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Delivering the Goods: Manufacturer-Retailer Relations and The Implications for Competition and Trade Policies

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Delivering the Goods: Manufacturer-Retailer Relations and The Implications for Competition and Trade Policies

Executive Summary

The purpose of this Paper is: (a) to identify the implications for international business and markets of various vertical restraint practices; (b) to provide a comparative analysis of the treatment vertical business practices are accorded in the law of Canada, the U.S. and Japan; and (c) to examine some of the implications for the coordination of trade and competition policies. In particular, the Paper analyses five specific vertical restraints in detail: resale price maintenance (RPM), exclusive territorial and customer restricitions (ETCR), exclusive dealing (ED), tied sales (TS) and vertical franchising agreements (FA).

Vertical relationships refer to agreements among the manufacturer and wholesalers or retailers (i.e., distributors) in the chain running from input sourcing to production to retail marketing to consumers. The purpose of these contracts is to enable the distributors to become efficient and compete in the marketplace. A well-tuned distribution network efficiently delivers goods and services to their destination, makes the economy function better and contributes to economic well-being.

Vertical contracts can lead to efficient links among firms at various stages, which may lower production costs and improve product quality. Economic efficiency and welfare, in this case, will be enhanced. Such a result suggests that vertical restraints should not be automatically illegal under competition law.

This positive view is tempered by concern over the economic harm that vertical price and non-price restraints might have on competition. The principal concerns are that vertical restraints raise prices to consumers and can be used to facilitate horizontal collusion at either the manufacturer or dealer level. Firms in a vertical relationship can agree to terms and conditions that give them market power that can be used to extract higher profits. Vertical restraints can result in distortions in consumption and in the allocation of resources. In this view, vertical restraints should be prohibited because they reduce economic welfare.

National competition policy with regard to distribution networks can interact with trade policy through interesting channels. For example, potential entrants could bump up against an entrenched sole importer and distributor. In such a market, the monopoly price of imports is analytically similar to a tariff. Sweeping away the explicit tariffs while allowing monopoly distributors is not likely to result in genuine competition and liberalized markets. Competition policy must underpin the momentum built by a free trade regime.

There is a distinction drawn in competition law between the legal test to be met in a case tried under the *per se* and rule of reason standards. Under the *per se* standard, once a court determines that all the elements of a proscribed practice are found, no further proof of anti-competitive effect is required. In contrast, according to the rule of reason approach, the plaintiff/applicant must show that the impugned practice has had an adverse impact on competition.

Interestingly, our survey of the economics literature points out that more than one type of vertical restraint can be used in manufacturer-dealer contracts to deal with a particular vertical arrangement situation. Which vertical restraints may be used to deal with the problems faced by a manufacturer-retailer/supplier vertical structure will depend on the particular circumstances of the situation. Not all vertical arrangements will increase overall economic efficiency. In general, depending upon the facts, vertical contracts may increase, reduce or leave unchanged economic efficiency. The conclusion one ultimately reaches regarding the overall acceptability of a given vertical restraint will depend on the facts of each specific case. This argues for a rule of reason approach rather than outright prohibition (the *per se* illegality approach) when judging vertical restraints under competition policy.

With regard to specific practices, RPM agreements attempt to take away the re-seller's discretion in product pricing. RPM is unlawful in most jurisdictions. The U.S. treats price ceiling schemes (as well as price floors) as *per se* illegal, like any other kind of price restriction. In Canada, competition law only prohibits restrictions that prevent reductions in price or influence prices upward. In Japan, an approach analogous to the rule of reason appears to exist. Among the three jurisdictions examined in this Paper, Japan is the only country where there are several products that have been specifically exempted from the application of RPM provisions.

Exclusive territorial and customer restrictions (ETCR) are often acceptable under the competition laws examined in this Paper where they do not have an adverse effect on competition. The U.S. Supreme Court, for example, has determined that ETCR should be judged under the rule of reason, rather than be regarded as *per se* illegal. Exclusive dealing (ED) practices in the U.S. normally are also tested by the rule of reason standard. Although U.S. jurisprudence on ED still retains an element akin to a *per se* illegality approach, an alternative based on the rule of reason has gathered considerable strength over the last few decades. In Japan, relevant ED cases are considered on a case-by-case basis, echoing similar treatment in the Canadian system. Finally, competition laws in most countries apply a flexible rule of reason treatment to TS. One important exception has been the U.S., where tying practices in some circumstances have been considered *per se* illegal. However, considerable market analysis is required and a number of conditions must be satisfied before the *per se* rule is applied.

Analysis of the jurisprudence related to vertical restraints is also affected by exemptions provided for in law. However, an assessment of exemptions for vertical arrangements in any one country is best done by considering all other significant competition-related practices that are also exempt from competition law. The annex to this Paper provides an inventory of such U.S., Japanese and Canadian exemptions.

In both Canada and the U.S., there is a defence available for activities that run afoul of competition laws but flow from compliance with government-imposed regulations. In both the U.S. and Japan, exemptions from the application of competition law are sometimes accorded to entire sectors. In contrast, such sectoral exemptions exist for only three situations in Canada. In Canada, exceptions are provided more usually for specified activities and appear to be based on preserving efficiency and competition enhancing considerations rather than outright carveouts. A comparison with the exemptions in the U.S. and Japan is striking. Exemptions in the U.S. are numerous, if not more numerous than in Japan.

In sum, after reviewing the economics and jurisprudence of vertical restraints, this Paper recommends that countries should adopt the rule of reason treatment for all vertical manufacturer-retailer practices, including resale price maintenance agreements and tied sales, and *without any sectoral or other exemptions.* This would require some adjustments in the approach taken by the three countries reviewed in this Paper, especially the U.S. and Japan.

In this context, it should be noted that the deregulation process (i.e., the elimination of exemptions to competition) does not imply that one or a few foreign firms should be accorded some numerical share of the domestic (regulated) market. A major thrust of this Paper is that vertical business arrangements should develop among firms as a natural process as determined in a competitive marketplace. If the power of a foreign government is used to dictate that domestic firms have to do their distribution business with <u>specific</u> foreign corporations, the process of deregulation is pushed back and competitive markets recede further on the horizon. This point is particularly relevant in light of the on-going bilateral discussions between the U.S. and Japan, including in the area of deregulation and the Japanese distribution system.

Moreover, suggesting that all countries take an exemption-free, rule of reason legal approach to both price and non-price vertical restraints requires further thinking in a number of important directions. These include:

- How to develop a common set of rules or guidelines based on international consensus by which the rule of reason approach will be implemented. Several guidelines are tentatively identified in section 6 to encourage further discussion.

- The role of formal enforcement cooperation agreements based on positive comity principles.

With regard to the latter point, it would be useful to explore whether a Quadrilateral (Canada, the U.S., the EU and Japan) positive comity agreement might be negotiable, in part to encourage greater transparency in Japanese enforcement practices.

Finally, international guidelines would ultimately require monitoring and dispute settlement mechanisms of some sort. A few observers have pointed to the creation of a new international competition tribunal, although this may seem exceedingly ambitious at this time. In any event, the more appropriate fora might be the newly established World Trade Organization (WTO) and the North American Free Trade Agreement (NAFTA) which will likely begin to address the competition and trade policy connection (including the prospects for some common standards) over the next several years.

Another, perhaps more interim option, might be to develop, among a limited set of countries (in the Quadrilateral context? in NAFTA?), a NAFTA-like side agreement dispute settlement mechanism that would focus on the enforcement of <u>domestic</u> competition standards (<u>not</u> the harmonization or convergence thereof). The dispute settlement mechanism could be triggered if there were an alleged "persistent pattern of failure to effectively enforce" a country's <u>own</u> law.

Résumé

Ce document a les objectifs suivants : a) préciser les conséquences pour le commerce et les marchés internationaux de diverses pratiques de restriction verticales; b) fournir une analyse comparative du traitement des pratiques commerciales verticales qui est prévu dans les lois du Canada, des États-Unis et du Japon; c) examiner certaines des conséquences sur la coordination des politiques en matière de commerce extérieur et de concurrence. Nous analysons en détail cinq restrictions verticales précises : la vente à prix imposé (VPI), les contraintes d'exclusivité de territoire et de clientèle (CETC), la vente exclusive (VE), les ventes liées (VL) et les ententes de franchisage vertical (EFV).

Un rapport vertical est une entente entre le fabricant et les grossistes ou les détaillants (les distributeurs) dans la chaîne qui va de l'approvisionnement à la production puis à la vente au détail aux consommateurs. Les distributeurs cherchent, par de tels contrats, à assurer leur efficience et leur compétitivité sur le marché. Un réseau de distribution bien au point permet de livrer de manière efficiente les marchandises et les services à leur destination. Ainsi, il améliore le fonctionnement de l'économie et contribue au bien-être économique.

Un contrat vertical peut permettre l'établissement de liens efficients entre entreprises de niveaux différents et, par le fait même, la diminution des coûts de production et l'augmentation de la qualité des produits. Dans ce cas, l'efficience et le bien-être économiques sont accrus. Un tel résultat peut laisser croire que les restrictions verticales ne devraient pas forcément être illégales en vertu des lois sur la concurrence.

Cette opinion positive est tempérée par les inquiétudes sur les dommages économiques que pourraient causer à la concurrence des restrictions verticales portant sur le prix ou sur un autre aspect. Selon les principales inquiétudes, les restrictions verticales pourraient faire augmenter les prix à la consommation et pourraient être utilisées pour faciliter la collusion horizontale, au niveau du fabricant ou du vendeur. Des entreprises qui ont conclu un accord vertical peuvent fixer ensemble des modalités et des conditions qui les placent en position de force sur le marché, position qu'elles peuvent exploiter pour accroître leurs bénéfices. Les restrictions verticales peuvent occasionner des distorsions dans la consommation et dans la répartition des ressources. Selon ce point de vue, les restrictions verticales devraient être interdites car elles diminuent le bien-être économique.

On peut remarquer qu'il existe, entre la politique nationale de concurrence sur les réseaux de distribution et la politique en matière de commerce extérieur, des rapports réciproques intéressants. Par exemple, les nouveaux arrivants éventuels pourraient se heurter à un importateur et à un distributeur unique indélogeable. Dans un tel marché, le prix monopolistique des importations est analogue, sur le plan analytique, à un tarif douanier. Il est peu vraisemblable que l'élimination des tarifs douaniers explicites puisse engendrer une concurrence véritable et des marchés libéralisés si elle est combinée à la tolérance de distributeurs en situation de monopole. La politique de concurrence doit soutenir l'élan donné par le régime de libre-échange.

Les lois sur la concurrence établissent une différence entre le critère juridique qu'il faut respecter dans une cause jugée en vertu de la norme intrinsèque ou de la règle du bon sens. En vertu de la norme intrinsèque, si le tribunal détermine que tous les éléments d'une pratique prohibée sont présents, aucune autre preuve d'effet anti-concurrentiel n'est requise. Par contre, d'après la règle du bon sens, le plaignant ou le demandeur doit prouver que la pratique contestée a eu des effets négatifs sur la concurrence.

Il est intéressant de noter que notre examen de la documentation économique indique que les contrats entre fabricant et vendeur peuvent avoir recours à plusieurs types de restrictions verticales pour une situation particulière d'arrangement vertical. Les restrictions verticales qui peuvent être utilisées à l'égard des problèmes que rencontre une structure verticale fabricant-détaillant (ou fournisseur) dépendent des circonstances précises. Tous les arrangements verticaux n'accroissent pas l'efficience économique d'ensemble. En général, selon les circonstances, un contrat vertical peut accroître ou diminuer l'efficience économique, ou encore n'avoir aucune incidence en ce domaine. Ainsi, la conclusion que l'on peut tirer sur le caractère acceptable d'une restriction verticale donnée dépend des particularités de chaque cas. Cela plaide en faveur de l'adoption de la règle du bon sens plutôt que pour l'interdiction pure et simple (l'illégalité intrinsèque) quand il s'agit de juger des restrictions verticales en vertu de la politique de concurrence.

Nous nous penchons ensuite sur chacun des types de pratique. Les ententes de VPI cherchent à supprimer le pouvoir discrétionnaire que possède le revendeur dans la fixation du prix du produit. La VPI est illégale dans la plupart des pays. Aux États-Unis, les mécanismes de fixation de plafonds de prix (et de planchers de prix) sont intrinsèquement illégaux, comme tous les autres genres de restriction sur les prix. Au Canada, les lois sur la concurrence n'interdisent que les restrictions qui empêchent les prix de diminuer ou les font augmenter. Au Japon, une règle similaire à la règle du bon sens semble prévaloir. Parmi les trois pays examinés pour le présent document, le Japon est le seul où plusieurs produits ont été expressément exonérés de l'application des dispositions sur la VPI.

Les contraintes d'exclusivité de territoire et de clientèle (CETC) sont souvent acceptables aux termes des lois sur la concurrence que nous avons examinées, à condition de ne pas avoir d'effets négatifs sur la concurrence. Par exemple, la Cour suprême des États-Unis a déterminé qu'il fallait juger les CETC selon la règle du bon sens au lieu de les considérer intrinsèquement illégales. Habituellement, les pratiques de vente exclusive (VE) sont aussi jugées selon la règle du bon sens aux États-Unis. Bien que la jurisprudence américaine sur la VE suive d'assez près la méthode de l'illégalité intrinsèque, une solution de rechange fondée sur la règle du bon sens a pris une importance croissante au cours des dernières décennies. Au Japon, les cas pertinents de VE sont considérés sur une base individuelle, ce qui correspond au traitement en vigueur au Canada. Enfin, les lois sur la concurrence de la plupart des pays appliquent avec souplesse la règle du bon sens aux ventes liées (VL). Les États-Unis constituent une exception importante car, dans certaines circonstances, les pratiques de ventes liées y sont considérées intrinsèquement illégales. Néanmoins, des analyses de marché très poussées sont nécessaires et un certain nombre de conditions doivent être remplies pour que la règle de l'illégalité intrinsèque puisse être appliquée.

Les exemptions prévues par la loi ont aussi une incidence sur l'analyse de la jurisprudence liée aux restrictions verticales. Toutefois, le meilleur moyen d'évaluer les exemptions accordées aux arrangements verticaux dans les différents pays est de considérer toutes les autres pratiques importantes touchant la concurrence qui sont aussi exemptées des lois sur la concurrence. L'annexe du présent document donne l'inventaire de ces exemptions aux États-Unis, au Japon et au Canada.

Au Canada comme aux États-Unis, les activités qui contreviennent aux lois sur la concurrence mais résultent de l'observation de règlements imposés par le gouvernement peuvent bénéficier d'une défense. Les États-Unis comme le Japon exemptent parfois des secteurs entiers de l'application des lois sur la concurrence. Par contre, de telles exemptions sectorielles n'existent que dans trois cas au Canada. Au Canada, les exceptions concernent plus souvent des activités bien précises. Elles semblent fondées sur des considérations de maintien de l'efficience et d'accroissement de la concurrence plutôt que par des principes catégoriques. La comparaison avec les exemptions accordées aux États-Unis et au Japon est frappante. Aux États-Unis, les exemptions sont nombreuses, voire plus nombreuses encore qu'au Japon.

Ainsi, après avoir examiné, au sujet des restrictions verticales, les facteurs économiques et la jurisprudence, le présent document recommande que les pays adoptent le traitement de la règle du bon sens pour toutes les pratiques verticales détaillant-fabricant, notamment les ententes de vente à prix imposé et de ventes liées, et ne prévoient *aucune exemption, sectorielle ou autre*. Il faudrait pour cela que les trois pays étudiés dans le présent document, surtout les États-Unis et le Japon, apportent certaines modifications à leurs stratégies.

Dans un tel contexte, il est à noter que le processus de déréglementation (c.-à-d. l'élimination des exemptions à la concurrence) ne signifie pas qu'il faut accorder à une ou à quelques entreprises étrangères une part numérique donnée du marché intérieur (réglementé). L'une des idées maîtresses du présent document est que les entreprises devraient conclure entre elles des accords verticaux de manière naturelle dans le but de pouvoir être concurrentielles au sein du marché. Si un gouvernement étranger utilise son pouvoir pour exiger que les entreprises nationales confient leur distribution à des sociétés étrangères précises, le processus de déréglementation recule et les marchés concurrentiels disparaissent dans le lointain. Cet aspect est particulièrement pertinent à la lumière des discussions bilatérales en cours entre les États-Unis et le Japon, notamment en ce qui a trait à la déréglementation et au système de distribution japonais.

En outre, pour proposer que tous les pays adoptent la voie légale de la règle du bon sens, sans aucune exemption, pour toutes les restrictions verticales, liées au prix ou non, il faut porter une attention supplémentaire à certains aspects importants :

- Comment élaborer un ensemble commun de règles ou de principes fondés sur un consensus international pour la mise en oeuvre de la règle du bon sens? La section 6 établit une liste de principes provisoire afin de susciter la poursuite de la discussion.

- Le rôle d'accords de coopération officiels de mise en vigueur fondés sur le principe du comité positif.

Au sujet du dernier point, il serait utile de se demander s'il serait possible de négocier un accord de comité positif quadrilatéral (Canada, États-Unis, UE et Japon), en partie pour accroître la transparence des pratiques de mise en vigueur du Japon.

Enfin, des principes internationaux nécessiteraient, en fin de compte, l'instauration de mécanismes de contrôle et de règlement des litiges. Certains observateurs ont proposé la création d'un nouveau tribunal international de la concurrence, mais cela semble un peu ambitieux à l'heure actuelle. La nouvelle Organisation mondiale du commerce (OMC) et l'Accord de libre-échange nord-américain (ALENA) pourraient être des tribunes plus appropriées. Ils vont vraisemblablement commencer à se pencher sur les liens entre la politique de concurrence et la politique en matière de commerce extérieur (notamment la possibilité d'instaurer des normes communes) au cours des prochaines années.

Une autre possibilité, peut-être davantage provisoire, pourrait être d'établir au sein d'un petit groupe de pays (dans le contexte quadrilatéral? dans l'ALENA?) un mécanisme de règlement des litiges semblable à celui de l'accord parallèle de l'ALENA et qui serait axé sur la mise en vigueur des normes sur la concurrence de chaque pays (et non sur l'harmonisation ou le rapprochement de celles-ci). Le mécanisme de règlement des litiges pourrait être déclenché en cas de prétendu défaut continu par un pays de mettre en vigueur ses propres lois.

1. Introduction

> Either from indolence, or carelessness, or because people think it fine to pay and ask no questions, three-fourths of those who can afford it give much higher prices than necessary for the things they consume; while the poor often do the same for ignorance and defect of judgement, want of time for searching and making inquiry, and not infrequently from coercion, open or disguised. For these reasons, retail prices do not follow with all the regularity which might be expected from the action of the causes which determine wholesale prices.
>
> —John S. Mill[1]

Vertical relationships refer to private agreements among the manufacturer and wholesalers or retailers (i.e., distributors) in the chain running from input sourcing to production to retail marketing to consumers. The purpose of these contracts is to enable the distributors to become efficient and compete in the marketplace. A well-tuned distribution network efficiently delivers goods and services to their destination, makes the economy function better and contributes to economic well-being.

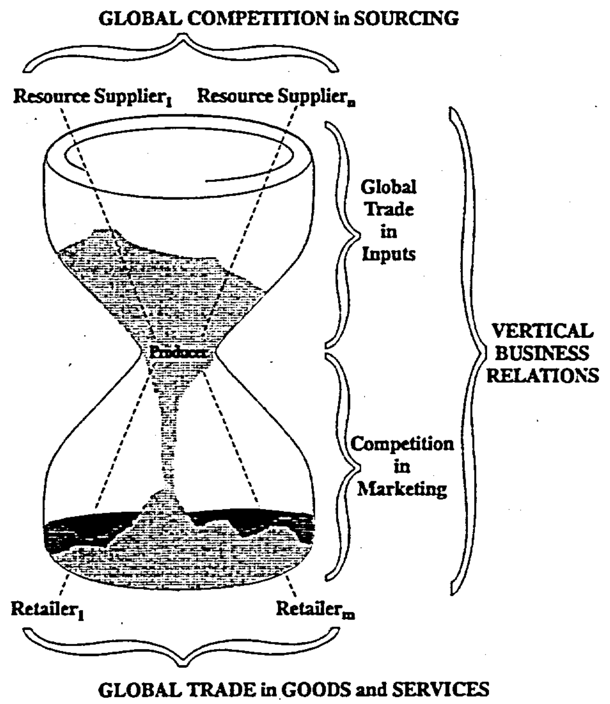
An hour-glass, such as in Figure 1, is often used to illustrate the two segments of the vertical chain. First, in the downstream vertical arrangements, contracts between the manufacturer and retailers contain terms that may affect decisions related to such issues as wholesale or retail prices, franchise fees, the purchase of other products that are tied to the sale of another product and which dealer is assigned to which territory. Second, in the upstream vertical contracts, the producer and input suppliers may agree to deal on an exclusive basis or may set a multi-part pricing formula and so on.

Consider the automobile business by way of illustrating a vertical structure depicted in Figure 1. Ford, for example, sources many parts for its cars from independent suppliers. These suppliers of intermediate inputs constitute the upstream segment of automobile manufacturing. Ford assembles cars and sells them through its retailers located at the downstream stage of the whole process. In a vertical business structure, the manufacturer does not make all the components in-house. Nor does it supply the final users himself. In contrast, a vertically integrated operation does all the processes in-house.

[1] John Stuart Mill, *Principles of Political Economy with Some of their Applications to Social Philosophy*, 1848, new edition Routledge and Kegan Paul, 1912, p. 441.

Figure 1

COMPETITION and TRADE in DELIVERING GOODS



Vertical restraining clauses are essential for the distributors to perform their function. Vertical restraints[2] may put restrictions on the behaviour of individual distributors, but they may promote competition by enabling each player in the distribution chain to do its job in a cost minimizing fashion.

This positive view is tempered by concern over the economic harm that vertical price and non-price restraints might have on competition. Countries use competition policy and regulatory regimes to permit restraints on competition in the vertical chain that do not cause economic harm in the economy. However, not all vertical restraints deliver net benefit to consumers in all situations. The principal concerns are that vertical restraints raise prices to consumers and can be used to facilitate horizontal collusion at either the manufacturer or dealer level. Most countries treat vertical price fixing (e.g., resale price maintenance) as outright illegal. In contrast, actual competitive effects of vertical non-price restraints (e.g., exclusive territories, customer restrictions) are examined on a case-by-case basis in the context of specific facts attending the practice. Consequently, countries differ with regard to those vertical restraints that are treated as outright illegal and which tests or defences businesses are to meet for lawful vertical agreements.

An analysis of vertical business restraints is important because it deals with national distribution systems. An example of the potentially contentious role of distribution systems is the U.S. charge that the distribution system in Japan shuts out imports.

