regarding their implementation in practice.

In this case, we observe that ZAMR specifies the market share of several products on the Tmall marketplace, which is uncommon in administrative penalty cases involving vertical monopoly agreements. We assume ZAMR has two purposes for specifying these market shares:

- To evaluate whether the agreements at issue satisfied conditions for the exemption stipulated in Article 15 of the AML (i.e., the agreements are concluded for the listed purposes, do not severely restrict competition in the relevant market and can even benefit consumers); and
- To explain why the distributors were not punished, which required ZAMR to prove that the manufacturer had dominant position in the relevant product market and that the distributors were somehow dependent on the manufacturer's key products.

No matter what the purpose for specifying the relevant product market share is, we can interpret from these data that there is no generally applicable "safe harbor" for RPM. In particular, we observe that ZAMR even determined a product has a market dominant position by referring to its 2019 market share—which was less than 30%. This suggests that vertical monopoly compliance is no longer just the concern of large enterprises when trying to reach RPM, but it is rather a matter of attention for all enterprises.

## Practice and compliance

Vertical monopoly agreements for RPM are a common arrangement in practice, especially for those enterprises that produce tangible products and adopt distribution sales models. These enterprises are quite accustomed to exercising control over distributors' resale price systems through such arrangements, most of which are small market players that tend to neglect the underlying anti-monopoly risks.

However, whether in AML legal provisions or enforcement, enterprises are strictly prevented from entering into vertical monopoly agreements to maintain resale prices and violators will be subject to penalties. As mentioned above, at present, AML enforcement authorities supervised resale price control by adopting the illegal per se approach, "prohibited in principle, exempted individually". AML enforcement authorities adhere to the following logic in taking such approach:

- First, a vertical agreement may be presumed to have effects of eliminating or restricting competition and be treated as violation of the AML by the enforcement authorities if an enterprise has entered into distribution contracts, sales policies, or performance appraisal standards, or has had communications with distributors that contain provisions to fix or restrict minimum resale prices for distributors and has implemented such provisions.
- In such cases, in order to be exempted, the enterprise must prove that the agreement falls into one of the statutory scenarios listed in the AML (e.g., with the purpose of improving technology, researching and developing new products, improving quality, reducing cost, saving energy, protecting the environment, or alleviating overproduction), does not cause serious harm to competition and benefits consumers.

In practice, enterprises will find it challenging to prove the RPM satisfies the exemption conditions, because they do not only bear rather high burden of proof for the above-mentioned statutory scenarios, but also need to prove the agreements do not seriously restrict competition in the relevant market and allow consumers to share benefit derived therefrom.

If an anti-monopoly enforcement authority finds that a company has reached and implemented a vertical monopoly agreement for RPM, the company will be ordered to cease its violation, forfeit any illegal gains, and be imposed with a fine of 1% – 10% of the company's sales turnover in the previous year.

Therefore, vertical monopoly agreements for RPM have long been a focus for AML enforcement in China. In fact, the first huge penalty issued for an AML violation was issued in 2013 for RPM behaviors of two liquor companies, which resulted in a fine totaling RMB449 million. In another case, nine infant milk powder companies were subject to fines totaling RMB670 million for RPM. In the first half of this year, an anti-monopoly enforcement authority punished a pharmacy company by imposing a fine of 764 million for its RPM behavior. In addition, there have been several instances where enterprises in automobile sales, home appliance, and pharmaceutical industries were also targets of investigations and were punished for RPM, both at the central and local levels.

Although enforcement against prevalent RPM practice remains generally insufficient due to limited enforcement resources, enterprises stand a high risk of being subject to anti-monopoly investigations in the event of a shortage of products, collective price increases, or receipts of complaints by distributors, consumers or third parties.

### **Compliance recommendations**

To mitigate risk, we recommend enterprises to enhance their anti-monopoly compliance against RPM. Enterprises should avoid imposing restrictions on distributor resale prices, discounts, or pricing methods, whether in distribution contracts signed with distributors or in their own sales policies and performance evaluation standards, and prevent proposing requirements with similar effects in actual operations. However, this should not prejudice enterprises' discretion in determining ex-factory prices, maintaining their own pricing methods, and setting recommended retail prices for end users (but they cannot fix recommended retail prices with reward-penalty mechanism). In addition, we will continue to observe the attitudes and compliance practices of enforcement authorities toward new business models that have recently arisen in the market, such as restrictions on maximum resale prices, customized discounts, and distributor profit-sharing models.

## ***Important Announcement***

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