National competition policy with regard to distribution networks can interact with trade policy through interesting channels. For example, potential entrants could bump up against an entrenched sole importer and distributor. In such a market, the monopoly price of imports is

[2] The terms vertical restraints, vertical controls or vertical contracts are often used interchangeably.

analytically similar to a tariff. Sweeping away the explicit tariffs while allowing monopoly distributors is not likely to result in genuine competition and liberalized markets. Competition policy must underpin the momentum built by the free trade regime.

The following are some of the important international issues pertaining to vertical business practices:

- Have our trading partners adopted national competition laws or enforcement practices which sanction vertical restraints that would otherwise be deemed unlawful? Is such foreclosure (while also affecting potential national industries) considered desirable as a matter of national policy aimed at precluding access to the market by foreign companies?
- Would a change in policy with respect to vertical restraints increase foreign investment in new local competitors (who are now excluded from their own domestic market), thereby increasing competition and consumer welfare in those local markets?

The purpose of this Paper is: (a) to examine various vertical restraint practices, especially with an eye to their implications for international business and markets; (b) to provide a comparative analysis of the treatment vertical business practices are accorded in the law of Canada, the U.S. and Japan; and (c) to draw out some of the implications for the coordination of trade and competition policies.

Since the 1960s, few questions in the field of industrial economics have been debated more heatedly than vertical restraints. In 1985, the Antitrust Division of the U.S. Department of Justice (AD-DOJ) under the Reagan Administration issued Vertical Restraint Guidelines on three areas of controversy. Recently, the AD-DOJ under the Clinton Administration, led by Assistant Attorney General Anne K. Bingaman, again lit a fire under the debate about the role of vertical antitrust when it withdrew the 1985 Guidelines in August 1993. The perception was that the 1985 Guidelines were too lax.[3] The AD-DOJ has also issued draft guidelines on the relationship between intellectual property rights and antitrust law.

[3] Rebecca P. Dick, "Antitrust Enforcement and Vertical Restraints", Department of Justice, Washington, D.C.. An address before the ABA Section of Antitrust Law and the Corporate Bar Association of Westchester and Fairfield, the Plaza Hotel, New York, 4 November 1994.

1.1 Vertical Relations in an Information-Age World Economy

i) Transformation of manufacturer-subcontractor relations

In a traditional manufacturing model, a producer would send its purchasing officer to subcontractors with detailed blueprints and instructions on how to make the parts. Parts would be further subjected to quality controls after delivery. This old model is being replaced by new technology in the emerging information economy.

Digitial technology offers an improved and more efficient way of securing supplies. Producers will soon be able to send three-dimensional drawings down modem links to subcontractors. As computer-aided designs (CAD) grow more sophisticated, the practicality of most designs of parts can be tested by computer with increased reliability before delivery. In computer-aided manufacturing (CAM), good software enables machines to perform quality checks.

With on-line communications, it is as swift and easy to send out a parts order to 25 potential subcontractors as to five; or to Chicago, or Tokyo or Singapore as it is to Toronto. Having placed an order on-line, the company can wait to see which supplier offers to fulfil it most efficiently. The on-line opportunities will enable the firm to scour the world for the best deal. These links help to ensure that manufacturers obtain faultless parts at short notice. In time, traditional producer and parts' supplier relations will become uncompetitive and will be replaced by these new links based on much enhanced information technologies.

ii) Transformation of manufacturer-retailer relations

One key assumption of early vertical restraint cases was that the retailer at the point of sale had the best information and would be the most responsive to market forces because its investment was at stake. The manufacturer, having sold the product down the distribution chain, was supposed to be indifferent to subsequent developments and to remain detached from immediate market signals. In the information age, that assumption will increasingly become less applicable.

In the traditional producer-retailer setup, each retailer has to source its merchandise from a number of producers with enough stocks in the warehouse to meet its peak demand. As computer network linkups grow wider and become cheaper, the manufacturers and dealers will be able to establish e-mail and video contacts with a couple of clicks on the mouse. As industrial networking catches on, retailers with varying patterns of demand can use each other's stocks and reduce the requirement to hold large amounts of overall stocks on hand.

For instance, car dealers and real estate agents already enjoy an on-line search capability through region-wide inventory data bases.

New network services will make it possible for manufacturers to compete anywhere, anytime. Already it is possible to schedule, monitor and coordinate the production of multiple factories in a number of countries from a single location. The linkage via information technology enables firms to become less vertically integrated in the formal ownership-based sense, while increasing the importance of vertical relationships not based on ownership. Manufacturing capacity becomes a commodity that can be accessed almost anywhere in the world using network technology.[4] The same should be possible for retail outlets and other operations.

The retailers of the future will use telecommunications and information systems to capture microlevel data, which the manufacturers will consolidate and process. Networking in the context of manufacturer and retailer relations will imply significant shifts in the division of responsibility and activities between the two.

Manufacturers are taking on functions, such as ticketing, sales forecasting, advertising and in-store services—functions that have traditionally been the responsibility of retailers. Some manufacturers, empowered by their increased access to data and service capabilities, view the retailer of the future as providing space for showing their products. On the other hand, powerful retailers are inducing manufacturers to provide an unprecedented number of services in addition to the products they offer. Companies, such as Wal-Mart, are eliminating third-party distributors and brokers.[5] The availability of shopping channels on television introduces new marketing relations.

The upshot is that, in the information age, it is the manufacturers who are likely to have superior information about price elasticity, market trends and other factors which are not as easily seen by the retailer. However, this shift in the distribution functions may come at the cost of higher investment outlays and greater overall risk than in the past for the manufacturer.

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[4] R. Jaikumar and D.M. Upton, "The Coordination of Global Manufacturing", in S.P. Bradley, J.A. Hausman and R.L. Nolan, eds., *Globalization, Technology and Competition: The Fusion of Computers and Telecommunications in the 1990s*, Boston, MA: Harvard Business School Press, 1993, p.169-83.

[5] Janice H. Hammond, "Quick Response in Retail/Manufacturing Channels", in S.P. Bradley, J.A. Hausman and R.L. Nolan, eds., *op. cit.*, 1993, p.185-214.

In general, creativity and flexibility in the production and retailing processes should count for more in future. This may call for more vertical coordination and joint ventures among manufacturers and dealers. Policy makers need to know which of these vertical arrangements are efficiency and competition enhancing. One thing is clear. A presumption that all the new vertical restraints will be *per se* competition lessening is not a practical hypothesis. Forward-looking trade and competition policies will have to facilitate those vertical restraints that foster these creative and flexible features in the economy.

This Paper is organized as follows. In section 2, the issue of vertical restraints is developed and some of the related concepts elaborated upon. In section 3, theoretical reasons for why manufacturers and dealers agree to vertical restraints are discussed. An economic and legal analysis of five major vertical restraints in several major markets is presented in section 4. Section 5 contains the summary of the law on vertical restraints and exemptions accorded to vertical practices in Canada, the U.S. and Japan. A discussion of the policy implications is found in section 6.

2. Manufacturer-Dealer Transactions

2.1 Concepts and Definitions

The following are the definitions of some frequently encountered vertical contractual practices.

Resale Price Maintenance

Resale price maintenance (RPM) refers to a vertical price agreement in which a manufacturer-supplier attempts to remove all or part of the re-seller's independent pricing discretion. Retailers charging a lower price than the manufacturer posted price floor may have to reckon with the loss of distribution privileges. RPM may also take the form of a maximum or a fixed price. In general, the term RPM is used only for those transactions in which one perceives that the agreement is being used to remove the pricing decision from competitive market forces.[6] On an intuitive basis, some analysts have viewed specifying the minimum price with grave concern.

[6] For a discussion of case law on this point, see Alan H. Silberman, "Antitrust and the Distribution Process", Sonnenschein Nath & Rosenthal, Chicago, Illinois, mimeo., June 1994: 35-40.

Exclusive Franchising

In exclusive franchise arrangements, the producer limits the competition an individual dealer faces from other outlets distributing the manufacturer's line. Many franchises rely on the manufacturer's self interest in not authorizing more outlets than would be consistent with good marketing and profit maximization over time. In general, in structuring their relationship the manufacturer/franchisor can choose from a range of price and non-price vertical or horizontal practices. In one arrangement, each dealer buys the product according to a two-part tariff.[7] For the dealer, exclusivity is attractive because, by lessening competition, it permits wider price-wholesale cost margins than could be sustained under an unrestricted access policy.

Exclusive Dealing

The practice of exclusive dealing obliges a seller to carry products of a specific manufacturer and not others. Exclusive dealing is an effort to make the seller economically dependent on the promotion of the manufacturer's product. Exclusive dealing is often employed in conjunction with exclusive franchising; for example, a Midas franchise is supposed to sells only Midas-brand exhaust systems and brakes. Alternatively, the dealer may be allowed to carry the products of several manufacturers who are not direct competitors with one another (e.g., a grocery store might be restricted to selling only one brand of light bulb, but still be allowed to sell hundreds of other products).

Exclusive Territory or Geographic Market Restrictions

Under an exclusive territory, a single distributor is the only one who obtains the rights from a manufacturer to serve consumers in a specific geographic region. This geographical exclusivity may be enforced by limiting the geographic location of authorized dealers, while allowing a dealer to serve any customer who comes into the store. Alternatively, the manufacturer may explicitly forbid a retailer from serving customers who are located in the territory assigned to another dealer.

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[7] As explained below, under a two-part tariff, one part of the overall cost is a fixed franchise fee and the other part depends on how many inputs the franchisee buys from the franchisor.

Tying

Under a tying arrangement, the purchaser of one good is compelled to agree as a condition of purchase (or lease) to buy supplies of some other good from the seller. The agreement, in effect, forecloses competing materials suppliers from selling the *tied* good to that purchaser.

Bundling

Under bundling practices, the seller insists that the buyer take a package of products, bundled together and offered at a single price per bundle. Bundling differs from tying in that the products bundled as a package are usually related and that, if items are offered singly, the price would tend to be higher.

Forcing

Under a forcing contract, the dealer is required to purchase a given amount of the input.

Requirement Contracts

In this type of agreement, a manufacturer imposes the requirement that dealers sell only to the general public and not to other dealers on a wholesale basis. The agreement simply reflects the manufacturer's decision and is not necessarily a collusive limitation designed to undermine inter-brand market forces.

Price Discrimination

In the simplest terms, a question of price discrimination may be presented whenever different customers for the same good are charged different prices. The actual legal strictures are more detailed, since the law may reference competing customers and an injury to competition. Discriminatory pricing can be profitable because it allows a seller to extract higher prices or surplus from customers with a greater willingness to pay. Alternative consumer surplus extraction techniques are: tying, bundling and quantity forcing arrangements.

Market Foreclosure

Market foreclosure is a commercial practice that reduces the buyer's access to a supplier (i.e., upstream foreclosure) and/or limits the supplier's access to a buyer (i.e., downstream foreclosure). There are many tools (including mergers) used to achieve market foreclosure. A buyer may purchase a supplier or set up its own production unit so as to manufacture the intermediate good internally; or it can fill at least some requirements internally. The upstream division may then refuse to deal with external buyers or, equivalently, may engage in a "price squeeze" (i.e., charge them an exorbitant price). A supplier may sign exclusive-dealing or exclusive-territory contracts with its buyers. A manufacturer of two complementary products may impose a tie-in or make its basic good incompatible with the complementary goods sold by other manufacturers.

Refusals to Deal

A refusal to deal occurs when a manufacturer refuses to allow a retailer to act as a dealer for the manufacturer's product on the same terms as are granted other retailers. In other words, a refusal to deal occurs when someone is unable to enter into transactions at all. A refusal to deal on the same terms may be a price discrimination. It may also be perfectly lawful. Refusals to deal may be wholly unilateral or they may flow from an exclusive arrangement agreement. In either case, the *de facto* effect is the same, but the legal status may be quite different.

Quantity Dependent Pricing

The price that the buyer pays per unit of the intermediate good may depend on the total amount of the good that the buyer purchases. For instance, under a two-part tariff, the dealer pays a one-time fixed fee (called a *franchise fee*) plus a constant per unit charge to purchase the input. In other words, the total cost to the dealer consists of fixed and quantity related costs. Consequently, the overall per unit cost paid by the dealer falls as more units are bought. Bundling and forcing are well known forms of quantity dependent pricing.

Promotional Efforts or Services

Retailers often provide services that make the manufacturer's good more attractive to consumers: trading coupons, free alterations, free delivery, credit, pre-sale information, advertisements, elaborate premises, extra sales help that keeps waiting lines short and so on.

2.2 Development of the Issue

The issues in vertical structure can be viewed in terms of (a) the functional division of responsibility among the manufacturer, suppliers and retailers, and (b) the control of vertical instruments to achieve targetted outcomes or agent performance. In each case, the incentives to take on a specific function or to turn in the desired level of performance depend on the reward structure in the vertical network. Before turning to the two approaches, we discuss the incentive structure in vertical arrangements as contrasted with vertical integration.

Vertical restraints are to be distinguished from horizontal restraints (e.g., price-fixing). Horizontal restraints are agreements that augment market power of firms in competition with each other. Horizontal restraints affect market competition by creating "private government". In contrast, some form of private agreement is necessary for the players in the vertical chain to be efficient and compete in the market. A manufacturer must enter into agreements with its suppliers and retailers. Vertical restraints do not carry much risk of aggregating power. In other words, horizontal and vertical restraints are not cut from the same fabric.

- *The incentive structure*

Conceptually, arm's length transactions could take place between firms at each stage in the vertical structure. In practice, players in the vertical chain from suppliers to the manufacturer, and from the manufacturer to the retailers will attempt to arrange their business dealings with each other in a way that maximizes their profit.

Input prices paid to suppliers and subcontractors feed into production costs, which in turn figure in the wholesale price the manufacturer charges its retailers. Suppliers make a profit when they get paid in excess of their resource costs. Competition among suppliers will ensure that they make normal profit only, while the manufacturer pays a competitive price and there takes place an efficient allocation of resources in the upstream segment of the vertical chain.

The wholesale price the manufacturer charges the retailer affects the final consumer price and the retailer profit. At the same time, retailers also affect the manufacturer's profit by making or withholding efforts in promoting the product and providing before and after sales services. In other words, the manufacturer and retailer interactions criss-cross in an interdependent loop that has a feedback track going from one to the other.

The decisions made at each segment of the vertical structure can be broadly classified as price and nonprice (e.g., quality, service and advertising) policy choices. Vertical price agreements primarily concern vertical price fixing cases, such as RPM. The vertical nonprice restraints divide generally into two categories: (a) restraints such as exclusive territories, customer restrictions and profit pass-over arrangements, which limit *intrabrand*[8] competition among dealers of a single supplier; and (b) restraints such as tying, which limit *interbrand*[9] competition by denying competing suppliers access to distribution channels or by forcing purchasers to buy products they do not want. Vertical restraints typically reduce intrabrand competition, but may increase interbrand competition.

- *Vertical relationships or vertical integration*

In thinking about competition policy concerns in vertical restraints, a comparison with *vertical integration* is often made. A vertically integrated firm would make the entire product and would also sell the good itself. In theory, vertically <u>integrated</u> and <u>vertically</u> controlled structures could emerge as an answer to the same overall production problem. Under competition law, <u>integrated firms are legally allowed to implement almost any internal contract.</u>

It is also well known that, in some situations, the costs of production and distribution under vertical integration may be higher due to the use of an inefficient corporate structure. The contrary view from transaction cost economics argues that <u>transaction costs</u> associated with coordinating and arranging for production are generally lower when goods are produced <u>within</u> a single firm. But, <u>production costs</u> are usually reduced by procuring from an outside supplier that enjoys economies of scale due to specialization. <u>Nonetheless, competition law in many countries restricts the writing of arm's length vertical contracts by independent firms.</u> For instance, resale price maintenance (RPM) is *per se* illegal in most countries.

Competition laws on vertical restraints may have the unintended side effect of actually encouraging formal vertical integration (e.g., through takeovers or mergers), even in situations where this form of business organization is not the most efficient one. Relationships in the distribution system should be based on who can perform the task in the least costly way.

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[8] Intrabrand competition refers to competition among retailers of the same brand-name product. For example, a city that has six General Motor dealerships (and no other car dealership) will be characterized by retailers competing within the GM brand of automobiles. The intrabrand setting brings out the issues involved in vertical supplier-buyer relations.

[9] Interbrand competition takes place among retailers who sell multiple brands. For example, a city that has six General Motor dealers and four Ford dealers will be characterized by retailers who not only compete within their own brand but also with rival brand automobiles. There is interbrand competition in a stereo equipment store selling brands such as Sony, Toshiba, Sanyo, RCA and so on.

Therefore, a key vertical restraint issue is the ability of the legal system to understand how shifts in the allocation of functions over time should be analyzed.

- *A functional approach to the distribution system*

Distribution decisions, which lie at the heart of all vertical relationships, involve an allocation of the functions between various players in the distribution chain. In moving the goods in the vertical chain from one to the next point and finally to the consumers, many functions are performed. A partial list of such functions would include: the sourcing of raw materials, components, technology and other inputs; manufacturing, packaging and transporting the good; product promotion through advertisements and so on; holding of inventories; arranging store displays; training the distribution/sales staff; the organizing of pre-sale information events; after-sales services, such as repairs and the stocking of spare parts; and so on.

In a well functioning distribution network, goods and services are efficiently delivered to their destination. The main issues that a distribution system must address are:

- Which player (e.g., the manufacturer, the wholesaler or retailer) is best able to perform the function?
- How clearly can the obligation to perform a desired function (or to refrain from performing a function) be expressed?
- What is the point at which the cost of allocating the function to one level or another justifies a shift in allocation—up to and including the point at which the manufacturer determines that costs (including costs created by legal risk) are so great that it is more efficient to assume the function itself?

In vertical relationships, the manufacturer and wholesalers or retailers (generally referred to as distributors) enter into private agreements; some are formal contracts, while others are informal agreements. In these vertical contracts, parties can restrain each other's behaviour in the market by agreeing on which functions to perform and which not to. Many of these contracts reflect agreements on price and non-price decisions of the distributors.

- *Instruments-objectives approach to vertical restraints*

The principal (i.e., the manufacturer) would juggle instruments of specific vertical practices, such as RPM, tied sale or exclusive dealing, to obtain some desirable level of product promotion or service or inventory holdings and so on from its agent (i.e., the retailer).

The manufacturer may fix the final price the retailer is to charge the consumers. He may delineate the area of distribution for each retailer, or impose tie-in purchases of other goods. Depending on which price and non-price policies toward its retailers the manufacturer decides to control, the retailers may or may not be induced to put forth optimal sales effort. Consequently, the level and division of profit between the producer and dealers crucially depend on the type of competition-restraining clauses they have agreed upon in their vertical contracts.

In the context of instrument control, along with price and non-price restraints, the distinction that is essential in examining vertical relations is intrabrand versus interbrand competition. We will return to these issues in our discussion of the economics of vertical contracts in section 3 and of the case law experience in section 4.

2.3 Efficiency, Welfare and the Legal Treatment of Vertical Restraints

Some analysts have argued that competition policy should aim to prohibit vertical restraints that reduce efficiency and welfare, whereas efficient and pro-competitive restraints should be allowed. We present the debate under a stylized economic view and a stylized legal view.

- *An economic view*

In the economics literature, vertical restraints raise concerns about the effects that a manufacturer's power over retail-level decision making may have on the overall course of competition.[10] However, a school of thought sometimes associated with the University of Chicago contends that this is not a significant question whenever competition exists among manufacturers of several brands of products.[11] Furthermore, even when one is unsure of the anticompetitive consequences of vertical restraints, this line of argument contends that government intervention would frequently come at a higher cost than is socially efficient. Consequently, proponents of this line of thought would argue against intervention.

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[10] Underlying the concerns about vertical restraints is the deeper issue, which is beyond the scope of this Paper, that centralized decision-making is largely distrusted. Competitive markets provide considerable latitude for dispersed decision-making, even though the final outcome may be characterized by one result, such as a market price centred around the mean price. There are social benefits from dispersion of decision-making.

[11] The Chicago School would subject to close scrutiny practices, such as price fixing, that are used to facilitate horizontal collusion at either the manufacturing or retailer level, as they are likely to be anticompetitive.

Depending upon the facts, vertical contracts may increase, reduce or leave unchanged economic efficiency. On economic grounds, one view holds that vertical restraints result in distortions in consumption and in the allocation of resources. Vertical arrangements may be used as a device to deny market access to rivals and may even create monopolies. Firms in a vertical relationship can agree to terms and conditions that give them market power which can be used to extract higher profits. In this view, vertical restraints should be prohibited because they reduce economic welfare.

The counter view, also based on economic grounds, holds that vertical contracts can lead to efficient links among firms at various stages, which may lower production costs and improved product quality. Economic efficiency and welfare, in this case, will be enhanced and, consequently, vertical restraints should not be illegal.

In our example of automobiles in section 1, the manufacturer has contracts with its subcontractors and dealers. These contracts contain clauses that may restrain the behaviour of individual suppliers and retailers. Should these contracts be *per se* illegal? Vertical contracts may have restrained individuals, but they may promote competition rather than restrain it.

The crucial question here is understanding the true nature of the relationship between Ford and its suppliers/retailers. Our discussion suggests that the firm (Ford) may or may not impose inefficiencies or deny market access to potential entrants. In practice, competition policy concerns turn on whether we can isolate those situations in which we see economic harm due to vertical restraints.

Conceptually, as we said above, Ford could produce all the parts and services to make an automobile in-house. Integrated manufacturing would permit Ford to get around competition policy concerns. Yet, a vertically integrated Ford may not be as efficient a producer. Thus, non ownership-based vertical arrangements that promote efficiency should not be automatically prohibited.

The effect on *intra*brand competition versus *inter*brand competition of a given vertical practice is one of the fundamental issues in assessing the overall desirability of the arrangement from society's point of view.

Competition policy analysts often examine whether a given business arrangement is pro- or anti-competitive and, consequently, whether a given practice should be banned or not. Some competition policy analysts may use or emphasize the effects on consumer surplus alone in evaluating economic efficiency of a business practice. However, from society's perspective, the sum of both consumer surplus and producer surplus[12] is a more appropriate measure of economic efficiency. Vertical restraints that increase producer surplus and offset any reduction in consumer surplus would still improve economic efficiency.

Most economists today would agree that efficiency rationales for vertical restraints are valid in various circumstances. Consequently, one must proceed to determine economic harm only after a comprehensive analysis of the facts surrounding a particular case.

- *A legal view*

One view, more common in the past than today, holds on legal grounds that vertical restrictions are injurious because they override the right of a retailer to make decisions about how and where it will compete on a case-by-case basis. Underlying this view is the notion that what is at stake is the property right in the product being resold and that this property right has passed on sale from the manufacturer to the retailer. The contrary legal view holds that the manufacturer should have the right to offer the retailer whatever contracts it wishes. The retailer is free to drum out contracts that are unattractive. Voluntary vertical contracts, in this view, should not be prohibited.

The view that vertical restraints are primarily agreed upon to perform an allocation function points out two tests for evaluating vertical restraints. First, horizontal restraints which masquerade as vertical restraints should be screened out. Second, the focus of vertical relationship law must be on deciding when and why there should be intervention into private agreements which parties in the distribution system have entered into in order to structure their own affairs. In other words, we need to identify significant economic risks in private agreements in the absence of government intervention.

In general, evaluating the net welfare effects of vertical practices may be extremely difficult. Any given restraint may enhance or reduce efficiency. For instance, there is an unresolved debate over whether promotional activities should be viewed as the provision of information (assumed to be good), or as a way to create false image differentiation (assumed to be bad). In practice, the focus is on the effects of vertical restraints on competition and whether they do economic harm or not.

In this Paper, economic efficiency is taken as the objective of competition policy (and of trade policy).

[12] A proxy for producer surplus can be producer profits.

3. The Logic of Vertical Restraints

Firms sign on to vertical contracts to agree on a number of factors, such as wholesale price, franchise fee, the quantity purchased by a retailer, the final consumer price, promotional effort, retail location and so on. For the contracting parties, specific vertical arrangements are instruments that can be used to target a number of objectives, such as the retail price, surplus extraction and the promotional effort by the retailer. Each party accepts the contract only if they find it profitable to do so. In general, vertical contractual relationships are just a special case that belong to a full range of contracting scenarios between the manufacturer and the retailers.

In deciding on which price and non-price vertical restraints to impose on its suppliers and retailers, the manufacturer has to balance the lure of extracting profit for itself against the size of the profit margin for the dealers. In situations where simple two-part pricing is not sufficient to increase his private profit, the manufacturer can put in more complex clauses in vertical contracts with dealers. For instance, the manufacturer may use one or more vertical restraints to provide retailers a large retail margin, i.e., a hefty difference between the final consumer price and the wholesale price paid by the retailer.

A number of different vertical restraints may address the same common situation that a manufacturer may be confronting, such as raising promotional effort by retailers to some desired level, getting retailers to protect the brand name image and reputation of the product, providing the retailer some measure of stability of profit over time, or preventing entry by potential competitors.[13]

In this section, we briefly review the literature concerning a selected number of vertical restraints. The discussion of the effect of vertical restraints on *intra*brand competition is followed by that on *inter*brand competition.

3.1 Vertical Restraints and Intrabrand Competition[14]

Consider a single manufacturer dealing with multiple retailers. In this case, an argument can be made that the manufacturer's profit will be greatest when his dealers are perfect competitors with one another. The manufacturer can set the wholesale price (WP) in

[13] Michael L. Katz, "Vertical Contractual Relations", in R. Schmalensee and R.D. Willig, eds., *Handbook of Industrial Organization*, Volume 1, North-Holland, 1989, chapter 11, p. 712-3.

[14] See footnote 8 above.

excess of its marginal cost (MC) of production. The competition among retailers drives the final market price paid by consumers to an equality with retailer marginal cost (which is WP). This scheme allows the manufacturer to appropriate all of the profits from the sale of the good and economic efficiency is achieved. This outcome obtains, provided the input bought from the manufacturer is not substitutable.

In contrast, when input substitution is possible, setting WP any higher than MC will not only erode the dealer margin in the first instance, but also motivate the dealer to search for alternatives. The input substitution possibilities introduce increased intrabrand competition in the final market that may reduce overall upstream industry profits.

Let us consider the role of vertical restraints in a few stylized situations.

Stylized Scenario: Surplus Extraction

Consider a business circumstance where either the retailer does not capture the consumer surplus fully or the retailer does not pass on a desired share of its profit to the manufacturer. The manufacturer can use vertical restraints as described below and target either the consumer or retailer surplus.

(1) The manufacturer can impose *a resale price floor*, whereby WP is set at his MC level and then a franchise fee is set to appropriate any dealer surplus.

(2) Another way for the manufacturer to get at consumer surplus in different geographical markets is to eliminate intrabrand competition through the assignment of *exclusive territories*. By placing territorial customer resale restraints on his dealers, the manufacturer can facilitate geographic price discrimination. If territorial restrictions can be enforced, then hauling goods from higher priced locations to lower priced areas can be checked and profitable price discrimination can be practised. The manufacturer can induce optimal price discrimination by setting all the wholesale prices equal to marginal cost.

(3) Alternatively, the use of a system of *resale price maintenance* under which the maintained price varies across regions would also achieve the desired downstream geographic discrimination.

Stylized Scenario: Retail Margins and Raising Promotional Effort

It is commonplace that product promotion results in increased consumer demand and higher sales. The retailer is often recognized to be the better agent to deliver the promotional services to customers.[15] Consequently, it is in the manufacturer's interest to provide the retailer with sufficient retail margin (i.e., the retailer price is in excess of the wholesale price) to perform the necessary promotional services.

In a situation where the manufacturer senses that the dealers do not optimally promote the product, the manufacturer may configure the incentive structure in a way that induces retailers to choose the adequate level of promotional services, after sales services, retail price and so on. The manufacturer can build in additional vertical restraints in its contracts with dealers.

(1) *Resale price maintenance* (RPM) can be used to preserve a larger dealer margin that generates downstream incentives to engage in promotional activities. Moreover, a restriction on price competition (i.e., a floor price) makes it difficult for a low-service dealer to free ride on a high-service dealer, because it limits the ways in which the low-service dealer can attract consumers away from the other dealer (e.g., through price cutting). In this way, RPM both protects a high-service dealer and gives a low-service dealer an incentive to raise his service level.[16]

(2) One other arrangement, which does not come without its costs on the manufacturer, would impose *exclusive territories* (ET), under which the final market is divided into non-overlapping geographic segments with one dealer in each segment. ET are also a way of preserving the dealer's opportunity for return on incremental investment developing the territory since it assures that the dealer will reap the benefit of that investment directly.

(3) In addition, the manufacturer can use *customer resale restraints* to block free-riding directly. This method of non-geographic customer restraints can work much like exclusive territories to prevent free-riding. Faced with customer restrictions, a dealer is prevented from stealing the business of a consumer in whom another dealer has invested time and money in making a sales pitch or providing other customer-specific promotional services for the manufacturer's brand.

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[15] In situations where this not true, the manufacturer could simply perform this function and there would no longer be a need for the vertical restraint.

[16] Frank Mathewson and Ralph Winter, "The Law and Economics of Vertical Restraints", in Frank Mathewson, Michael Trebilcock and Michael Walker, eds., *The Law and Economics of Competition Policy*, Vancouver, B.C.: The Fraser Institute, 1990.

Stylized Scenario: Preserving Brand Reputation

Frequently the dealer can affect consumers' valuation of the overall quality or brand image of the good. Products and brand names sold in well laid out and customer friendly stores at premium locations often carry an image of superior quality. An individual dealer can contribute to a brand's reputation which is likely to bring repeat business. Higher demand may also spill over to other dealers selling the same well recognized brand name. However, dealers tend to undersupply quality efforts by using fewer inputs than optimal.

(1) To coax dealers to bring forth the optimal level of reputation enhancing effort, in addition to *RPM*, the manufacturer can *impose quality standards on dealer performance*. For instance, many franchise arrangements have minimum quality standards built in their contracts.

Stylized Scenario: Picking Dealers

The manufacturer's profits typically vary with the number of dealers. A large number of dealers may have negative effects, as the competition among dealers could result in discount pricing and reduced dealer services. On the other hand, a manufacturer may benefit from having multiple retailers.

First, multiple dealers increase intrabrand competition, which serves to limit the markup of the final price over marginal cost and hence confers some vertical control to the manufacturer. Second, when dealers differ by the quality of services they provide, an increase in their number tends to stimulate demand for the manufacturer's output. Third, consumers may be heterogeneous. Having retailers located at different points in the geographical or quality spectrum enables a manufacturer to better appropriate their surplus. Fourth, having multiple dealers allows the manufacturer to develop a benchmark against which to measure any one dealer's performance.

To get the desired number of retailers, the manufacturer can consider a range of vertical restraints.

(1) The manufacturer can choose the number of dealers by simply *refusing to deal* with more than a set number of downstream firms.

(2) The manufacturer can choose the number of retailers either directly, or indirectly by setting the *franchise* fee (the number of retailers is determined by the last franchisee who merely breaks even). The higher the fixed franchise fee, the lower the number of retailers who can afford to enter the market.

(3) Another way to restrict the number of dealers is to assign a limited number of *exclusive territories*. The imposition of exclusive territories also can be used to raise individual dealer profit and increase the number of dealers that the downstream market can support.[17]

(4) When consumers value dealer variety, a manufacturer would have incentives to implement *a RPM* (such as a resale price floor) in order to increase the number of dealers by preserving their price-cost margin.[18]

(5) Still another way of dealer selection is to define the style of the dealer's marketing (i.e., size of shop, types of additional products and services which must be offered and so on). This may be more than preserving brand reputation. It may be designed to ensure that the manufacturer's product (or group of products) is presented to the market in a certain way, for instance, as part of a one-stop shopping approach or as part of a marketing strategy that emphasizes depth of inventory or location of outlet.

Stylized Scenario: Dealers Forming Cartels

Competing retailers may pressure a manufacturer to impose competition reducing vertical restraints. As an example, consider the case of a group of retailers that purchases an intermediate good at the competitive price: the wholesale price (WP) equal to marginal cost (MC). These retailers compete on the final price and charge the final price equal to MC. They make zero economic profit.[19]

(1) Suppose now that they come up with the clever idea of creating a trademark. They set up an institution to certify that the product meets some arbitrary standards.

(2) In turn, this certification institution "imposes" a *RPM* or *exclusive territories* on the retailer cartel of the trademark holders.

In both cases, the creation of a phony upstream institution allows the retailers to make profits by reducing competition.

[17] L.E. Preston, "Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards", *Law and Contemporary Problems*, (30) 1965: 506-29, cited in M.L. Katz, 1989, *op. cit.*

[18] J.R. Gould and L.E. Preston, "Resale Price Maintenance and Retail Outlets", *Economica*, (32) 1965: 302-12.

[19] Jean Tirole, *The Theory of Industrial Organization*, Cambridge, MA.: 1988, pp. 184-5.

Stylized Scenario: Providing Dealer Insurance and Incentives

Consider an environment of business uncertainty. Retail markets are constantly buffeted by fluctuations in demand and costs. Consequently, retail profits become uncertain. The manufacturer has to come up with schemes, such as RPM or competition among retailers or exclusive territories (ET), that provide some insurance to retailers without distorting their incentives to engage in promotional efforts. Consider these three schemes in turn (competition, RPM and ET) under cost and demand uncertainty.[20]

(1) Under the manufacturer-induced *competition among dealers* scheme, each dealer faces the residual demand curve (i.e., the market demand shared with other dealers). Under the scheme of competition among retailers, the dealers are fully insured against both cost and demand fluctuations. Why? Any demand or cost change that hits one dealer, indirectly affects his rivals in a similar way. In this view, all the retailers respond in tandem (such as raising the price when the cost rises). Retailers are insured against demand and cost fluctuations. Moreover, competition has desirable properties, as it can also be seen as a device that is compatible with dealers' incentives to engage in promotional efforts.

(2) Under *RPM,* in the form of a fixed price, the price does not adjust to either changes in costs or demand. RPM and dealer competition schemes are equally profitable for the manufacturer when dealers face demand uncertainty. However, in the face of cost shocks, RPM does poorly because it introduces price rigidity. In this regard, RPM fares worse than dealer competition and *exclusive territory* schemes.

(3) Let us compare RPM and ET. From the point of view of the manufacturer, ET is superior to RPM under cost uncertainty because ET does not inhibit price adjustment to changes in cost. However, when retailers are risk averse and care about the level of retail profits, RPM is better than ET under demand uncertainty. As demand fluctuates, the manufacturer can adjust the wholesale price and the retailer can maintain the posted retail price and its profit. Thus, RPM preserves incentives for a retailer to engage in product promotion and service. In this situation, RPM can provide some income stability in the face of market fluctuations.[21]

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[20] P. Rey and J. Tirole, "The Logic of Vertical Restraints", *American Economic Review*, (76) December 1986: 921-39.

[21] *Ibid.*

3.2 Vertical Restraints and Interbrand Competition[22]

Competition in international markets is often among multiple manufacturers. Each producer may source a number of suppliers. Here, in addition to the spillover effects across dealers, there may arise spillover effects and strategic behaviour across manufacturers themselves. Three cases can be distinguished. In the first case, the possibility of service spillovers across brands can be tackled by imposing some vertical restraints that enhance efficiency by encouraging the manufacturer to provide services. In the second case, the effects of vertical contracts on interbrand competition are brought out. In the third case, the effects of vertical restraints on the conditions of entry into the manufacturing stage become important.

Stylized Scenario: Opportunistic Retailer-Manufacturer Behaviour

First, there is the problem of free riding across brands by dealers. Consider the following example. Let each manufacturer produce one brand only. Suppose that the manufacturers rely solely on uniform pricing and that one manufacturer engages in heavy advertising that attracts consumers to the dealer. Once consumers have come into the store, the dealer has the incentives to persuade the consumers to purchase whichever brand offers the largest profit margin. That brand need not be the one that conducted the advertising and got the consumers into the store. Free riding across manufacturers may lead to levels of promotional activity below the level consistent with profit maximization. There are several vertical arrangements that can deal with the problem of free riding across manufacturers.

(1) The advertising manufacturer could lower his wholesale price and compensate for this price reduction by increasing a *franchise* fee. If each manufacturer sets his wholesale price equal to his marginal cost, then there would be no distortions in the dealer's incentives. However, a low wholesale price may lead to unprofitably low prices for retailers due to inter-dealer competition.

(2) Under a RPM imposed by all manufacturers, *a resale price floor* could eliminate this problem. But RPM would fail to mitigate the problems of wholesale price reductions by rival manufacturers that undercut the advertising manufacturer, or inefficient risk-bearing by the dealers.

[22] See footnote 9 above.

(3) Alternatively, the advertising manufacturer could demand *a royalty payment* based on the dealer's total revenues or unit sales across all brands. In many respects, this form of multiproduct pricing is like a cooperative advertising agreement.

(4) Another way a manufacturer can respond to the problem of within-store brand switching is by imposing *exclusive dealerships*. However, single-brand retailers might suffer diminished sales.

Second, opportunistic behaviour presents a particular problem when one side of the manufacturer-dealer relationship makes expenditures on assets that have value only in that relationship. Once the relationship-specific costs have been sunk by one party (the manufacturer), the other party (the retailer) may reopen bargaining over the term of the contract. The manufacturer is somewhat locked into the relationship. One way to increase the value of maintaining the relationship to both sides is to have the dealer offered as a hostage. In some instances, some vertical restraint provisions of the manufacturer-dealer contract can serve to create a hostage situation.

(1) One means of creating a hostage, for example, is to have a low wholesale price coupled with a large *franchise* fee. The right to the low wholesale price becomes a relationship-specific asset owned by the dealer.

(2) Dealer reputation may be another candidate for a relationship-specific asset. A multi-brand dealer may be able to develop a reputation as a good dealer per se. Consequently, an *exclusive dealing* arrangement may lead to the dealer's reputation becoming a relationship-specific asset.

(3) Another way to deal with opportunistic recontracting is to limit the threats that the dealer can make. A *requirement contract*, for instance, eliminates the buyer's ability to take his business to another manufacturer.

Stylized Scenario: Scope for Collusion Among Manufacturers

The manufacturers could among themselves agree on such price and non-price clauses in contracts with their distributors that reduce interbrand competition at the retail level. The manufacturers would collectively gain from successful collusion.

(1) Under *exclusive dealing* arrangements, consumers who want to comparison shop are forced to visit several stores. The higher costs of comparison shopping tend to discourage consumers from undertaking this search activity, limiting the extent of interbrand competition

and raising industry profits. Moreover, if all other manufacturers demand exclusive dealing, then an individual manufacturer has no real choice. Consequently, the entire industry will be characterized by exclusive dealing contracts.

(2) Some analysts also argue that *RPM restraints* weaken interbrand retail competition. Under RPM, each brand has a single final price, which is easy to monitor. Retailers that cheat on such collusive agreements can be disciplined. Contract provisions that improve monitoring may thus facilitate collusion.

Stylized Scenario: Strategically Foiling Rivals

(1) A standard argument in the vertical restraints literature points to the role of foreclosure through *exclusive dealing* arrangements as a means of raising a rival's costs. Suppose that there are economies of scale and scope in distribution. In this case, a system of exclusive dealers raises the distribution costs of smaller firms by more than it raises the distribution costs borne by larger firms. Consequently, smaller firms are put at a disadvantage by this industry configuration. The net effect may be to raise the profits of larger firms, even though their costs of distribution are raised as well.

Moreover, by demanding an exclusive dealing arrangement, a manufacturer with a large market share may be able to tie up the good dealers (e.g., retailers with locational advantages or who enjoy the greatest economies of scope).[23]

(2) A manufacturer can take advantage of the knowledge of the sales contracts or franchise agreements among dealers selling other manufacturers' brands. The manufacturer can make his dealer a more aggressive competitor in the retail market by setting his wholesale price below marginal cost, when other manufacturers set their wholesale price at or above marginal cost. Faced with a more aggressive rival, the other dealers lose sales, which raises the profits of the first dealer. That dealer's manufacturer then appropriates the profits through a fixed *franchise fee*.[24]

[23] In a model where two manufacturers of substitute goods compete for a single potential dealer, if the demand for one of the goods is larger than the other, then the manufacturer of that product may demand an exclusive arrangement with the retailer. See G. Frank Mathewson and Ralph A. Winter, "The Competitive Effects of Vertical Agreements: Comment", *American Economic Review*, (77) 1987: 1057-68.

[24] C. Fershtman and K.L. Judd, "Equilibrium Incentives in Oligopoly", *American Economic Review*, (77) 1987: 927-40; and Thomas W. Ross, "When Sales Maximization is Profit-Maximizing: A Two-Stage Game", working paper CIROU 87-01, Carleton University, 1987.

Stylized Scenario: Strategic Behaviour Among Manufacturers

It has been argued that some vertical restraints are used by manufacturers to restrict upstream competition.

- *Entry Deterrence:*

One of the better known arguments is that *exclusivity contracts* (such as exclusive dealing, long-term contracts with retailers) form a barrier to entry. Such contracts force new manufacturers to set up their own distribution networks (which is costly, whether or not the new distributors can quickly offset their disadvantages in terms of goodwill and experience). Thus, new manufacturers are less inclined to enter.

(1) The incumbents possess first-mover advantages. Consider a single incumbent facing a single potential entrant in which a dealer must have some units of two intermediate goods to sell the final product.

- If the incumbent ties the sales of the two goods, then the potential entrant will be forced to enter both markets.

If there are substantial fixed costs of entering the two markets simultaneously, then the risk involved in entry is increased. Or, is it decreased?

- Bork argued that the need to raise capital for entry into two markets simultaneously would not make entry more difficult since the potential reward from entry would be commensurately increased.[25]

- Williamson countered that, when the profitability of entry depends upon specialized knowledge or skills that are not readily observable, a potential entrant's lack of experience in a given market may increase the firm's cost of raising capital. The threat of entry would thus be reduced if, in order to come into the target market, the entrant also had to come into a market with which it was unfamiliar.[26]

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[25] R.H. Bork, "Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception", *University of Chicago Law Review,* (22) 1954: 157-201.

[26] Oliver E. Williamson, "Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transactions Cost Approach", *University of Pennsylvania Law Review,* (127) 1979: 953-93.

(2) Similar effects may arise when the "tying" occurs over time. Suppose that a firm has a monopoly or near monopoly today, but it fears entry in the future. The firm may have incentives to reach long-term *requirement contracts* with retailers in order to foreclose the market to potential entrants. When contract expiration dates are spaced out or staggered over time and there are large fixed costs of entry, requirement contracts may block entry forever. In the presence of the staggered vertical contracts, the entrant is able to compete for only a small portion of the total business at any one time. Given the large fixed costs of entry, it may not be profitable to go after demand in bits and pieces.

(3) There also may be a foreclosure motivation behind *exclusive dealing*. The incumbent manufacturer, we have argued above, may be able to take advantage of its position by tying all the top-notch retailers. By making small scale entry unprofitable, the incumbent:

- raises the financial risk (i.e., sunk costs) of entry;
- makes it more credible that the incumbent will not accommodate an entrant (the entrant has to get a large market share in order to survive, which should pose a greater threat to the incumbent); and
- makes it costlier to enter since growth typically takes time.

A key objection to this view raised by many analysts is this: Why would a dealer sign a contract that lowers the probability of entry and lessens competition among suppliers?[27] Consequently, foreclosure need not follow. A response to this objection goes like this. With many retailers, each one may think that its individual signing decision has no effect on the likelihood of entry. Each individual dealer ignores the collective effect, signs on and the entry is completely blocked.

(4) In addition to blocking entry into a market that it already monopolizes, an incumbent may use its market power in one input market to block entry into another one. There is a long tradition in the vertical restraints literature of asking whether a manufacturer would use a *tying contract* to "leverage" monopoly position in one input market into a second monopoly position in another input market.

The prevailing view, from the Chicago School of antitrust, is that a monopolist would not find it profitable to engage in leveraging. In this debate, the counter argument is that an

[27] R.H. Bork, *The Antitrust Paradox: A Policy at War With Itself*, New York: Basic Books, 1978; and R.A. Posner, *Antitrust Law: An Economic Perspective*, Chicago: University of Chicago Press, 1976.

incumbent could find it profitable to use bundling of two inputs as a "strategic foreclosure" of entry. The ability to bundle may give the incumbent a credible threat to use against a potential entrant.[28]

- *Strategic Restraining of Upstream Competition:*

The second argument related to upstream competition is one of market discipline. It has been argued that RPM can help competing manufacturers sustain collusion by reducing the efficacy of secret wholesale price cuts.[29] It is also possible that restraints that reduce downstream competition (such as exclusive territories) may soften upstream competition. Thus, the manufacturers may also adopt vertical restraints for strategic purposes directed at the upstream level.[30]

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In short, the survey of the economics literature in this section shows that more than one type of vertical restraint can be used in private manufacturer-dealer contracts to deal with a particular problem of vertical arrangements. Which vertical restraints may be used to deal with the problems faced by a manufacturer-retailer/supplier vertical structure will depend on the particular circumstances of the situation. Most vertical arrangements involve restraints that aim to maximize private profit. However, not all of them will increase economic efficiency. The conclusion one ultimately reaches regarding the overall acceptability of a given vertical restraint will depend on the facts of each specific case. This argues for a rule of reason approach rather than outright prohibition (the *per se* illegality approach) when judging vertical restraints under competition policy.

In both intrabrand and interbrand competition, the two-part tariff (such as a wholesale price plus a franchise fee) and RPM are frequently used price restraint instruments; while exclusive territories, exclusive dealing and requirement contracts would top the list of non-price vertical restraints.

Economic analysis points out that the producer should not be automatically viewed as the only party calling competition restraining shots with retailers and suppliers. In some

[28] M.L. Katz, *op. cit.*, 1989, p. 709.

[29] L. Telser, "Why Should Manufacturers Want Fair Trade?", *Journal of Law and Economics*, (3) 1960: 86-105.

[30] Jean Tirole, *op. cit.*, 1988, p.186.

situations, suppliers or retailers could increase their profit by colluding to impose vertical restraints with the producer.

The analysis of vertical arrangements among producers of multiple brands, their suppliers and retailers highlights that vertical restraints raise issues of market foreclosure. That is, in the presence of the dominant market position of parties, vertical restraints can lead to foreclosure. Often times, vertical restraints may raise anticompetitive concerns when combined with horizontal restraints. Consequently, the entire spectrum of business restraining practices needs investigation to gain a more comprehensive understanding of which business practices do and which arrangements do not inflict economic harm.

4. Major Vertical Restraints and Their Legal Treatment Under Selected National Regimes

In this section, we discuss five major classes of vertical practices. For each practice, we will present the debate on economic efficiency and describe the substantive law that is applied in Canada, the U.S. and Japan. Certain similarities and differences in the competition policy framework established by Canadian, U.S. and Japanese law, however, merit some introductory observations.

First, there is a distinction drawn in competition law between the legal test to be met in a case tried under the *per se* and rule of reason standards. While this terminology only applies in U.S. law, the conceptual equivalent is also to be found in the Canadian regime. Although competition law in Japan apparently maintains this distinction, closer examination reveals that the rule of reason approach is, in fact, the norm. In those jurisdictions in which the distinction is observed, once a court finds that a rule of *per se* liability applies, no further proof of anti-competitive effect is required. According to the rule of reason approach, however, the plaintiff/applicant must show that the impugned practice has had an adverse impact on competition. Such a legal finding of anti-competitive effect or a substantial lessening of competition rests upon an assessment of the market power of the accused/defendant. While "market power" is sometimes referred to as "the ability to raise prices above those that would prevail in a competitive market", this determination in turn rests upon an even more fundamental decision, the definition of the relevant geographic and product markets in question. The approach adopted by each jurisdiction to deal with these issues is the subject of closer examination later in this section.

Another element that affects competition law cases is whether legal enforcement is sought through criminal or civil litigation. Under Canadian law, it is the Competition Act itself that prescribes either criminal or civil process for each anti-competitive practice. In the

U.S., however, the antitrust legislation is generally silent on this issue, with the result that the Antitrust Division of the Department of Justice enjoys a certain discretion and may choose to proceed by way of criminal prosecution or civil litigation in response to a variety of technical and public policy factors. Enforcement by the Federal Trade Commission and private antitrust suits, of course, are all decided through administrative and civil litigation. In Japan, the Fair Trade Commission ("FTCJ") pursues primarily a civil-administrative process. Although criminal prosecution may be utilized for private monopolization and unreasonable restraints of trade (indeed the maximum fines have recently been raised from ¥5 million to ¥100 million), the agency appears to regard criminal indictment as a method of last resort. Moreover, this criminal-civil process distinction is not without impact on the eventual legal outcome, since the standard of proof to be met by the prosecution in criminal cases is substantially higher than that placed on the plaintiff/applicant in civil litigation. Although the assessment of legal treatment that follows will not place any particular emphasis on this issue, the effect of the criminal-civil process dichotomy should not be forgotten.

While the subject of comparative enforcement processes lies beyond the scope of this Paper, one significant feature of Japanese competition law that is not shared by the other regimes examined should be noted. Article 6 of the Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade ("AML") specifically provides for the regulation of international contracts. Both entrepreneurs and trade associations are prohibited from entering into an international contract "which contains such matters as constitute unreasonable restraint of trade or unfair business practices". Furthermore, entrepreneurs who have entered into an international agreement of a type prescribed by the FTCJ are required to file a notification with the Commission with a copy of the agreement within thirty days. Although the term "international contract" is not defined, the FTCJ prescribes the treatment of notifiable international contracts. On 30 March 1992, this prescription was amended, the effect of which is to substantially reduce the number of such contracts notified in fact.

It must be emphasized that the authors have no quarrel with a substantive policy that proscribes agreements, both domestic and international, that violate competition law. The aforementioned asymmetrical Japanese notification requirement, however, means that, as a matter of enforcement practice, certain international contracts will automatically be brought before the FTCJ for scrutiny and, if found problematic, for administrative resolution, whereas domestic contracts will not. The concerns raised by this enforcement policy are exacerbated in view of the position adopted by the FTCJ regarding the nexus between competition policy and the exercise of intellectual property rights. In 1989, the FTCJ issued its *Guidelines on the Regulation of Unfair Business Practices in Patent and Know-how Licensing Agreements*. These Guidelines indicate which otherwise anti-competitive practices incidental to the exercise of intellectual property rights would be regarded as not unlawful in principle, which may be held unlawful and which are likely to be held unlawful. For example, while some vertical restraints examined in this Paper fit within either the first or second categories, RPM explicitly falls within the third. Yet, because of the notification requirement of s. 6 of the AML, international contracts incorporating all such IP rights will be vetted to ensure that their implementation poses no anti-competitive threat to the domestic market, while their domestic counterparts escape such automatic examination. This observation remains true throughout the entire range of Japanese competition law enforcement.

This part of the Paper must also be prefaced with a caveat with regard to the discussion of U.S. law. Constitutional antitrust jurisdiction in the U.S. has been exercised at both the federal and state levels of government. Considerations related to the length of this Paper, however, preclude analysis of state antitrust law; only federal law will be considered. Therefore, it must be noted that one of the fundamental characteristics of each type of practice discussed under U.S. federal law is that it must affect interstate commerce. There are different tests that may be applied in order to determine whether the particular fact situation before the court is appropriately tried under federal or state law. While consideration of this issue is also beyond the scope of this Paper, the examination of U.S. law that follows is nonetheless implicitly set within this framework.

Finally, it should be noted that in all three countries there is a range of exemptions from the application of national competition law. The specific "shape" of these exemptions can take on a rich variety of forms, from a narrowly-stated defence for a particular violation to an outright sectoral carveout. This wide variety poses certain difficulties when trying to present the information in a somewhat cohesive, if not readily digestible, form. Nonetheless, the attempt has been made to set the material out in tabular format in Annex I.

4.1 Resale Price Maintenance (RPM)

In our discussion of the economics of vertical restraints, the provision of RPM frequently emerged as a candidate in private vertical arrangements. Are there enough offsetting harmful social effects of RPM? Why has RPM been treated as *per se* illegal in most countries? Three major private incentives for RPM stand out: a manufacturer cartel that sells very similar products; a cartel among retailers which carry similar products; and a single manufacturer which uses RPM to corner the market for its product on the basis of quality and service.

First, the usual explanation of the *per se* illegality of RPM is that it is assumed to facilitate horizontal price fixing and, thus, can be used as a cartel-facilitating instrument. Cartels often break down as members chisel on cartel price. RPM can be used to provide the cartel some stability by allowing price-fixing at the retail level. The test of a manufacturer cartel, facilitated by RPM, is whether the prices for all products in the relevant market are maintained at the same level. If this is the case, the prohibition of RPM, or any facilitating device, will enhance efficiency. In practice, such cases are not difficult to identify. However, they are the exception rather than the rule.[31]

Second, a contentious issue is the possibility of a retailer cartel coercing a manufacturer to aid the stability of their cartel through RPM. Under this arrangement, retailers use manufacturers to co-ordinate the cartel prices at the retail level. The retailer cartel is enforced by boycotting any manufacturers which refuse to impose RPM. The effect, if the cartelization is successful, is to delay or block entry by discount stores. However, the retailer cartel hypothesis for RPM is less relevant today than historically, since discount stores are well-established in most relevant retail markets.[32]

Thus, the two cartel explanations of RPM do not appear to provide sufficient justification for the current status of RPM as *per se* illegal in most countries. The majority of cases of RPM do not fit the cartel explanations.

Third, most RPM situations appear to involve one manufacturer or a group of manufacturers acting unilaterally. However, RPM adds nothing that could not be achieved by the manufacturer when it sets the wholesale price for the product. Why would a manufacturer set a higher price and take a hit in sales at the retail level? There must be other factors than price that influence demand for the product and motivate manufacturers to resort to RPM.

There are three main explanations. First, RPM is welfare-enhancing as it encourages retailers, by eliminating the free rider problem, to provide "pre-sale service" for certain types of products. Second, RPM can increase the number of service-oriented retailers willing to carry the product and thus positively influence market demand. Third, for products where demand depends partly on whether some of the high reputation retailers carry the product, such service-intensive dealers could provide a degree of "quality certification" to the product.[33]

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[31] G. Frank Mathewson and Ralph A. Winter, *Competition Policy and Vertical Exchange*, Vol. 7 of the Royal Commission on the Economic Union and Development Prospects for Canada, Toronto: University of Toronto Press, 1985, p. 102. For a discussion of cartel instability, also see William Ehrlich and I. Prakash Sharma, "Competition Policy Convergence: The Case of Export Cartels", *Policy Staff Paper*, No. 94/3, DFAIT, Ottawa, April 1994.

[32] Frank Mathewson and Ralph Winter, "The Law and Economics of Vertical Restraints", in Frank Mathewson, Michael Trebilcock and Michael Walker, eds., *The Law and Economics of Competition Policy*, Vancouver, B.C.: The Fraser Institute, 1990, p. 110.

[33] See H. Marvel and S. McCafferty, "Resale Price Maintenance and Quality Certification", *Rand Journal of Economics*, Vol. 15, No. 3, Fall 1984: 340-59.

Price maintenance is required in order to cover previous (sunk) costs incurred by the retailer in building up its reputation.

The very existence of a retail distribution system for a product implies that retailers provide some value-added through retail services, otherwise the product could be sold by mail order. The problem is that some services offered by retailers are subject to free-riding unless RPM is introduced. Where services include providing information to the consumer about the product being sold, some retailers may choose to discount on prices and attract consumers who have been informed at other outlets. It is much easier to enforce a contract against cutting price than enforcing service standards. In other words, contracting on price is an indirect means of ensuring service.

Some authors such as Scherer[34] and Comanor[35] have criticized this efficiency defence of vertical restraints, while others have argued that the use of RPM as a means of competing through enhanced service is much more general than free-riding.[36] For the manufacturer, monitoring of RPM is less costly than monitoring retail sales effort, shelf space, competent retailer advice and so on. If the indirect effect of increased product availability and service more than offsets the negative direct impact of a price increase, a manufacturer will profit from establishing a price floor in the form of RPM.

Finally, there is the overall question: why should a transfer of monopoly power of setting RPM to suppliers be desirable on economic welfare grounds? Alternatively, why is it not preferable, from the consumer's point of view, to encourage more competition at the retail level by prohibiting RPM and all other types of vertical restraints?

In general, economic analysis indicates that the consumers are unaffected by the presence or absence of vertical restraints.[37] Rey and Tirole have attempted to cast doubt on

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[34] F.M. Scherer, "The Economics of Vertical Restraints", *Antitrust Law Journal*, vol. 52 (3), 1983.

[35] William S. Comanor, "Vertical Price Fixing and Market Restrictions and the New Antitrust Policy", *Harvard Law Review*, vol. 98, March 1985: 990-8.

[36] A sufficient condition for the incentive to impose RPM is that consumers who are more careful shoppers (sensitive to price differences across retailers) must be less influenced on average by product promotion services. See G. Frank Mathewson and Ralph A. Winter, "An Economic Theory of Vertical Restraints", *Rand Journal of Economics*, (15) 1984: 27-38.

[37] In models of certainty about market conditions and ignoring better quality or information effects of RPM, the absence or presence of vertical restraints affects only the distribution of profits between the manufacturer and the retailer. Also, in a number of models overall economic surplus increases when vertical restraints are present.

this result in a framework which ignores the effect of RPM on the provision of better product quality and information by the retailer, and the effect on the number of retailers.[38] On balance, however, RPM is more appropriately viewed as a means of reducing information-related externality that occurs where product differentiation, style and/or complexity create a demand for consumer service and information. Such conclusions are not affected by the Rey and Tirole arguments. A case that RPM practices are *per se* objectionable cannot be sustained.

In many countries, RPM is *per se* illegal with few exceptions or exempted products. However, many economists now advocate adopting a less stringent approach in competition law towards RPM and other vertical restraints. Even ardent proponents of the Harvard school, such as Scherer and Ross, would find it hard to leave intact the existing presumption of *per se* illegality of RPM:

> On the one hand, some resale price maintenance arrangements facilitate new entry or the provision of desirable services, and except when RPM spreads to cover the bulk of an industry's output, depriving consumers of a meaningful choice between high-service and low-price outlets, most are probably innocuous. On the other hand, Chicagoans' claims that strictly vertical RPM cannot impair economic efficiency are plainly wrong, and their estimates of the benefits from RPM are correspondingly exaggerated. The overall balance between benefits and costs is probably close.[39]

Under the law of the United States and Canada, however, RPM is *per se* illegal, while in Japan it appears to be subject to an assessment of market power.

4.1.1 RPM in Canada

In 1951 Canada became the first country in the world to statutorily proscribe RPM, although other jurisdictions, particularly the US, had applicable common law prohibitions. The 1951 legislation prohibited manufacturers or suppliers of articles and commodities from requiring or inducing, or attempting to do so, any other person to resell at or above a specific price or discount, or refusing to supply another person because of that person's refusal to observe the specified resale or discount price. It was the substantial changes which were

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See Jean Tirole, *op. cit.*, 1988.

[38] The authors conclude that, in an environment of uncertainty about market conditions, consumers would be better off under competition than under RPM or exclusive territories. Rey and Jean Tirole, *op. cit.*, 1986.

[39] Fredrick M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3rd edition, Boston: Houghton Mifflin, 1990, p. 558.

enacted in 1976, however, that established the current legislative standard. RPM is proscribed under s. 61 of the *Competition Act* which reads as follows:

> 61. (1) No person who is engaged in the business of producing or supplying a product, or who extends credit by way of credit cards or is otherwise engaged in a business that relates to credit cards, or who has the exclusive rights and privileges conferred by a patent, trademark, copyright or registered industrial design shall, directly or indirectly,
>
> (a) by agreement, threat, promise or any like means, attempt to influence upward, or to discourage the reduction of, the price at which any other person engaged in business in Canada supplies or offers to supply or advertises a product within Canada; or
>
> (b) refuse to supply a product to or otherwise discriminate against any other person engaged in business in Canada because of the low pricing policy of that other person.

A related provision is found in subsection (6) which states:

> No person shall, by threat, promise or any like means, attempt to induce a supplier, whether within or outside Canada, as a condition of his doing business with the supplier, to refuse to supply a product to a particular person or class of persons because of the low pricing policy of that person or class of persons.

The legislation is silent regarding the effect of the impugned practice on competition. Once the court is satisfied that all the required elements of the offence are present and that none of the available defences apply, a violation will be found regardless of whether or not there has been, or will likely be, a substantial lessening of competition. Therefore, RPM in Canada is accorded the equivalent of *per se* treatment under the *Competition Act*. Contravention of either subsection (1) or (6) is an indictable offence, which upon conviction may lead to a fine or to imprisonment for a maximum term of five years, or both, at the discretion of the court.

The proscription applies to any person engaged in the business of manufacturing or supplying a product, persons extending credit by way of credit cards and those holding intellectual property rights. It should also be noted that the term "product" is defined under the Act to include services as well as articles. Similarly, the definition of the word "article" encompasses both real and personal property "of every description", while "service" captures those of "any description whether industrial, trade, professional or otherwise". Subsection (2) stipulates that subsection (1) does not apply where the influencer and the influencee, so to speak, are affiliated corporations or directors, agents, officers or employees of the same or affiliated entities. Legal principal-agent relationships under which title in the goods remains with the principal, as would occur in *bona fide* consignment arrangements, for example, also lie beyond the purview of s. 61.

Because the Act only proscribes attempts to influence resale prices of those "engaged in business", a person may, with impunity, influence the resale prices of persons not so engaged. In *R. v. Camrost*, an unreported decision of the Ontario District Court dated May 10, 1985, the contract of purchase and sale of a condominium developer required consent of the developer to any resale; consent, however, was only given if the resale price were not less than price of comparable units for sale at the same time. While the accused was convicted with respect to its attempt to influence the resale price of one owner, a company in the real estate business, it was acquitted on charges relating to attempts to influence individuals who had purchased condominiums as a real estate venture. The Court found that because these latter purchases were only isolated activities and a sideline to the regular business of these individuals, these persons were thus not "engaged in business" within the meaning of the Act.

<u>It is attempts to influence price "upward" that are proscribed.</u> Unlike the broader definition of RPM captured under U.S. law which generally prohibits attempts at agreements to fix prices in whatever direction by any means other than through unimpeded market forces, in Canada attempts to influence prices downward would not violate this particular provision—although arguments between firms to fix prices downwards by a monopsonist cartel would be captured under the general conspiracy provisions, s. 45.

Only attempts made through "agreement, threats, promises or any like means" are prohibited; it is not illegal to use discussion, persuasion, complaints, suggestions, requests or advice. Whether the facts involved in any particular case lead to a characterization of the attempt as an"agreement, threat, promise or other like means" or simply discussion, persuasion, etc. is a finding of fact to be made by the trial court. In *R. v. Brown Shoe Co of Can. Ltd.*, an unreported decision of the Ontario Provincial Court dated July 9, 1982, the Court held that "the voicing by the salesman ... of a complaint of a competitor and the suggestion that he should charge the suggested retail price, when the salesman knew that it would not affect the pricing policy, is not a "like means" of an agreement, threat or promise". An example of a different conclusion may be found in *R. v. Moffats Limited (1957)*.[40] Involved in this case was a cooperative advertising plan designed to induce dealers to advertise at prices at or above those stipulated by the manufacturer. According to this plan, Moffats paid 50% of dealer advertising costs on the condition that prices in the ads were not below those fixed by Moffats. Beyond this inducement, the accused made no other attempt to influence prices nor was it unusual for dealers to make occasional sales at prices below those advertised. Nonetheless, the accused was convicted. In its denial of an appeal based on the argument that the Crown had failed to show the requisite intent to control resale prices, the Ontario Court of Appeal pointed out that intent was adequately indicated by the cooperative advertising agreement itself and that such agreements fell within the proscription.

[40] 25 C.R. 201 (Ont. C.A.), (1957).

This raises another aspect of Canadian law that is, at least at first glance, not shared by the U.S. regime. Under U.S. law, a manufacturer can act unilaterally to affect prices; it is joint action or "agreement" that is the target of antitrust liability. In Canada, it is not an "agreement", or lack thereof, that is the threshold determination but an attempt, even a unilateral one, to influence prices upward. This unilateral action-joint action dichotomy, however, is more apparent than real. It can be argued that antitrust liability will be found in both the U.S. and Canada in those circumstances in which a manufacturer, acting alone, uses threats or some form of coercive pressure to ensure a particular level of resale price. U.S. courts would establish a basis for liability by finding an "agreement", albeit a coerced one, whereas Canadian courts would find a unilateral attempt to influence prices made through an "agreement, threat, promise or any other like means". Even though the legal approach to liability might be somewhat different, the conclusion would effectively be the same.

Subsection (3) raises a rebuttable presumption that a suggestion by a producer or supplier of a resale price or minimum resale price, in the absence of evidence that the person also made it clear that there was no obligation to accept the suggestion, is proof of an attempt to influence. Similarly, subsection (4) stipulates that an advertisement by a supplier of a product, other than a retailer, that mentions a resale price for that product is to be deemed an attempt to influence price unless it is also made clear that it may be sold at a lower price. These subsections were passed in 1976 in order to overcome the tendency of resellers to assume that they are required to sell at suggested retail prices, thereby making it more difficult for a suggested retail price to become a minimum resale price. It might be noted that, on a narrow interpretation of these two subsections, while a suggestion or advertisement is deemed to be an "attempt", it is not also deemed to be an "agreement, threat, promise, or any like means".

This interpretation of subsection (4) was put to the test in *R. v. Phillips Electronics*.[41] The accused placed advertisements for TV converters which specified a resale price but without the disclaimer that they could also be sold at a lesser price. The Crown argued that, although there was no evidence of an agreement, threat or promise, the advertisement itself constituted "like means" within the meaning of s. 61(1)(a). The Ontario Court of Appeal rejected the argument that simple failure to indicate any other price in the advertisement was to be considered "like means". The majority opinion indicated (at 134) that:

> ... the impugned advertisements standing by themselves are in no way similar to an agreement, threat or promise and accordingly are not included within the purview of the words "any like means."

[41] 30 O.R. (2d) (139), (1981).

The Court commented that the effect of subsection 61(4) is limited to removing the necessity of the Crown proving intent or *mens rea* on the part of the accused insofar as conduct falling within the provisions of the subsection. On the other hand, some commentators have argued that the effect of this decision has been to render the subsection ineffective.

An accused charged with "refusal to supply" a product pursuant to paragraph 61(1)(b) may raise a successful defence if it can be shown that the accused believed, on reasonable grounds, that the person who was refused supplies made a practice of using the products in question as loss-leaders or as a means to attract customers for the purpose of selling other products, engaged in misleading advertising with respect to the product, or failed to provide a reasonable level of servicing. In order to establish the basis for these defences, the accused need not prove that the person refused had observed these practices in fact, but must demonstrate, on a balance of probabilities, that the accused itself had reasonable cause to believe that the customer had acted in such a manner. The reason for refusing to supply a particular person is a question of fact to be decided by the trial court.

Such subsection 61(10) defences are limited, however, and are not available for attempts to influence price upwards under s. 61(1)(a) or for other types of discrimination prohibited under 61(1)(b). The asymmetric application of these defences could lead to a problematic result since a supplier may, without communicating any concerns to its purchaser or dealer, terminate that customer where the supplier has a reasonable belief that the customer is engaged in loss-leadering. On the other hand, the same supplier could be held liable under s. 61 if the supplier first communicates its concerns and "threatens" to cut off a customer if the latter does not cease the practice.

One of the first tests of the loss-leader defence is to be found in *R.. v. Sunbeam.*[42] The accused established a "minimum profitable resale price plan" ("MPRP") which was designed to maintain resale prices on electric shavers. The MPRP was based on alleged "cost" estimates made by Sunbeam of the "average operating costs" of retailers to whom it sold. It then set resale prices that would cover these costs plus a "reasonable profit". This information was sent to retailers along with a statement that lower prices would be considered "loss-leadering" and could lead to a refusal of supplies. Sales personnel then visited dealers in order to persuade them to adhere to prices set by the MPRP. There was no evidence that any loss-leadering had in fact occurred and Sunbeam argued that it was attempting to prevent the practice. The Court concluded, however, that the defence could not be used as a

[42] 1 O.R. 661 (Ont. C.A.) (1967).

preventative, but could only be triggered after the product had been loss-leadered at which point the supplier could refuse to deal.

The service defence found in paragraph 61(10)(d) has rarely succeeded. In *R. v. H.D. Lee of Canada,*[43] the Court disallowed the defence of inadequate customer service in the sale of jeans. The decision turned on two factors. First, the Court considered an interpretation of the French language version of the Act which limits the application of the defence to post-sales service rather than pre-sales service. Second, there were no complaints by customers of the well-known discount store regarding inadequate service.

4.1.2 RPM in the U.S.

Antitrust jurisprudence in the U.S. forms a unique body of law, the development of which roughly mirrors that of micro-economic theory. With few exceptions, the statutory definition of what constitutes an anti-competitive practice can only be described as minimalist. For example, section 1 of the Sherman Act (SA), one of the fundamental antitrust proscriptions, reads as follows:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restaint of trade or commerce among the several States, or with foreign nations, is declared illegal....

Similarly restrained is s. 5 of the Federal Trade Commission Act (FTCA) which reads:

> Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.

Although RPM (as well as virtually the entire range of other antitrust activities) is captured by both provisions, this rather skeletal legislative treatment has allowed the courts the flexibility to elaborate substantive antitrust standards in the context of specific cases. Not surprisingly, the case law reflects the fluctuations of an on-going, exceptionally vigorous debate, one aspect of which is the question of whether a particular practice merits *per se* or rule of reason treatment. In *Northern Pac.R. Co. v. United States,*[44] the U.S. Supreme Court articulated the antitrust standard for *per se* illegality as follows:

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[43] (57 C.P.R. 186), *(1980).*

[44] 356 U.S. 1, 78 S. Ct. 514 (1958).

> ... there are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.

Since 1970, the Court has in several cases demonstrated growing reluctance to use the *per se* rule. Moreover, the apparent dichotomy between the two approaches can be somewhat simplistic since, as the Court itself pointed out, "there is often no bright line separating *per se* from rule of reason analysis. *Per se* rules may require considerable inquiry into market conditions before the evidence justifies a presumption of anti-competitive conduct."[45] Notwithstanding this caution, however, some *per se* rules are firmly established. Although the rule of reason is increasingly the standard against which non-price vertical restraints are measured, the U.S. Supreme Court has consistently held that vertical price fixing agreements are *per se* illegal.

Yet this immediately raises the question as to why RPM has fallen into the *per se* category of antitrust offences. The case that is usually cited as support for this approach is *Dr. Miles Medical Co. v. John D. Park & Sons Co.,* (220 U.S. 373 (1911)) which involved agreements to maintain prices set by the manufacturer and printed on medicine packages. Proponents of this position argue that RPM precludes intrabrand price competition by constraining resale price discretion. This reduction or elimination of intrabrand price competition results in the stabilization of prices in the interbrand market, thus facilitating interdependent pricing (cartelization) by competing manufacturers. Moreover, if a manufacturer cartel already exists, then resale price fixing serves to police the participants and prevent "cheating". Finally, resale price maintenance may intensify cartelization at the retailer level if the manufacturer imposes uniform prices in response to dealer pressure, as was discussed in section 3.1 above.

Nonetheless, other commentators have argued that the true conclusion to be drawn from the decision in *Dr. Miles* has been obscured. Alan H. Silberman states that the issue in this case was in fact framed as one involving a manufacturer's unfettered liberty to control all downstream behaviour by fiat — a proposition which has only a few adherents, even among those who believe that interbrand competition is the exclusive concern of antitrust.[46] He argues:

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[45] *N.C.A.A. v. Board of Regents of University of Oklahoma* 468 U.S. 85, 104, n.26 (1984).

[46] Alan H. Silberman, "Antitrust and the Distribution Process: an Outline of Vertical Antitrust Issues", mimeo., Sonnenschein Nath & Rosenthal, Chicago, Illinois, 1994, p. 20.

> Except for Mr. Justice Holmes' dissent (which suggested that the manufacturer might indeed be the person in the distribution chain with the information and incentive to choose prices which would promote long run competition), ... the Court was concerned with maximizing the individual decisional freedom of participants in the distribution chain as a matter of liberty, rather than considered economic judgement. And, in *Dr. Miles*, Mr. Justice Hughes erroneously assumed that, without need for further inquiry, a series of vertical agreements are indistinguishable from horizontal agreements, a proposition which would be almost universally rejected today.
>
> The list of what is missing from the decsion is instructive:
>
> *Dr. Miles* did **not** state that all vertical agreements referring to price were designed to prevent competition.
>
> *Dr. Miles* did **not** state that conduct having an effect on price was tantamount to an agreement restricting pricing independence. It did not even concern itself with indirect price effects.
>
> And *Dr. Miles* did **not** hold that all debate about price activity was to be halted under the guise of a *per se* rule.
>
> Quite the opposite: In *Dr. Miles*, the Court recognized that one can look to other evidence (if there is other evidence) to see if there is something more than interference with pricing independence designed to prevent competiton, before classifying the agreement as one which falls within the per se rule....

Whatever the economic merits of the *per se* approach, where it applies antitrust liability will be found when all the elements of RPM have been established, notwithstanding any attempt at justification and regardless of the market position of the seller. It must be noted, however, that although vertical price fixing clearly contravenes the law, not every means of achieving resale price control will be considered unlawful resale price maintenance.

There are essentially four avenues available to exercise resale price control:

(a) unilateral conduct by a seller or manufacturer, including announcement of a suggested price policy and a simple refusal to deal, or acquiescence in the suggested pricing by the dealer;
(b) certain *bona fide* consignment and agency agreements;
(c) specific promotional pricing agreements which are not seen as RPM; and
(d) licensing agreements where the license involves an intellectual property right such as a patent, copyright, trademark or know-how.

Only the first two will be considered below. The fourth turns upon the relationship between antitrust and intellectual property law and thus lies beyond the scope of this Paper.

(a) Concerted and Unilateral Conduct

Section 1 of SA only applies to a "contract, combination or conspiracy". Therefore, attempts to control resale prices contravene antitrust law only where they are implemented through concerted action; the seller that obtains resale price stability through unilateral action does not violate s. 1. This statement of principle was established by the U.S. Supreme Court in *United States v. Colgate & Co.*.[47] In this case, the Court set aside a criminal indictment charging that a manufacturer, through blackmail and threats of refusal to deal, had engaged in resale price fixing on the grounds that the government had failed to charge the requisite *agreement* to fix resale prices. The *Colgate* doctrine states that a manufacturer is allowed unilaterally to announce maintained prices and refuse to deal with any price-cutters.

Although the *Colgate* opinion seemed to sanction resale price maintenance achieved by any method short of an express agreement, the Court later included implied agreements within the proscription. Subsequent cases expanded this to include not only express or implied agreements but also the exact type of non-consensual collaboration, or coerced conduct that was involved in *Colgate*. Because both voluntary and coerced agreements to fix resale prices fall within the s.1 (SA) proscription, the agreement itself need not be in writing to constitute concerted action under that provision; it may be inferred from the actions of the parties.

Yet given the ambiguity and facial similarity between desirable and undesirable activities, it is difficult indeed to determine the point at which legal unilateral action by a supplier in response to dealer complaints becomes illegal concerted action between the complaining dealer and the supplier. The cases reflect the nature of the conceptual challenge. In *Link v. Mercedes Benz* (618 F. Supp. 679 (1985), at 688), the Court instructed the jury that "when you start to use words like teach, advocate, persuade and cajole, it seems to me you come a little closer on the line to joint or concerted activity." Similarly, in *Russell Stover Candies Inc.*, (FTC Dkt. 9140 (1982)), a decision that was later reversed (718 F. 2d 256 (1983)), the FTC considered an announcement of a policy not to sell to non price-conforming dealers as constituting a threat sufficient to create an agreement.

On the other hand, in *Jack Walters & Sons Corp. v. Morton Building, Inc.* (737 F. 2d 698 (1984), Judge Posner dealt with promotional pricing and maximum price fixing by stating that "manufacturers are in a direct economic relationship with ultimate consumers", thereby sanctioning substantial manufacturer involvement in price formation. And in

[47] 250 U.S. 300, 39 S. Ct. 465 (1919).

Monsanto Co. v. Spray-Rite Service Corp., (465 U.S. 752, 104 S. Ct. 1464 (1984) the Supreme Court held that termination of a price-cutting distributor in response to complaints from competing distributors is not sufficient to establish that the termination resulted from a vertical price-fixing conspiracy. The Court demanded evidence that tended to exclude the possibility that the manufacturer and non-terminated distributors were acting independently; direct or circumstantial evidence of a conscious commitment to a common scheme designed to achieve an unlawful objective was required. This decision also emphasized the right of the dealer to acquiesce in a price recommendation, thereby removing such acquiescence from the list of evidence that suggests the existence of an illegal scheme.

Thus, the manufacturer that circulates suggested list prices to its dealers is safe from antitrust attack if each dealer independently decides to adhere to them. However, reliance on various enforcement techniques, such as obtaining assurances from retailers that the supplier's pricing policy will be adhered to or the use of coercion to secure adherence to that policy, may transform permitted unilateral action into an unlawful price maintenance agreement. The first is prohibited because it clearly results in an agreement to fix prices, while coercion is proscribed because involuntary acquiescence in a seller's pricing scheme will be construed as a form of tacit agreement. The courts have observed that persuasion does not rise to the level of coercive enforcement. Although they disagree as to where persuasion ends and coercion begins, the issue to be determined is whether the supplier's conduct interferes with the dealer's ability to exercise freely its independent pricing discretion or whether it is calculated to appeal to individual self-interest so that the dealer voluntarily complies.

(b) Consignment and Agency Agreements

Under a consignment and agency arrangement, a manufacturer supplies its products to a dealer without surrendering title and control. Such retention of title and control, and thus any associated economic risk, means that a supplier may legally fix the price at which the dealer sells the product. Yet factual characterization of the arrangement as a true consignment or agency agreement by the court is essential to antitrust immunity. Simply by labelling a contract as a 'consignment', for example, does not necessarily preclude liability, since the courts have distinguished between *bona fide* consignment agreements and what are in fact resale agreements. Moreover, where the agreement involves a large number of products, it may be seen as part of a distribution network and, therefore, no longer a consignment arrangement.

4.1.3 RPM in Japan

The primary legislation establishing competition law in Japan is the *Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade* (Act No. 54 of April 14, 1947) ("AML") as amended. Pursuant to its provisions, RPM is regarded as an unfair business practice. In addition, the FTCJ issued guidelines in 1991 ("*Antimonopoly Act Guidelines Concerning Distribution Systems and Business Practices*") in which it elaborated upon the treatment to be accorded RPM. In the discussion on "refusals to deal", the same Guidelines also characterize as an "unreasonable restraint of trade" those situations in which manufacturers and distributors concertedly attempt to exclude price cutting distributors by refusing or restricting supply — the classic basis of a vertical price-fixing agreement under U.S. law or an attempt, whether unilateral or concerted, to "influence prices upward" in Canadian law. Yet, while this ambivalence might support the applicability of the prohibition against unreasonable restraint of trade to RPM, certain legal interpretations attached to this category preclude its use. Both categories are outlined below.

(a) Unfair Business Practices

It is AML Art. 19 that prohibits entrepreneurs from engaging in unfair business practices, while s. 8 (1)(v) prohibits trade associations from causing entrepreneurs to employ such practices. "Unfair business practices" is defined in s. 2 (9) as:

> any act coming under any one of the following paragraphs, which tends to impede fair competition and which is designated by the Fair Trade Commission as such....

Two pre-conditions are necessary for a practice to be found within this definition. First, the activity must be one cited in the section. Of the six items that are mentioned, those relevant to the purposes of this Paper are primarily the following:

> -unjustly discriminating against other entrepreneurs (s. 2(9)(i));
> -unjustly ...coercing customers of a competition to deal with oneself (s. 2(9)(iii));
> -dealing with another party on such terms as will restrict unjustly the business activities of the said party (s. 2(9)(iv)), and
> -dealing with another party by unjust use of one's bargaining position (s. 2(9)(v)).

Second, the practice must also be captured by an FTCJ designation, since the section requires the FTCJ to designate conduct which "tends to impede" fair competition. RPM has been so designated by the FTCJ in s. 12 of FTCJ Notification No. 15 of 1982 which reads:

> Supplying a commodity to the opposite transacting party who purchases the said commodity from oneself while imposing, without proper justification, one of the restrictive terms specified below:

(a) Causing the said party to maintain the sales price of the commodity that one has determined, or otherwise restricting the said party's free decision on sales price of the commodity, or

(b) Having the said party cause an entrepreneur who purchases the commodity from the said party to maintain the sales price of the commodity that one has determined, or otherwise causing the said party to restrict the said entrepreneurs free decision on sales price of the commodity.

The 1991 *Guidelines* indicate the enforcement approach adopted by the FTCJ when assessing RPM. Although these *Guidelines* state that a manufacturer's suggested retail price or quotation itself does not constitute RPM, an attempt by the manufacturer to restrict the resale price of the distributors would indeed be regarded as illegal. Whether resale prices have been restricted depends upon whether "any artificial means" have been taken to secure the sales at the price indicated by the manufacturer. Thus captured would be written or oral agreements that required distributors to sell at the price indicated by the manufacturer, including those cases in which a manufacturer "only starts dealing with such distributors" that accept such resale condition or "requires that unsold goods not to be discounted" but returned to the manufacturer.

The imposition of, or threat to impose, economic disadvantage if sales are made below the indicated price, are also considered "artificial means" and thus proscribed. Examples include curtailment of shipments, reduction of quantities shipped, raising the shipment price, reduction in rebates or refusal to supply other products. The offer of additional economic rewards, such as rebates or lower shipment price if sales are made at the requested price, are similarly regarded as "artificial means". So, too, are intrusive administrative or monitoring methods like patrolling retail establishments and transmitting complaints to price-cutting distributors from nearby distributors.

As in Canadian and U.S. law, the specific means chosen by an enterprise to ensure maintenance of resale prices may violate other provisions of the AML and the FTCJ designations. For example, s. 1 of FTCJ Notification No. 15 of 1982 states that a collective refusal to deal by agreement among competing enterprises is unlawful in principle, a designation which captures both primary and secondary boycott. An illustration of the proscribed practice may be found in the *Market Stabilization Council* case.[48] In this case, a trade association of manufacturers of household television sets jointly determined that wholesalers and retailers would be required to observe certain resale price levels. This decision was supported by a mutual agreement to direct wholesalers to stop supplying any retailer who failed to observe these prices.

[48] FTCJ Decision, 17 Oct. 1957, *Shinketsushu*, 9 (1958), 11.

Similarly, when an entrepreneur enters into an agreement with another party and restricts transactions with a third party without good cause, it falls under FTCJ Notification No. 11 of 1953, s. 8 of which reads:

> Dealing with customers under conditions which, without good reason, restricts any transaction between the said customers and the suppliers of commodities, funds, or other kinds of economic benefit to them, or between the said customers and any person receiving such benefits from them, or between the said customers and their competitors.

Yet the inclusion of such phrases as "tends to impede fair competition"[49] and "without good reason"[50] suggests that the RPM sanction will not be applied in those cases in which competition will not be affected or where the practice is reasonable, etc..

These guidelines apply not only to the direct relationship between manufacturers and their direct customers, but also to indirect relationships with secondary wholesalers or retailers. As in Canadian and U.S. law, an exception is made for consignment sales "where the direct purchaser only functions as a commission agent and if in substance the sale is made between the manufacturer and its ultimate purchasers" and *de facto* direct transactions between a manufacturer and customers. On the other hand, no exceptions are allowed for RPM pursuant to the exercise of intellectual property rights.

Section 24.2 of the AML enables the FTCJ to designate as exemptions from RPM commodities intended for daily use by general consumers that are subject to "free competition". The exemptions are limited to individual RPM contracts; collective activities to maintain RPM are not exempted. Moreover, any firm entering into an RPM-exempt contract is required to file a report with the FTCJ within thirty days of the signing the contract unless the FTCJ has stipulated otherwise.[51] Art. 24.2 also exempts the application of RPM provisions to books and other matters subject to copyright.

Historically, the FTCJ began exempting products within a few years of adopting the AML. Designated items included products such as cosmetics, hair dye, toothpaste and soap (approved 1953); liquor, caramel and medicine (approved 1954); cameras (approved 1955); and shirts (approved in 1959). However, in 1966, liquor, caramel, cameras for domestic use and shirts were removed from the designation. Additional commodities were removed from

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[49] AML s. 2(9).

[50] FJCJ Notification, n.d., s. 8.

[51] Hiroshi Iyori and Akinori Uesugi, *op. cit.*, 1983, p. 113.

the designation in 1973. By 1983, only cosmetics for which the list price is less than 1,000 yen and medicines remained as the designated exempted commodities. Many of these remaining products were taken off the exemption list in April 1993 and some others were slated to be struck off on 31 December 1994. A list of the remaining products on the exemption list is found in section A3.2 of Annex I to this Paper.

(b) Unreasonable Restraint of Trade

Art. 3 of the AML states:

> No entrepreneur shall effect private monopolization or any unreasonable restraint of trade.

While "entrepreneurs" are captured by Art. 3, "trade associations" that fall outside the definition of "entrepreneur" are nonetheless subject to a parallel proscription in Art. 8 (1) (i) that stipulates:

> No trade association shall engage in any acts which come under any one of the following paragraphs:
>
> (i) Substantially restraining competition in any particular field of trade....

Art. 2 (6) defines "unreasonable restraint of trade" to mean:

> ...that any entrepreneur, by contract, agreement or any other concerted actions, irrespective of the names, with other entrepreneurs, mutually restrict or conduct their business activities in such a manner as to fix, maintain, or increase prices, or to limit production, technology, products, facilities, or customers, or suppliers, thereby restraining, contrary to the public interest, substantially competition in any particular field of trade.

According to this definition, the elements of the offence are:

(i) concerted activity among entrepreneurs by means of a contract, agreement or understanding, which
(ii) mutually restricts their business activities,
(iii) fixes prices, limits production and other terms of business, and
(iv) which causes, contrary to the public interest, a substantial restraint of trade in any particular field of trade.

Horizontal agreements are unquestionably captured by AML. Where vertical agreements are used to buttress an underlying horizontal agreement, the 1991 Guidelines make it clear that the totality constitutes a boycott and an unreasonable restraint of trade. The decision of the Tokyo High Court[52] in the *Newspaper Distribution* case, however, effectively precludes its application to vertical agreements. Part of the case turned on the definitional requirement of a "mutual restriction". Newspaper companies, acting upon an agreement among themselves, individually entered into distribution agreements with retailers by which each retailer was assigned to an exclusive territory. Although the FTCJ concluded that these distribution agreements constituted a violation of Art. 2(6), the decision was reversed on appeal. The Tokyo High Court interpreted the "mutual restriction" requirement to mean that the parties to an agreement must be subject to the same kind of restriction. In other words, "mutual" was interpreted effectively to mean "equal". In this case, because the newspaper companies were not subject to the same kind of restriction as distributors, these agreements lacked the mutuality in restriction necessary to constitute an unreasonable restraint of trade.

In view of this decision, it is doubtful indeed whether the terms involved in vertical agreements can in fact ever attain the level of mutuality required. Yet the 1991 *Guidelines* apparently indicate that vertical agreements, at least in certain circumstances, may be held to constitute an unreasonable restraint of trade. On the issue of "mutual restriction", the Guidelines state:

> ...The content of restrictions of business activities in this context does not need to be identical in all firms (for example, distributors and manufacturers), but is sufficient if the conduct restricts the business activities of each firm and is for the purpose of achieving a common purpose, such as the exclusion of any specific firm.

While this note in the *Guidelines* appears to offer a more flexible interpretation of the level of mutuality required to meet this branch of the definition, the *Guidelines* themselves constitute a statement of enforcement policy rather than a statement of law. Only when this interpretation is adopted by a court will it assume legal status. Until the law is amended, the current test for mutuality precludes the application of Art. 3 to RPM.

4.2 **Vertical Exclusive Territorial and Customer Restrictions** (ETCR)

Exclusive territorial and customer restrictions can take on a rich variety of forms. Under the closed territory distribution, the retailer has monopoly rights to all customers within a specified area. For example, the repair and servicing of consumer durables (such as products made by General Electric, Maytag, etc.) is franchised to independent service firms in a given geographic area. Sometimes the territory assignment is less strict in that retailers have zones of influence. For example, McDonald's franchisees may be given guarantees by

[52] *Kosai Minshu*, 6/9 (1953), 435, 9 Mar. (1953).

head office on the locations of actual or potential competing McDonald's outlets. However, neither the head office nor the franchisee can prevent customers from sampling other outlets.

One purpose of vertical ETCR assignments is, like that of RPM, to protect retail margins and encourage dealers to enhance services they provide. Another major role of territorial restrictions is to act as a protection for a retailer against a "hold-up" problem, as discussed in section 3.1 above, where a manufacturer may opportunistically exploit retailers' investments in assets such as market goodwill and reputation for quality service.

ETCR facilitate the separation of retail markets, which eliminates arbitrage across these markets and can facilitate three main types of price discrimination. First, the manufacturer can price discriminate by territory; for example, charge urban and rural regions different prices. Second, the manufacturer could price discriminate within a territory by sorting an expensive neighbourhood from a low priced neighbourhood and charging what the market in each neighbourhood will bear. Third, the manufacturer can price discriminate across consumer classes. For instance, fleet sales of trucks (presumably negotiated at lower prices) could be reserved for the national head office, while dealers are permitted to service other sales.

In theory, it is possible to argue that ETCR can contribute to a cartel's market power at the manufacturer or retailer level. Nonetheless, there is little evidence that it has been used in this way in practice. Where ETCR are used by a single manufacturer producing a product for which there are substitutes in the marketplace, such restrictions are unlikely to signal a cartel. Rather, they provide sufficient ex ante incentives for investment in product development and efficient dealer networks and display.[53]

The application of the rule of reason approach in ETCR cases should balance the negative effects of the restraint on intrabrand competition against the beneficial effects on interbrand competition. Consequently, some analysts view the courts' increasingly liberal treatment of restricted distribution as appropriate.[54]

4.2.1 ETCR in Canada

Exclusive territorial and customer restrictions are considered matters reviewable by the Competition Tribunal under Part VIII of the Competition Act. They are legislatively addressed in s. 77. Subsection 77(1) defines "market restriction" to mean

[53] G. Frank Mathewson and Ralph Winter, *op. cit.*, 1990, p. 127.

[54] *Ibid.*

> ...any practice whereby a supplier of a product, as a condition of supplying the product to a customer, requires that customer to supply any product only in a defined market, or exacts a penalty of any kind from the customer if he supplies any product outside a defined market.

Such market restrictions may only be challenged by the Director of Investigation and Research of the federal Bureau of Competition Policy by making an application to the Competition Tribunal. Subsection 77(3) enables the Competition Tribunal to remedy market restrictions as follows:

> Where, on application by the Director, the Tribunal finds that market restriction, because it is engaged in by a major supplier of a product or because it is widespread in relation to a product, is likely to substantially lessen competition in relation to the product, the Tribunal may make an order directed to all or any of the suppliers against whom an order is sought prohibiting them from continuing to engage in market restriction and containing any other requirement that, in its opinion, is necessary to restore or stimulate competition in relation to the product.

In the case of all non-price vertical agreements included in the ambit of s. 77, it is clear that the <u>equivalent of a rule of reason approach in fact applies.</u> Several legal factors support this conclusion. First, the Tribunal must find that the impugned practice has been engaged in either by a "major supplier" of a product or that it is "widespread in relation to a product". The Tribunal must also determine whether the practice is likely to substantially lessen competition. Finally, in accordance with subsection 77(4), where the Tribunal is of the opinion that the market restriction is or will be engaged in only for a reasonable period of time to facilitate entry of a new supplier of a product into a market or of a new product into a market, no order will be issued.

Thus, several defences are available to the respondent. As implied above, the first would turn on the argument that the practice is expected to utilized for a short period of time to facilitate entry of a new supplier. Another exception to the application of this section will also be made for market restrictions between or among companies, partnerships and sole proprietorships that are affiliated. The definition of "affiliated" is relatively expansive. Subsection 77(5)(d) includes not only the expected corporate relationships but captures those involving trademarks and trade-names as follows:

> (d) a company, partnership or sole proprietorship is affiliated with another company, partnership or sole proprietorship in respect of any agreement between them whereby one party grants to the other party the right to use a trade-mark or trade-name to identify the business of the grantee....

Two preconditions must be satisfied, however, before this particular exception can be triggered. It must be established that:

> (i) the business is related to the sale or distribution, pursuant to a marketing plan or system prescribed substantially by the grantor, of a multiplicity of products obtained from competing sources of supply and a multiplicity of suppliers, and
> (ii) no one product dominates the business.

Further elaboration of the paragraph 77(5)(d) definition of "affiliated" is to be found in subsection 77(6):

> For the purposes of subsection (4) in its application to market restriction, where there is an agreement whereby one person (the "first" person) supplies or causes to be supplied to another person (the "second" person) an ingredient or ingredients that the second person processes by the addition of labour and material into an article of food or drink that he then sells in association with a trade-mark that the first person owns or in respect of which the first person is a registered user, the first person and the second person are deemed, in respect of the agreement, to be affiliated.

The effective result of this subsection is to make territorial and customer restrictions not reviewable where the manufacture of an article of food and drink is involved and the buyer sells the product in connection with a trademark owned by the supplier.

Market restrictions have not been largely featured in the enforcement of Canadian competition law. Indeed, only one inquiry, the Telephone Answering Services Inquiry, was commenced by the Director of Investigation and Research; it did not proceed to litigation.

4.2.2 ETCR in the U.S.

Three judgements issued by the U.S. Supreme Court during the 1960s and 1970s indicated the changing perspective on the legality and appropriate treatment of vertical customer and territorial restraints. In the first of these cases, *White Motor Co. v. United States*,[55] the defendant manufacturer had imposed both territorial and customer restraints, attempting to justify those restraints as (1) necessary for a small manufacturer to compete in a market dominated by massive and entrenched competitors; and (2) enhancing interbrand competition, even if intrabrand competition was limited. The district court issued a summary judgement in favour of the government. The U.S. Supreme Court reversed, holding that vertical customer and territorial restraints were not *per se* unlawful. It subjected this conclusion to a significant caveat, however, when it stated that it had insufficient experience with such restrictions to conclude that they had no purpose or effect other than to stifle competition. The Court cautioned (at 263):

[55] 372 U.S. 253, 83 S. Ct. 696 (1963).

> ...We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a pernicious effect on competition and lack ... 'any redeeming virtue' ... and therefore should be classified as *per se* violations of the Sherman Act.

Indeed, only four years later, in *United States v. Arnold, Schwinn & Co.*[56], the Court held that territorial or customer restrictions on the resale of a product after title had passed to the buyer were *per se* violations of the Sherman Act. The issues before the court essentially revolved around two basic questions:

(i) whether Schwinn could lawfully prevent distributors and retailers from reselling products that they had purchased to anyone but franchised retailers; and
(ii) whether Schwinn could lawfully impose territorial and customer restraints when its distributors were acting as agents or consignees.

As to the first, the Court adopted a rule of *per se* illegality, holding that the lower court had erred in differentiating between territorial and customer restraints. It stated (at 379):

> As the District Court held, where a manufacturer *sells* products to his distributor subject to territorial restrictions upon resale, a *per se* violation of the Sherman Act results. . . . [T]he same principle applies to restrictions of outlets with which the distributors may deal and to restraints upon retailers to whom the goods are sold. Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it.

The Court, however, applied the rule of reason approach to uphold Schwinn's restrictions on the distributors' activities as agents and consignees. While it did not rule that market restrictions are always lawful in the context of an agency or consignment plan, it decided that, in the factual circumstances in this case, Schwinn had acted reasonably. Moreover, even with regard to the application of the *per se* rule where title in the product had passed, the Court envisaged possible exceptions from the *per se* rule for a failing company or a new market entrant.

The application of the rule in *Schwinn* by the lower courts was uneven. While some courts focussed on the rule that all territorial allocations or customer restrictions in the resale of an article were *per se* unlawful, others seized upon the apparent ambiguity of the language (at 379) that "... it was unreasonable *without more* for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded ..." (emphasis added)) to distinguish *Schwinn* and thereby to circumscribe its reach. For example, in *Schwinn*, the

[56] 388 U.S. 365, 87 S. Ct. 1856 (1967).

district court found that the defendant had been "firm and resolute" in enforcing its territorial and customer restrictions, as evidenced by the communicated danger of termination.[57] The U.S. Supreme Court concluded that such firm and resolute behaviour was *per se* illegal, even though the defendant did not cut off any distributors. Subsequently, several lower courts held that various market restrictions were not *per se* illegal in the absence of "firm and resolute" behaviour or actual termination of distributors, and proceeded to apply the rule of reason.

Another ground used to distinguish *Schwinn* was the nature of a product which required special marketing procedures. The essential issue here was whether the unique characteristics of the product posed safety problems for the consumer. The fact that an exclusive distributorship was involved in *Schwinn* was also relied upon since the U.S. Supreme Court endorsed the legality of exclusive distributorships, stating that a manufacturer may decide where and to whom it will sell its product. Territorial and customer restraints imposed within the context of such an arrangement were deemed lawful if reasonable. Thus, determination by a court that a particular business arrangement constituted an exclusive distributorship frequently had the effect of eliminating the foundation of the plaintiff's complaint.

Other special factual circumstances relied upon by the lower courts included unfinished trademarked products, certain legitimate business practices, relationships other than manufacturer and independent distributor, restraints immunized by state law and those incidental to the exercise of patent rights. In addition, as noted above, the *Schwinn* court itself suggested a possible exception to the *per se* rule for a company that was either failing or a struggling newcomer.

The *per se* rule in Schwinn which had barred territorial or customer restrictions on the resale of a product after title or dominion had passed to the buyer was eventually overruled by the Supreme Court decision in *Continental T.V., Inc. v. GTE Sylvania, Inc.*.[58] As part of a marketing strategy designed to increase its small share of the national market, Sylvania required each of its franchisees to sell its products only from the location at which it was

[57] 388 U.S. 365, 1967. In this case, territorial and price issues in the retailing of Schwinn bicycles were involved. In *Schwinn*, the Court had found that the Schwinn company had committed *per se* violations of the Sherman Act in selling bicycles only to franchised dealers who enjoyed territorial monopoly and agreed to perform pre-delivery that the manufacturer considered essential to the product and, therefore, to the maintenance of the brand name. Reacting to the decision, Schwinn called off the contracts with its twenty-two independent wholesale distributors and set up a vertically integrated wholesaling subsidiary.

[58] 433 U.S. 36, 97 S. Ct. 2549 (1977).

franchised.[59] The strategy proved successful in that the defendant's market share increased from 1 or 2 percent to about five percent within three years. The Ninth Circuit distinguished the challenged location restrictions from those involved in *Schwinn* and then held that Sylvania's location clause should be judged by the rule of reason.

Although the U.S. Supreme Court reasoned that the location clauses fell within the *per se* rule in *Schwinn*, it then explicitly overruled *Schwinn* and applied the rule of reason. It noted that:

(i) *Schwinn* was an abrupt departure from *White Motor*, decided only four years previously and in which the Court refused to apply a *per se* rule to vertical non-price restrictions;
(ii) *Schwinn* had been the subject of much scholarly criticism and lower courts had gone to great lengths to distinguish it; and
(iii) the commercial experience of ten years since *Schwinn* should be considered in passing on the legality of vertical non-price restrictions.

Not only did the Court hold that the *per se* rule in *Schwinn* could not be justified under the *Northern Pac* standard (excerpted above in section 4.1.2) for *per se* illegality, it also suggested that use of the non-sale transaction exception to the *Schwinn per se* rule might be beyond the means of smaller firms. The sale/non-sale distinction, it stated, appeared to be "inconsistent with the Court's articulated concern for the ability of smaller firms to compete effectively with larger firms". The Court also emphasized that, although vertical restrictions may reduce intrabrand competition by limiting the number of sellers of a particular product competing for business of a given group of buyers, they also promote interbrand competition by enabling the manufacturer to distribute its product more efficiently. It stated (at 54):

> Vertical restrictions promote inter-brand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products.... Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers.... For example, new manufacturers and manufactures entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. Established manufacturers can

[59] A dispute between Sylvania and one of its dealers led to the *GTE Sylvania* case. In 1962 Sylvania, to tackle its falling share of the TV market, had began to distribute its TVs through exclusive dealers, each of whom was assigned specific locations. In 1965, over Continental's objections, Sylvania located a new dealer close to one of Continental TV's stores in San Francisco and refused Continental a Sylvania TV dealership in Sacramento. In the ensuing dispute, Sylvania cancelled Continental TV's franchises and Continental sued GTE Sylvania claiming the territorial restrictions violated Section 1 of the Sherman Act. At the time, GTE Sylvania had a 5% share of TV sales country wide, up from about 2% in 1962 and a 15% share in Sacramento.

> use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products.... Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation....

It concluded that the rule of reason was the appropriate standard against which such restrictions should be measured. At the same time, the Court in *GTE Sylvania* reaffirmed the *per se* illegality of ETCR restrictions that are horizontal agreements:

> There may be occasional problems in differentiating vertical restrictions from restrictions originating in agreements among retailers. There is no doubt that restrictions in the latter category would be illegal *per se.*

Thus there is a continuing risk under this branch of U.S. antitrust law that the courts may characterize certain ETCR arrangements as dealer-level horizontal agreements and subject to *per se* treatment.

In the wake of *Sylvania*, vertically-imposed non-price restraints are no longer *per se* illegal. Although *Sylvania* concerned only a territorial vertical restriction, the Court clearly considered vertical customer restrictions to be subject to the same standard. In *Business Electronics Corp. v. Sharp Electronics Corp.,*[60] it reiterated that "a vertical restraint is not illegal *per se* unless it includes some agreement on price or price levels".

Even under the rule of reason standard, a violation of s. 1 (SA) only occurs where there is concerted action. Therefore, vertical market restraints violate s.1 only when they result from concerted action. The case law regarding this "agreement" issue, outlined in the context of RPM (section 4.1.2), applies here as well.

After *Sylvania*, a vertical non-price restraint imposed by concerted action is judged by the rule of reason. The critical issue is whether the challenged restraint ultimately promotes or suppresses competition in the relevant market. As the U.S. Supreme Court pointed out (in *Chicago Board of Trade v. United States*):[61]

> The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.

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[60] 485 U.S. 717, 108 S. Ct. 1515 (1988).

[61] 246 U.S. 231, 38 S. Ct. 242 (1918).

While the business context, the history of the restraint and the reasons for its use may all be considered, the court must first define the product market and assess the market power of the manufacturer that imposes the restraint in order to evaluate the competitive effects. Although market share is not dispositive of the reasonableness of the restraint, to the extent market share approaches dominance, the possibility of anti-competitive effects in the interbrand market is increased. On the other hand, when the manufacturer has little market power, a court may find that the restraint has insufficient impact on interbrand competition to be unreasonable.

In assessing the reasonableness of the restraint, courts consider its purpose and effects. Although the courts frequently indicate that under rule of reason, the presence of an unlawful purpose in the absence of anti-competitive effect does not violate s.1 (SA), intent may nonetheless be relevant in determining whether the effect of a restraint is anti-competitive. *Sylvania* also required courts to balance intra- and inter-brand competitive effects.

The cases in which the courts have struck down territorial vertical restrictions under the rule of reason are rare. In two cases, the FTC found certain vertical restraints by soft drink companies unreasonable. Congress overrode these decisions, however, in enacting the Soft Drink Interbrand Competition Act[62] which authorizes use and enforcement of territorial restrictions in trademark licensing agreements for the manufacture, distribution and sale of trademarked soft drink products. Territorial restrictions may nonetheless be found unlawful if the products covered by the agreements are not in "substantial and effective competition with other products of the same general class in the relevant market or markets".

4.2.3 ETCR in Japan

ETCR is treated as a violation of s. 19 and s. 8(1)(v) (AML). Three major variants of vertical territorial arrangements are recognized in the 1991 *Guidelines*:

- (i) the area of primary responsibility,
- (ii) the restriction of the location of establishment, and
- (iii) strict territorial allocation.

Falling into the first category are those situations in which a manufacturer assigns to each dealer a geographical area as its "area of primary responsibility" rather than an exclusive territory. Under this arrangement, a dealer typically is not absolutely prohibited from engaging in business in other areas. The second category addresses those circumstances in

[62] 15 U.S.C. ss. 3501-3503 (1980).

which a manufacturer designates the location at which a dealer can set up his business establishment. In a strict territorial allocation, the final category, each dealer is given a territory and is prohibited from engaging in business in other areas or selling to customers located outside that territory. According to the 1991 *Guidelines*, only the third variant is of potential concern as a violation of s. 13 of Notification No. 15 of 1982 which reads:

> ... dealing with the opposite transacting party on conditions which unjustly restrict any transaction between the said party and his opposite transacting party or other business activities of the said party.

Two criteria must be met before such restrictions will be found to violate the AML. First, the restriction must be imposed by an "influential" manufacturer, and, second, it must have the effect of maintaining the price of the commodity supplied by the manufacturer. The determination of whether a manufacturer is "influential in a market" rests upon a definition of precisely which "market" is being considered. A "market" definition encompasses geographic and product market dimensions. An assessment of this market power of a manufacturer turns primarily upon its market share. According to the *Guidelines*, the threshold consideration is:

> ...whether it has no less than 10% or its position is within the top three in the market.... In case of a low-ranked or newly-entered manufacturer which has a market share of less than 10% and whose position is the fourth or later, the price level of the product usually would not be maintained by exclusive territory....

The purpose of this market share criterion is to establish an enforcement threshold; manufacturers that fall below this threshold are generally immune from challenge by the FTCJ. Even where a manufacturer meets the criterion, however, its practices are not then automatically held unlawful. The FTCJ will evaluate additional factors including (i) the situation that prevails in the market as a whole, such as the degree of concentration, the characteristics of the products involved, the degree of product differentiation, the condition of distribution networks and ease of entry; (ii) the position of the party in the market, including its market share, ranking and brand prestige; (iii) the number of other parties to the transactions and their position in the market; and (iv) the impact of the ETCR on these other parties.

In the *Fuji X-Ray* case,[63] the FTCJ found an unfair business practice where the manufacturer of X-ray film with a 70% market share imposed vertical territorial restrictions on each dealer, thereby eliminating inter-dealer competition. The same conclusion was

[63] FTC Decision, 11 May 1981, *Shinketsushu*, 28 (1982), 10.

reached in the *Morinaga* case where a manufacturer of powdered milk with a large market share restricted dealers to sell only to retailers designated by the manufacturer.[64]

Whether the "price level of the product covered by the restriction is likely to be maintained" is assessed on the basis of the level of *inter-brand* competition (the factors addressed include market concentration, characteristics of the product, degree of product differentiation, distribution channels, barriers to entry, etc.), as well as *intra-brand* competition (factors addressed include degree of price dispersion, numbers of distributors affected and their market position, impact of the restriction on their business activities, etc.). Territorial restrictions have been considered justifiable if they promote interbrand competition or if they assist new or weak retailers to become fully competitive. Finally, where the restrictions are an incident of the exercise of intellectual property rights, it will, in principle, not be found unlawful according to the FTCJ *Guidelines on the Regulation of Unfair Business Practices in Patent and Know-how Licensing Agreements*, issued in 1989.

4.3 **Exclusive Dealing** (ED)

An exclusive dealing contract reflects an agreement in which the customer (i.e., the distributor) is restrained in its choice of business activity by commitment to the party with which it has previously decided to deal. Exclusive dealing may result in a loss of returns to scale. For instance, the retailer's employment is increased and consumers' search costs are reduced when the retailer carries several products, rather than a single or more limited line under ED. However, exclusive dealing may also bring a gain in efficiency. The argument here is that a retailer may have to be granted an exclusive dealing (*a priori*, an upstream competition reducing restraint) to give him incentives to provide pre-sale information. Exclusive dealing is then seen as a way of giving the manufacturer a property right on his promotional expenses and a protection against free riders.[65]

Exclusive dealing restrictions have assumed two forms in competition policy history. First, a buyer or a downstream firm requires that all of the output of the seller be made available to the buyer. The second, and more litigious form, is where an upstream manufacturer requires a downstream retailer to take only the products of that manufacturer to the exclusion of all substitute products.

[64] FTC Decision, 28 Nov. 1977, *ibid.* 24 (1978), 106.

[65] H. Marvel, "Exclusive Dealing", *Journal of Law and Economics*, (25) 1982: 1-26.

The critical economic question is whether exclusive dealing constitutes an entry barrier and promotes an inefficient allocation of resources. Foreclosure of retail markets is the key factor in analyzing the impact of exclusive dealing.

Exclusive dealing may guarantee a sufficient quasi-rent stream to underwrite product development expenses. Even if products already exist, competition for the distribution networks, when ED contracts are short-lived, may result in lower wholesale prices as manufacturers curry the favour of retailers. If wholesale price reductions are sufficient, ED contracts may simultaneously be profitable yet yield increased consumer welfare if lower retail prices more than compensate for a reduction in product choices.

The analysis of ED turns on the interaction between manufacturer and retailer, and the structure of the retailer market. If the market is small and can only support one retailer (as happens in many small towns), then ED would limit the choices available to consumers. Are consumers worse off for this? Not necessarily. ED may result in a lower retail price, provided the manufacturer offers the retailer a low wholesale price (a bait to sign on as an exclusive dealer), which the retailer in turn passes on to consumers.

While economic analysis yields no simply applied rules even for a rule of reason approach, critical factors include sunk investments by manufacturers that yield appropriate quasi-rents by other firms, substitutable products, short-lived ED contracts and significant competition for dealer networks.[66] All these features favour the welfare enhancement role of ED.

The critical legal question is whether exclusive dealing prohibits the products of a competitor from reaching the market. Are there circumstances when exclusive dealing lessens competition substantially? The answer must remain empirical.

4.3.1 ED in Canada

Exclusive dealing is considered in subsection 77(1) of the Competition Act which defines exclusive dealing as:

[66] When interbrand rivalry in any one retail outlet for several brands is not strong, manufacturers may not adopt ED; and when all manufacturers do adopt ED, economic welfare can increase from lower retail prices and higher sales as investment by manufacturers in promoting retailers rises. See David Besanko and Martin K. Perry, "Equilibrium Incentives for Exclusive Dealing in a Differentiated Products Oligopoly", *RAND Journal of Economics*, vol. 24 (4), Winter 1993: 646-67.

> (a) any practice whereby a supplier of a product, as a condition of supplying the product to a customer, requires that customer to
>
> (i) deal only or primarily in products supplied by or designated by the supplier or the supplier's nominee, or
>
> (ii) refrain from dealing in a specified class or kind of product except as supplied by the supplier or the nominee, and
>
> (b) any practice whereby a supplier of a product induces a customer to meet a condition set out in subparagraph (a)(i) or (ii) by offering to supply the product to the customer on more favourable terms or conditions if the customer agrees to meet the condition set out in either of those subparagraphs....

The decision of the Competition Tribunal in *Director of Investigation and Research v. The NutraSweet Company*[67] established certain interpretive guidelines concerning the application of paragraphs 77(1)(a) and (b). The Director of Investigation and Research argued that the respondent, as a condition of supplying aspartame, required its Canadian customers to enter into exclusive contracts and that this requirement fell within the meaning of paragraph 77(1)(a) or, alternatively, that the various rebates in the same contracts constituted inducements for exclusive dealing in accordance with the definition in paragraph 77(1)(b). The Competition Tribunal, however, arrived at a different conclusion regarding the interpretation of paragraph 77(1)(a). It prefaced its judgement on this point by observing:

> ... in considering an allegation of exclusive dealing it is the circumstances in which the particular terms of supply were agreed upon that are critical. The ordinary meaning of the words used in paragraph 77(1)(a) is that the supplier must have refused to supply the product unless the buyer agrees to the terms described in subparagraph 77(1)(a)(i) or (ii).

The Tribunal took note of the fact that there was no evidence on the record that customers were either refused, or threatened with refusal of, aspartame supply if they did not enter into exclusive contracts with the respondent. Moreover, several customers had explicitly denied any coercion and admitted that the request for exclusivity originated with them. The Tribunal concluded that there was no exclusive dealing in the sense set out in paragraph 77(1)(a).

The Director's argument concerning the application of paragraph 77(1)(b) met with greater success. After noting that the respondent's contractual practice of providing rebates in the form of a logo display allowance and cooperative marketing funds encouraged customers to use only the respondent's brand of aspartame, the Tribunal observed that customers would have to pay substantially more for the respondent's product if they did not qualify themselves for these rebates. The Tribunal concluded that since customers clearly agreed to deal only or primarily in the products of the respondent and in return received various rebates whose

[67] (CT -89/2, 4 October 1990).

existence depended on exclusive use of the NutraSweet brand of aspartame, these financial incentives and exclusivity clause amounted to exclusive dealing within the meaning of paragraph 77(1)(b).

With regard to the definition of "practice", the *NutraSweet* decision adopted the standard articulated in *R v. William E. Coutts Co.*,[68] to the effect that a practice may exist where there is more than an isolated act or acts. The Tribunal then added that different individual anti-competitive acts taken together may also constitute a practice.

Once an activity is found to meet the definition set out in paragraphs 77(1)(a) or (b), the <u>legislative standard used to assess the practice of exclusive dealing is the equivalent of the rule of reason approach.</u> Subsection 77 (2) requires as follows:

> Where, on application by the Director, the Tribunal finds that exclusive dealing ... , because it is engaged in by a major supplier of a product in a market or because it is widespread in a market, is likely to
> (a) impede entry into or expansion of a firm in the market,
> (b) impede introduction of a product into or expansion of sales of a product in the market, or
> (c) have any other exclusionary effect in the market,
> with the result that competition is or is likely to be lessened substantially, the Tribunal may make an order directed to all or any of the suppliers against whom an order is sought prohibiting them from continuing to engage in that exclusive dealing ... and containing any other requirement that, in its opinion, is necessary to overcome the effects thereof in the market or to restore or stimulate competition in the market.

The threshold determination to be made, of course, is the definition of the relevant product and geographic "markets" that are potentially or in fact affected by these practices. The product market definition encompasses those products that are, or could be, effective substitutes for the one in issue. A wide variety of factors may be evaluated, including the physical characteristics of the products, safety factors and price elasticity of demand.

Critical to the definition of the geographic market is an assessment of whether an area is sufficiently isolated from price pressures emanating from other areas so that its unique characteristics can result in prices differing significantly for any period of time from those in other areas. For example, in its *NutraSweet* decision, the Competition Tribunal noted that the respondent's prices in Europe were 10% higher than Canadian prices in 1987 (the year in which its patents for the product expired in Canada), 6% higher in 1988 and 13% lower in 1989. The Tribunal also found that contracts negotiated by the respondent indicated country-specific prices, demonstrating the influence of the different market conditions existing in those

[68] (1 O.R. 549), (1968).

countries. Referring to the comparison of prices as the most important test in segregating the Canadian market from the rest of the world, the Tribunal concluded that Canada constituted a separate geographic market in this case.

An analogous test was applied to the facts in the *Director of Investigation and Research v. Laidlaw Waste Systems Ltd.*.[69] Here, however, the Tribunal found that communities located 45 kilometres apart constituted separate geographic markets because competitors of the respondent had not, on a regular and on-going basis, attempted to provide service to customers located that far from their base of operations. Moreover, the intervening area was sparsely populated and did not include any significant customers. The position of the respondent's expert witness, that a competitor based more than 50 kilometres away would restrain prices of a hypothetical monopolist, was rejected since it failed to take into account, *inter alia*, the possibility of selective price cutting by the respondent.

On the definition of "major supplier", the Restrictive Trade Practices Commission (RTPC) articulated a definition in its decision in *Director of Investigation and Research v. Bombardier Ltd. (1980)*. The RTPC stated:

> ... a major or important supplier is one whose actions are taken to have an appreciable or significant impact on the markets in which it sells.

The RTPC added that, where available, a firm's market share is a good indication of its importance since its ability to gain market share summarises its capabilities in a number of dimensions. Other characteristics of a supplier which might also be used in assessing its importance in an industry are its financial strength and its record as an innovator. The RTPC definition of "major supplier" was later adopted by the Competition Tribunal, the effective successor of the RTPC, in its *NutraSweet* decision. However, given the fact situation in *NutraSweet* in which the respondent had over 95% of the sales in Canada, the Tribunal found no need to look beyond this extremely large market share and share of production capacity in order to conclude that it was indeed a major supplier.

The remaining question to be resolved before a remedial order can be issued is whether the impugned practice has, or is likely to, result in a substantial lessening of competition. In *NutraSweet*, the Tribunal stated that paragraphs 77(2)(a)(b) and (c) provide clarification of the means by which the effect on competition would be achieved; thus, they are most meaningfully, and logically, considered as part of the overall question of whether exclusive dealing results in a substantial lessening of competition in a market. The factors to

[69] (40 C.P.R. (3d) 289), *(1992)*.

be considered in making such a determination are similar to those used in assessing market power. The essential issue is whether the anti-competitive acts engaged in preserve or add to the market power of the respondent.

The Bombardier and NutraSweet cases both illustrate the manner in which these tests will be applied. The Bombardier case was one of the first enforcement actions involving exclusive dealing. In order to carry snowmobiles made by Bombardier, dealers were required to sign exclusive dealing contracts. Eight dealers in rural Quebec, who had had their dealerships terminated because of violations of this condition, complained to the Director who referred the matter to the RTPC. Because the respondent had 60% of retail sales in Quebec and the Maritime provinces as well as 40% of the market in Ontario, it was clearly a major supplier of snowmobiles and snowmobile accessories. The Director argued that Bombardier's exclusive dealing arrangements with local distributors helped to maintain its dominant position in the market. In addition, foreign competitors of the respondent allegedly found entry into local markets difficult even though there were no tariffs on snowmobiles. Yet dealer contracts were terminated on an annual basis so that dealer turnover was substantial, barriers to entry into the retail market were low and competitors of Bombardier did in fact find dealers, as evidenced in part by an increase in their market share. The RTPC relied on these factors to conclude that the respondent's exclusive dealing arrangements had not substantially lessened competition nor was the long term viability of competition in the industry at issue.

The Tribunal came to a contrary conclusion in *NutraSweet.* The Tribunal found that the exclusivity provisions in the respondent's supply contracts, including both the clauses to deal only or primarily in NutraSweet brand aspartame and the financial inducements to do so, impeded "toehold entry", and inhibited the expansion of other firms, in the market. According to the Tribunal, it was clear that, since the exclusive use and supply clauses appeared in virtually all of the respondent's 1989 contracts and thus covered over 90% of the Canadian market, there would be little room for entry by a new supplier during the currency of those contracts.

Several defences are available to the respondent since, in accordance with subsection 77(4), the Tribunal shall not make an order where, in its opinion, the practice of exclusive dealing is or will be engaged in only for a reasonable period of time to facilitate entry of a new supplier of a product, or of a new product, into a market. In addition, where the practice is observed between or among companies that are affiliated, no order will be made. The definition of "affiliated" (except the "deemed" affiliation applicable to practices involving the manufacture of a trademarked article of food or drink, the application of which is limited to market restrictions) outlined above in section 4.2.1 of this Paper, obtains here as well.

4.3.2 ED in the U.S.

The primary concern of antitrust law is whether the effect of the exclusionary dealing is to restrict a buyer from purchasing goods from competitive sellers. The anti-competitive threat that stems from exclusive dealing contracts is that a seller may pre-empt its competitors from access to the marketplace and unduly restrict their capacity to compete. If the contract does not foreclose competition from a substantial portion of the market, the arrangement is not sanctionable under antitrust law. Therefore, exclusive dealing practices in the U.S. are normally tested by the rule of reason standard (but see the discussion below with regard to the quantitative test).

(a) Statutory provisions

Exclusive dealing arrangements can be challenged under s.1 (SA), s.3 of the Clayton Act (CLA) and s.5 of the Federal Trade Commission Act (FTCA). Section 5 (FTCA) supplements the operation of s.1 (SA) and s.3 (CLA) by arresting at an early stage practices that, if allowed to develop, would violate either of those two Acts. The U.S. Supreme Court has also held that trade practices which may not actually violate those acts, but which violate the spirit or basic policies of those Acts, may be condemned as unfair methods of competition under s.5 (FTCA).

Section 3 of the CLA reads as follows:

> It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented, for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.[70]

Section 3 (CLA) is designed specifically to prohibit restrictive methods of competition which prevent a buyer or a lessee from dealing in the goods of its seller's or lessor's competitors. There are several different elements that must be met by the plaintiff. First, s.3 only applies to a "lease", "sale" or "contract for sale". Thus, there must be an actual lease, sale or contract for sale if a transaction is to come within the statute. Loans or licensing

[70] (15 U.S.C. s. 14).

transactions involving patents, copyrights, trademarks or trade names, or sales of services all lie beyond its purview. On the other hand, s.1 (SA) applies to all of these transactions.

Second, s.3 (CLA) only applies to those transactions involving goods or commodities, i.e., tangible property. If the subject of the transaction is money, real property, newspaper, radio or television advertising, services or licenses, s.3 (CLA) will not apply. No such limitations apply to s.1 (SA).

The degree of competitive injury that must be established also differs under the two provisions. While s.1 (SA) only applies to actual restraints of trade, s.3 (CLA) applies to dealings that will probably lessen competition. Thus, under s.3 (CLA) a course of dealing can be halted before it becomes the actual restraint of trade required for s.1 (SA) liability.

The case law suggests that, under the rule of reason, an exclusive dealing contract probably would not meet the test required by s.1 (SA) unless it affected over 50% of the relevant market. However, under s.3 (CLA) exclusive dealings have been found to violate that law when just over 5% of the market was foreclosed to competition. The high degree of market foreclosure required under s.1 (SA) is probably the reason few such actions are brought under that section.

(b) Rule of reason standard

Rule of reason analysis requires, first, the definition of the relevant market in which competition will probably be affected and, second, the evaluation of the effect of the impugned practice within that market in order to determine whether there is or probably will be a substantial effect on commerce.

There are two components to the definition of the relevant market: the relevant product market and the relevant geographic market. All products that are actually competitive with the seller's product will be included in the product market. Essentially two factors are examined:

(i) the elasticity of product substitution, i.e., the reasonable interchangeability of use to which two or more products can be put, which is satisfied when products have either essentially the same physical characteristics or can be used for the same purpose; and

(ii) the cross-elasticity of demand, i.e., the extent to which consumer demand shifts freely between two or more products.

The area in which the seller effectively competes will be included in the relevant geographic market. This will be limited to an area in which:

(i) the buyer can effectively find other sources of supply; and

(ii) the transportation and transactions costs incurred by the seller will not force him to raise his price to a point at which he can no longer compete with other sellers.

Legal tests for substantial market foreclosure are resolved under one of two tests:

- the quantitative analysis test, or
- the qualitative analysis test.

Under the quantitative test, a seller foreclosing a substantial share of the relevant market to competition will be held liable. This approach appears to echo the application of a *per se* rule in that it does not appear to admit of any defences to justify the challenged practice. The alternative test, the qualitative substantiality test, requires an investigation of a broad range of economic factors and allows defendants to offer defences.

The U.S. Supreme Court decision in *Standard Oil Co. of California and Standard Stations, Inc. v. United States*[71] formulated the quantitative analysis test, providing that s.3 (CLA) is violated whenever "competition has been foreclosed in a substantial share of the line of commerce affected". There are two elements in this guideline. First, substantiality must be found within the context of a relevant market, measured as a percentage of foreclosure of that market. The cases following *Standard Stations* indicate that foreclosure of at least 5% of the relevant market may be considered substantial, given all the circumstances of the market in question. Substantiality may also be measured on the basis of the proportion of the dollar amount of sales, or the volume of goods foreclosed in the relevant market.

Nonetheless, the fundamental consideration here is the level of interbrand competition. Where there is effective interbrand competition or potential interbrand competition, market forces will operate to discipline the manufacturer who sells at an excessive price since it will suffer the loss of its exclusive distributors as soon as the arrangement comes up for renewal. A retailer will also lose the value of the ED arrangement if it sets its resale price above the output-maximizing price.

[71] 337 U.S. 293, 69 S. Ct. 1051, (1948).

Several business or economic factors are taken into account in the qualitative substantiality test. This test, which can be traced to the earliest s.3 (CLA) cases, was apparently rejected by the U.S. Supreme Court in its *Standard Stations* decision. In 1961, however, the Court appeared to reverse itself in *Tampa Electric Co. v. Nashville Coal Co.*,[72] when it held that the question of whether any given foreclosed market share was substantial could be answered only in relation to the various business factors that existed in the market itself. These factors, which must be considered jointly, are:

(i) the extent to which competition is foreclosed in the relevant market;
(ii) the dominance of a seller in his industry;
(iii) the relative strength of the parties;
(iv) the ease with which new outlets can be developed;
(v) the sales structure of the industry;
(vi) the extent to which competition has flourished despite the use of exclusive dealings or requirement contracts; and
(vii) the duration for which the arrangements are to run.

The critical difference between the two tests is that, under the quantitative test, the sole criterion is the percentage of outlets or sales volume foreclosed to competitors in the relevant market, whereas under the other test the percentage is only one of several factors considered.

While the courts have not yet articulated the circumstances in which either test is to be used, the presence or absence of dominant sellers who foreclose a substantial amount of commerce in the relevant market appears to be a critical factor. The case law suggests that where a dominant seller uses exclusionary conditions as a general practice and the percentage of the relevant market foreclosed to competition is substantial, the quantitative test will be used. If the seller does not dominate the market and either the percentage of market foreclosure is not substantial, or the seller or buyer requires the challenged practice for the operation of its business, the qualitative test will be applied. Thus, U.S. jurisprudence on ED still retains an element akin to a per se illegality approach, although the qualitative (rule of reason) alternative has gathered considerable strength over the last few decades.

[72] 365 U.S. 320, 81 S. Ct. 623 (1961).

4.3.3 ED in Japan

ED is considered an unfair business practice proscribed by s. 19 and designated as such by the FTCJ under s. 11 of Notification No. 15 of 1982 which reads:

> Unjustly dealing with the opposite transacting party on condition that the said party shall not deal with a competitor, thereby tending to reduce transaction opportunities for the said competitor.

In the 1954 *Hokkaido Newspaper Co.* case, the Tokyo High Court presented the following position regarding exclusive dealing:

> Generally speaking, dealing with another party on condition that the said party not receive any supply from one's competitor is not in itself illegal. Even if entrepreneur A adopts such a policy, entrepreneur B—A's competitor—is not prevented from entering into the market through price, quality, quantity, or service competition, so long as he can easily find distributors other than those who are dealing with entrepreneur A. In such cases, A's practice cannot be said to have a tendency to impede fair competition.

Since then, the FTCJ has appeared to place enforcement emphasis on attacking ED arrangements by market-dominating companies. In the *Muto Kogyo Co.* case of 1974, the respondent occupied nearly two-thirds of the drawing instrument industry, whereas in the *France Bed Co.* case of 1976, the respondent held 40% of the bed manufacturing industry. In the 1976 case of *Pigeon Co.*, 80% of nursing bottles, 35% of paper diapers and 10% of the baby powder market were held by the company. In each case, ED arrangements were held illegal by the FTCJ.

There are basically two citations in which ED is found an unfair business practice and a violation of the AML. The first is that in which a manufacturer requires dealers to cease trading in commodities which they were previously handling. The obverse situation, in which a dealer or trading company requires manufacturers to stop supplying its competitors, is also of concern. The rationale offered in support of the rule is the oppressiveness of a unilateral demand to fracture an existing trading relationship. Notwithstanding some comment critical of the narrowness of this approach and the recommendation that oppressiveness without more is insufficient, the rule has been incorporated in certain FTCJ decisions.

The second situation is that in which an enterprise that is "influential in a market" imposes the condition on other parties in a transaction that the latter cannot deal with its competitors. If it is an enterprise with market power that imposes such a condition, its competitors may be deprived of access to the market. As in Canadian and U.S. law, the core of the issue is market foreclosure. The 1991 *Guidelines* suggest that one of the criteria applied to assess the anti-competitive nature of vertical territorial and customer restrictions (see section 4.2.3) will also apply to an evaluation of ED, i.e., the imposition of the condition by an "influential" manufacturer. In addition, only where the restriction may result "in making it difficult for new entrants or competitors to easily secure alternative distribution channels" will the practice be found illegal. The relevant factors are considered on a case-by-case basis.

Even where intellectual property rights are involved, the same market foreclosure orientation is applied to evaluate the legality of the practice. In its 1989 *Guidelines on the Regulation of Unfair Business Practices in Patent and Know-how Licensing Agreements*, the FTCJ indicated that ED may be held unlawful where the licensor prohibits the licensee from handling, during the period of the agreement, competing products or adopting competing technology if the business opportunity from competing enterprises or the freedom of the licensee to choose products and technology is unduly restricted, thereby lessening competition. Of similar potential illegality is the requirement that the licensee sell only through the licensor or a designated third party if the licensee is unduly deprived of the freedom to choose sales outlets and competition is thereby reduced.

4.4 Tied Sale (TS)

The practice of tying is ubiquitous. The practice of tying sales comes in two different forms. First, under *bundling* the purchaser of one unit of a product must also buy one unit of another product. Second, the purchaser of one good must also buy all requirements for another good from the same supplier. For example, servicing a photocopier is tied to the brand name manufacturer or cinematic films must be purchased in bundles. One cannot easily buy an automobile without an engine or a coat without sleeves.

Tied sales become objectionable to the public interest in cases where there are potential or established separate markets for the tied goods. There are some good reasons why business firms may tie or bundle their products. Cost savings may be realized by producing or distributing the tied and tying goods together. The tourist industry frequently ties the sale of discounted air tickets to the purchase of hotel and restaurant services at the destination. Such practices are legal. No one argues that such tying practices be made illegal *per se*, even though they may reduce welfare in some cases.

However, tying can also be used to increase the profits derived from monopoly power. Tied sale is a contentious issue. The crucial questions in analyses of tied sales are market foreclosure issues. Does tying in any particular case represent:

(a) an extension of monopoly power from the tying-good market (where the action is initiated) to the tied-good market (the market affected by the action)—the foreclosure explanation,
(b) a means of metering demand response to price changes—the price discrimination explanation, or
(c) can the practice be explained as an efficient means of lowering costs?

The foreclosure argument runs as follows. The market in which monopoly power exists is the *tying* market. The monopolist extends its power to the *tied* market by requiring the purchase of its monopolized products in the second market, which the monopolist also dominates. This is a particularly effective policy when the two goods are complements. The monopolist forecloses the second market to rival producers. Consequently, it is sometimes argued that such a foreclosure will make entry into the tying market difficult, because any entrant into this market would simultaneously have to enter the tied-goods market as well.

One example of use of tying in facilitating an extension of monopoly power from one market to another existed in the Canadian telecommunications industry up until the mid 1970s. The sale of consumer telephone equipment was tied to the purchase of the basic telephone line service. Companies, such as Bell Canada, were conferred a monopoly by regulators (CRTC) in the telephone service market. The policy of tying effectively extended that legal monopoly to the telephone equipment market, which was eventually terminated by the CRTC. By the early 1980s, the telephone equipment market had become competitive.

One explanation of tying, associated with the Chicago School, is that the practice allows a producer with market power in the tying-good market to charge in the tied market different prices to different classes or types of customers. Consumers of the tying good (e.g., a central processing computer unit) differ in the value (i.e., differ in the reservation price) they place on software products, such as Word, WordPerfect, Corel Draw, or accessories such as the sound card, video card, CD-ROM and so on. If the reservation prices are correlated with the use of the tied product controlled by a monopolist (e.g., a CD-ROM in a computer system), then by charging a high price for the tied product (CD-ROM) to high intensity users of the computer unit, the monopolist extracts a higher "total" price for the package and obtains greater monopoly profits. Because price discrimination does not necessarily result in inefficiencies, the overall effect on total surplus (overall efficiency) is ambiguous.[73]

[73] The overall welfare effects of tying remain ambiguous, even though tying may be used for leveraging market power—a position often associated with Harvard School. See Michael D. Whinston, "Tying, Foreclosure and Exclusion", *American Economic Review*, September 1990: 837-59.

Consequently, in this view, the price discrimination role of tying does not necessarily provide a basis for antitrust intervention.[74]

4.4.1 TS in Canada

In Canada, the Competition Act defines tied selling in s. 77(1) as follows:

> (a) any practice whereby a supplier of a product, as a condition of supplying the product (the "tying" product) to a customer, requires that customer to
> (i) acquire any other product from the supplier or the supplier's nominee, or
> (ii) refrain from using or distributing, in conjunction with the tying product, another product that is not of a brand or manufacture designated by the supplier or the nominee, and
> (b) any practice whereby a supplier of a product induces a customer to meet a condition set out in subparagraph (a)(i) or (ii) by offering to supply the tying product to the customer on more favourable terms or conditions if the customer agrees to meet the condition set out in either of those subparagraphs.

The legal standard which is applied to determine whether the practice warrants intervention is the equivalent of the rule of reason and exactly the same as that used for exclusive dealing. Thus, a remedial order will issue only if the practice is engaged in by a major supplier or is widespread in a market; and is likely to impede entry into or expansion of a firm in the market or impede introduction of a product into or expansion of sales of a product or have any other exclusionary effect in the market with the result that competition is or is likely to be lessened substantially. Those observations made in section 4.3.1 concerning the various tests applicable to the terms "practice", "major supplier" and "substantial lessening of competition" apply in this context as well.

Among the defences available to the respondent are those set out in subsection 77 (4) which requires the Tribunal not to make an order:

> ... where, in its opinion,
> ...
> (b) tied selling that is engaged in is reasonable having regard to the technological relationship between or among the products to which it applies, or
> (c) tied selling that is engaged in by a person in the business of lending money is for the purpose of better securing loans made by that person and is reasonably necessary for that purpose....

In addition to these "technological relationship" and "loan security" defences, the corporate affiliation defence considered in section 4.3.1 is similarly available here.

[74] This argument, including the rebuttal by the Chicago School, was discussed above in section 3.2.

There are few tied selling cases on record. Although the Director of Investigation and Research in *NutraSweet* argued that the various anti-competitive practices observed by the respondent included tied selling, the Competition Tribunal refused to make any finding with respect to that position.

The RTPC decision in *Director of Investigation and Research v. BBM Bureau of Broadcast Measurement (1981)* provides an illustration of the circumstances in which the practice of tied selling may warrant remedy. BBM's pricing scheme effectively tied the purchase of its radio audience data to the purchase of its television audience data. The arrangement was facilitated by a pricing policy in which purchasers of either radio or television audience data paid a relatively high basic price while purchasers of both paid only a marginal amount more than the price for one type of data. For example, an advertiser with more than $25,000,000 of broadcast billings would have to pay $17,785 for either radio or television data. Where both types of data were purchased, however, the total charge was $18,460 (or only $675 more) to include the second type. Because it was the sole supplier of local and national radio audience data, BBM was in a strong competitive position in the supply of such information to advertisers and other purchasers. In addition, it held 85% of the Canadian market for television audience data. Neilson, its sole competitor, produced only data for television. Although this competitor sold television data at a lower cost than the respondent, consumers requiring both found a significant advantage in buying from the latter. The respondent was clearly a "major supplier" within the meaning of s. 77. The case, therefore, turned on the impact of the tying arrangement on competition. RTPC agreed with the Director's argument that the effect of the pricing schedule was to prevent expansion of the respondent's only competitor in the supply of television audience data, thereby substantially lessening competition. It issued an extensive prohibition order restraining BBM's pricing policies.

4.4.2 TS in the U.S.

As the U.S. Supreme Court has noted (*Jefferson Parish Hospital Dist. No. 2 v. Hyde*[75] (at 12)):

> ... the essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms.

Tying arrangements may violate s.1 (SA), s.5 (FTCA) and s.3 (CLA). The text of each has been set out in other parts of this paper. <u>Tied selling may be found either *per se*</u>

[75] 466 U.S. 2, 104 S. Ct. 1551 (1984).

unlawful or subject to the rule of reason. Actions brought under s.3 (CLA), however, will be judged by the latter only, since the plaintiff must show that the practice "may be to substantially lessen competition". The critical elements of each approach are considered below.

(a) Elements of per se illegality.

Since 1947, the Supreme Court has held that tying arrangements are *per se* illegal in certain limited circumstances. In 1984, the Court reaffirmed this approach in *Jefferson Parish*, although in that case it unanimously concluded that the particular tying arrangement at issue was lawful. The following are the elements of *per se* illegality:

(i) there are two separate products or services;
(ii) the sale of one of the products is conditioned on the purchase of the other product;
(iii) the seller has power in the market for the tying product; and
(iv) a "not insubstantial" amount of commerce in the market for the tied product is foreclosed.

In addition, some courts require proof of an anti-competitive effect in the tied-product market, and the existence of damages must be established. This requirement is controversial, however, and will be discussed separately below.

(i) Two separate products or services

In order to establish an illegal tying arrangement, two distinct products must be involved—the tying and the tied items. Although the existence of two distinct products would appear to be a straightforward determination, issues can arise that are difficult to resolve. The Supreme Court has had to address the point in several cases.

In *Jefferson Parish*, for example, the Court held that anesthesiological services were separate from other hospital services. While the Court considered a variety of circumstantial evidence in support of its conclusion, it focussed on the nature of the consumer demand rather than the functional relationship between the two services.[76]

[76] In *Jefferson Parish*, the U.S. Supreme Court found that a contract by Jefferson Parish Hospital to use exclusively a group of anesthesiologists did not constitute an unlawful tied sale to patients who, in receiving medical services in this hospital such as surgery, purchased a tied product—both the surgery and the anesthetic. The claim was that either product could be purchased by consumers in a competitive market and competing suppliers were free to sell either the entire package or its several parts.

In *Eastman Kodak Co. v. Image Technical Services, Inc.*,[77] the plaintiffs alleged that Kodak illegally tied the sale of parts and service. Kodak attempted to argue that "because there was no demand for parts separate from service, there cannot be separate markets for service and parts". This was rejected by the Court which observed that the evidence on the record indicated that service and parts had been sold separately in the past and were still sold separately to self-service equipment owners.

(ii) One sale conditioned on the other

Where the seller conditions the purchase of the tying product on the sale of the tied item, an illegal tying arrangement may be found. While a contractual provision requiring purchase of both products may satisfy this element, even if the seller does not coerce the buyer to buy the tied product, the clarity of this position was undermined by the U.S. Supreme Court in *Jefferson Parish* when it stated (at 27) "[t]ying arrangements need only be condemned if they restrain competition on the merits by forcing purchases that would not otherwise be made".

Absent a contractual tie-in of the two products, it is essential that the plaintiff demonstrate coercion, which requires more than strong persuasion. Thus, the seller cannot be liable if it offers each of the allegedly tied products for sale at reasonable prices, even if it also offers a discount on a package deal for two products. However, where the pricing of the individual products is so onerous that the buyer is coerced to accept both products in a discounted package, an illegal tying arrangement may be found.

The case law suggests that there is some question as to whether a potential buyer who refuses to purchase both products may recover damages for the allegedly illegal tying arrangements. If no buyer enters into the arrangement, the concerted action requirement of s.1 (SA) and s.3 (CLA) would be missing. While most courts hold that concerted action exists when a seller forces a buyer to accept a tying arrangement, the Tenth Circuit has held that there is no concerted action if the seller unilaterally imposes a tying arrangement on purchasers.

Although the courts appear to agree that s.3 (CLA) requires that the plaintiff purchase or lease the tied products, there is some disagreement under s.1 (SA). Some courts have indicated that a plaintiff-customer who refuses to enter such an arrangement may nonetheless demonstrate concerted action under s.1 (SA) by showing that the defendant coerced others into such an agreement; other courts have held that a plaintiff-customer must have been forced

[77] 112 S. Ct. 2072 (1992).

to buy the tying and tied items from the seller in order to challenge the arrangement under s.1 (SA). Where the plaintiff is a competitor of the seller, however, it need not purchase any product in order to challenge the arrangement but must show that the seller forced some purchasers into buying both products.

(iii) Seller's power in the market for the tying product

Until 1958, the Supreme Court held that a tying arrangement could be *per se* illegal only if the seller had monopoly power in the tied product market. However, in *Northern Pacific Railway v. United States,*[78] the court held that *per se* illegality can apply even absent monopoly power in the tying product market if the seller has sufficient economic power to impose an appreciable restraint on free competition in the tied product. The Court suggested that the very existence of a host of tying arrangements may in itself be compelling evidence of the defendant's great power where no other explanation has been offered for the existence of these restraints.

The Court went a step further in *United States v. Loew's, Inc.,*[79] when it indicated that economic power can be inferred from the desirability to consumers of the tying product or from the uniqueness in its attributes. The Court also stated (at 45) that "the requisite economic power is presumed when the tying product is patented or copyrighted."

Economic power was also addressed in *Fortner I* (*United States Steel Corp. v. Fortner Enterprises*)[80] and *Fortner II.*[81] The defendant company loaned the plaintiff US$2,000,000 for the acquisition and development of land on the condition that the plaintiff purchase prefabricated houses from an affiliate of the loan company. In *Fortner I*, the U.S. Supreme Court reversed summary judgement for the defendant, stating that "uniquely and unusually advantageous terms can reflect a creditor's unique economic advantages." Yet the Court also emphasized that it was not sufficient for the plaintiff to show that the loan was unique and unusual; economic power is to be inferred from the uniqueness of the tying product only when the seller has some cost advantage over its competitors or when its competitors are barred by legal or physical barriers from offering a competitive product.

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[78] 356 U.S. 1, 78 S. Ct. 514 (1958).

[79] 371 U.S. 38, 83 S. Ct. 97 (1962).

[80] 394 U.S. 495, 89 S. Ct. 1252 (1969).

[81] 429 U.S. 610, 97 S. Ct. 861 (1977).

In *Fortner II*, the Supreme Court reversed judgement for the plaintiff, concluding that the defendant did not have sufficient economic power in the tying-product market to be *per se* liable. The Court stressed that the issue to be determined was whether the seller has the power, within the market for the tying product, to raise prices or to require purchasers to accept burdensome terms that could not be exacted in a completely competitive market. In this case, there was no evidence that the defendant's loan was unique because of legal or physical barriers to competition. Moreover, the plaintiff did not establish that the defendant had any cost advantage in offering its loans. Neither test established by *Fortner I* had been met. Therefore, the defendant did not have sufficient economic power in the tying-product market even if its loan package was more attractive than other loans.

Fortner II also distinguished the decision in *Northern Pacific*. Where the Court in *Northern* found that a host of tying arrangements by itself supported a finding of *per se* liability, *Fortner II* made it clear that economic power cannot be inferred solely from evidence that a number of buyers accepted the tying arrangement. The Court emphasized that the approach in *Northern* depends on the absence of other explanations for the willingness of buyers to purchase the package. The tying arrangement in *Fortner II*, however, could be explained as a form of price competition in the tied product.

An assessment of the case law suggests that there are three potential methods of establishing economic power in the tying product market. The plaintiff may attempt to prove that:

(i) the defendant has sufficient market share to force buyers to purchase the tied product;
(ii) a high percentage of the seller's customers have accepted the tying arrangement, for which there is no valid explanation; or
(iii) the defendant has a competitive advantage due to special characteristics of the tying product or to legal barriers to the entry of competitors, such as trademark, copyright or patent.

(iv) Foreclosure of a substantial volume of commerce in tied-product market

Another element of a *per se* violation is that a "not insubstantial amount of commerce" is foreclosed in the tied-product market. In *Fortner I*, the Supreme Court stressed that the focus normally is on whether the dollar-volume of business foreclosed is not "merely *de minimis*", rather than on the percentage of the relevant market that is foreclosed. Further, the Court examined the entire volume of the defendant's sales of the tied product sold by means of the challenged practice, rather than only on the sales made to the plaintiff, and concluded that, even if the latter were the sole basis for consideration, it could not agree with the lower court that the sum of US$200,000 of sales to the plaintiff was paltry or insubstantial. In any event, the total amount of commerce foreclosed by the practices of the defendant exceeded US$2,000,000 annually.

In subsequent cases, while some courts have held that amounts as low as US$10,000 are sufficient to meet this test, others have found higher amounts to represent an insufficient foreclosure of commerce in the tied-product market. In addition, where there are no competitors in the market for the tied product, no competition will be foreclosed and thus no violation will be found.

(v) Anti-competitive effect in the tied-product market

Some courts require the plaintiff to prove anti-competitive effect in the tied-product market. While this requirement in a case of *per se* liability may serve to undermine the utility of the *per se* rule, the U.S. Supreme Court has recognized that the *per se* rule against tying may require considerable inquiry into market conditions before the evidence justifies a presumption of anti-competitive effect.

(b) Illegal Tying and the Rule of Reason

As a matter of law, an arrangement that survives *per se* scrutiny may nonetheless be invalid under the rule of reason. In *Fortner I*, for example, the Court stressed that even if a plaintiff does not establish the elements of *per se* illegality, it can still prevail on the merits whenever it can prove, on the basis of a more thorough examination of the competitive effects of the impugned practices, that the general standards of the SA have been violated.

Nonetheless, as a practical matter, because the *per se* rule against tying arrangements requires careful consideration of market conditions, an arrangement that is not *per se* illegal is unlikely to violate the rule of reason. Indeed, there appear to be no cases in fact where a court has held that a tying arrangement survived *per se* scrutiny but violated the rule of reason. On the other hand, the lower courts have in several cases addressed challenges to tying arrangements under the rule of reason. Some of these courts have found particular tying arrangements illegal under the rule of reason without deciding the issue of *per se* liability, while other courts have concluded that various tying arrangements are neither *per se* illegal nor invalid under the rule of reason.

(c) Defences

(i) Protection of goodwill or trademark

Recognizing that a seller may need to protect its goodwill or trademark, courts have sometimes allowed a business justification defense. An explanation of the reason for allowing such a defense when the tie-in would otherwise be *per se* illegal is offered by the Fifth Circuit in *Kentucky Fried Chicken Corp. v. Diversified Packaging Corp.*:[82]

> Unlike that of the tying party in a prototypical tying case, a franchisor's own success may depend in large measure on the success of the tie's victim, the franchisee. The franchisor will succeed only by establishing a favourable reputation among the consuming public, and in building that reputation the franchisor must depend largely on the quality of the franchisee's performance.

As established by the Supreme Court in *Standard Oil Co. v. United States*,[83] however, the defense is limited:

> The only situation in which the protection of goodwill may necessitate the use of tying clauses is where specifications for a substitute would be so detailed that they could not practicably be supplied.

In *Eastman Kodak Co. v. Image Technical Services, Inc.*,[84] the Supreme Court reversed summary judgement for Kodak. The Court assessed, *inter alia*, three proffered justifications for selling copying machine parts only to buyers of Kodak equipment who used Kodak service or repaired their own machines. The Court held that the two business justifications put forward by Kodak, one of which concerned the quality of service and the other which involved the improvement of asset management by the reduction of inventory costs, required factual determinations that could only be made after a trial on the merits. Moreover, Kodak's interpretation of the free-rider business justification was rejected by the Court as a matter of law (at 2092):

> Kodak claims that its policies prevent ISOs from exploit[ing] the investment Kodak has made in product development, manufacturing and equipment sales in order to take away Kodak's service revenues. . . Kodak does not dispute that respondents invest substantially in the service market, with training of repair workers and investment in parts inventory. Instead, according to Kodak, the ISOs are free-riding because they have failed to enter the equipment and parts markets. This understanding of free-riding

[82] 549 F.2d 368 (1977).

[83] 337 U.S. 293, 306, 69 S. Ct. 1051 (1949).

[84] 112 S. Ct.2072 (1992).

> has no support in our case law. To the contrary, as the Court of Appeals noted, one of the evils proscribed by the antitrust laws is the creation of entry barriers to potential competitors by requiring them to enter two markets simultaneously.

In *Metrix Warehouse, Inc.* v. *Daimler-Benz Aktiengesellschaft and Mercedes-Benz of North America, Inc.,*[85] on appeal from a district court's ruling, the appellate court upheld a jury's verdict that the tying of automobile parts to the dealership agreement by Mercedes-Benz was unlawful. The court rejected the view that there was a "business justification" for the tying arrangement. This business argument was that the mandatory use of branded replacement parts was necessary to protect goodwill, to monitor dealer behaviour and to fulfil consumer expectations of receiving genuine parts. The court rejected this defence because there was no proof that other means available to the manufacturer to guarantee quality levels, such as issuing to dealers the specifications for parts, were unfeasible.

(ii) New business defence

One court has recognized a "new business" defense. In *United States v. Jerrold Electronics Corp.*,[86] the court allowed the tying of engineering services to the sale of complex community television equipment on the ground that the community television business was in its early stages and there were no other firms with qualified personnel to service the defendant's equipment. This result can be justified on the simple basis that the plaintiff could prove no damages if it could not have obtained the tied product from any other company. In any event, once a business becomes established, the "new business" defence does not apply.

(d) Tying variation: designating third parties as sources of supply

It is not unusual for franchisors of systems which specialize in a limited product line to turn to third persons for the production or manufacture of goods. In such situations, the question arises whether the franchisor can require its franchisees to purchase their supplies only from its designated third parties. These situations have arisen most frequently in the fast-food business. Such approved supplier requirements have been held not to constitute tying arrangements absent evidence that the franchisor has coerced or otherwise required franchisees to purchase from itself or from a supplier in whose sales the franchisor has a financial interest. Thus, illegal tying arrangements have been found where coercion is shown, if the only supplier approved is one affiliated with the franchisor, or the franchisor receives a rebate from the supplier on sales to franchisees.

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[85] 1987, *Trade Cases* 67,697.

[86] 187 F. Supp. 545 (E.D. Pa. 1960), aff'd per curiam 365 U.S. 567, reh'g denied 365 U.S. 890 (1961).

4.4.3 TS in Japan

Tied-selling has been designated as an unfair business practice by the FTCJ in s. 10, Notification No. 15 of 1982. This provision reads:

> Unjustly causing the opposite transacting party to purchase a commodity or service from oneself or from an entrepreneur designated by oneself by tying it to the supply of another commodity or service, or otherwise coercing the said party to deal with oneself or with an entrepreneur designated by oneself.[87]

The practice may also be captured by s. 13 of the same designation:

> ... dealing with the opposite transacting party on conditions which unjustly restrict any transaction between the said party and his opposite transacting party or other business activities of the said party.

The 1991 *Guidelines* clarify that tying will be regarded as unlawful when the seller of a commodity who imposes the condition is "influential in a market" and where the restriction may result "in reducing the business opportunities of firms not buying or unable to buy products from the influential firm, or of competitors of the influential firm and making it difficult for those firms to easily find alternative trading partners". During enforcement evaluation of the practice, recourse will be had to similar market- and competition-based analysis utilized in the context of exclusive dealing and territorial and customer restraints.

Should the seller enjoy a dominant bargaining position over the purchaser, the practice of tied-selling may be found to violate the AML, apparently regardless of the seller's position in the market as a whole. The Guidelines indicate:

> One party in [the] transaction shall be found to be "in a dominant bargaining position over the other party" in such cases where the latter is obliged to accept the former's requests even if they are excessively disadvantageous to the latter, since discontinuance of transaction with the former would significantly damage the latter's business....

Yet in making this finding, consideration is to be given to such market-oriented factors as degree of dependence on the former, the position of the former in a market, changeability of customers, and supply and demand forces of the product. Although consideration of these factors could permit classic competition analysis to dismiss the interests of the more vulnerable market player, there also appears to be analytical room to accord them a certain deference as well.

[87] Japanese Fair Trade Commission Notification No. 15 of 1982, printed in Hiroshi Iyori and Akinori Uesugi, *op. cit.*, 1983, p. 268.

In the *Textbook* case,[88] the FTCJ found a violation of the AML with regard to the requirement, imposed by the only textbook wholesaler in the Nagano Prefecture, that textbook sellers (who also sold regular books) purchase ordinary books to the value of at least two-thirds of the value of the textbooks they purchased but for a total purchase of at least ¥3 million annually. The FTCJ came to the same conclusion in the *Farmers' Co-operative* case[89] in which a farmers' cooperative was authorized to issue agricultural modernization loans (a government subsidy loan at an interest rate lower than the market rate), but made the loans conditional upon the purchase of agricultural machines which it also sold.

Tying may be found justified in law where it is necessary to combine commodities for quality control or for the promotion of efficiency, such as the need for uniformity of image, or the protection of the brand or quality. As in territorial and customer restrictions and exclusive dealing, tied selling may also be found legal where it is utilized as an incident of intellectual property rights. The FTCJ *Guidelines on the Regulation of Unfair Business Practices in Patent and Know-how Licensing Agreements* indicate that it is not unlawful in principle to impose the obligation on the licensee to purchase materials and related items from the licensor or a third party designated by it, where this is necessary to maintain the goodwill of the trade mark or the use of the licensed technology because of restrictions on the quality of raw materials, components or related items. The practice may, nonetheless, be found unlawful where it is not essential to the maintenance of goodwill or where the licensee's freedom to choose, or competition in the market for, materials is unduly restricted. Thus, the Japanese approach to TS has both per se and rule of reason elements.

4.5 Vertical Franchising Agreements (FA)

In a franchise arrangement, the manufacturer of intermediate goods, called the franchisor, commonly assigns the dealers, called the franchisees, to specific territories or customers. The franchisor sells a proven product, trademark or business method and services and earns payments such as royalties from the franchisees. The franchising contracts may cover such matters as product prices, advertising, location, transfer of know-how or technical skills, type of distribution outlets, geographic area, etc.

Franchising contracts can specify restraints on some of the following provisions: franchise fee, royalties or commissions, price or quantity provisions, territorial or customer provisions, exclusive dealing and tie-in provisions. Other types of clauses may specify direct

[88] FTC Decision, 11 Feb. 1964, *Shinketsusha,* 12 (1965), 100.

[89] FTC Decision, 12 Dec. 1963, *Shinketsushu,* 12 (1965), 39.

controls or obligations on franchisors and franchisees. For instance, the franchisor may be obligated to train the staff at the retail outlet or may be in charge of national advertising.

Franchising arrangements fall somewhere between a fully vertically integrated business and the looser relations between upstream supplier and distributor. Franchising agreements sometimes fall under the purview of those provisions of competition laws that deal with vertical restraints. The objective of competition policy pertaining to franchising is not to stifle the development of efficient distribution systems, which can promote competition in the economy.

The co-ordinating of vertical restraint provisions of exclusive franchises can be attractive for both the manufacturer and the retailer. The exclusivity of a franchise keeps the same brand competitors at a distance, which can preserve retail margins. The franchisor can use the wider retail margin to induce franchisees to carry larger inventories, engage in high-quality product promotion and provide maintenance and repair services.

In assessing economy-wide efficiency effects of franchising restraints, there are a few important considerations. First, to the extent a franchisor, say McDonald's, transfers know-how to its franchisees, profits from the franchise arrangement would promote further investment in know-how. Second, when a franchise agreement increases profits, over time it may lead to entry and competition by new brands and new retailers.

Third, a franchise system may reduce competition among its existing retailers and increase the risk of cartelization. However, this franchise system would face competition from other brands and from other franchise systems, or other distribution systems may prevent any one franchise system from controlling the market. For example, the McDonald's franchise system competes for customers with other franchise systems, such as Harvey's, Burger King, Wendy's and A&W. The point is that if the franchise system faces actual and potential competition from other brands and retailers, the chances are small that vertical restraints in a franchise agreement will reduce economic efficiency. Strong competition at the manufacturer and retailer levels insures efficiency both of upstream production and of distribution services.

In short, since each type of provision found in franchise agreements may have pro- or anti-competitive economic effects, no provision can be presumed always to have either a negative or a positive effect on economic efficiency. Franchising can be an efficient means of supplying some types of goods and services. The following circumstances would be relevant in evaluating a given case:[90]

- the degree of upstream and downstream competition,
- the maturity of the market,
- the existence of barriers to entry,
- the possible transmission of know-how, and
- the informational environment and risk-sharing issues.

Some of the implication for the formulation of competition policy for franchising practices are as follows.

- First, an economic analysis of individual franchise agreements would be necessary to determine the effect of specific provisions on efficiency.

- Second, market structure, the conditions of entry, the level of concentration and potential market dynamics are important in assessing whether a franchising restraint provision is likely to harm or promote competition.

- Third, the definition of the relevant market is important for determining the effects of franchise provisions on economic efficiency.

In sum, the analysis of franchise vertical restraints has to rely on a case-by-case examination of a given provision and, thus, a rule of reason treatment of franchise agreements is the appropriate competition policy.

The element essential to any franchise agreement is the degree of control exercised by the franchisor over the manner in which the franchisee conducts its business. From the franchisor's perspective, it is precisely this control that makes such an arrangement advantageous. Indeed, where intellectual property rights are involved, adequate controls are sometimes required to maintain the protection offered by those rights. Yet many of the controls exercised in the franchise system may violate competition law. What must be distinguished from the discussion elsewhere in this Paper, however, is that while resale price maintenance, tied selling, etc. are all practices that are specifically addressed by competition law, the nature of franchising itself is not necessarily at issue; rather, it is a certain feature of a particular franchise that could be challenged in certain circumstances. This statement holds true, not only for vertical restraints but also the entire range of practices proscribed by

[90] OECD, *Competition Policy and Vertical Restraints: Franchising Agreements*, Paris, 1994, chapter 2.

competition law. Thus, if a court determines that a specific franchising practice meets all the elements of a particular offence and that none of the possible defences apply, antitrust liability will be found. This principle is observed by the competition law of all three countries examined in this Paper. For example, in the U.S. any attempt by a franchisor to control the price at which its product is resold by its franchisees is currently a *per se* violation of the Sherman Act (as a RPM arrangement). While a franchisor may suggest or recommend prices, it may not coerce the franchisee into observing them.

In addition, one of the essential features of any particular franchise is the exploitation of an intellectual property right. The relationship between intellectual property law and competition law is the subject of critical debate in several fora as well as the focus of draft policy guidelines issued by the US DOJ and the FTCJ *Guidelines on the Regulation of Unfair Business Practices in Patent and Know-how Licensing Agreements*. For reasons of space (and time), however, the policy nexus between the two fields lies beyond the purview of this paper. The authors have been obliged to limit themselves to the occasional reference to IP-related defence, an allusion that may serve to indicate a point of departure for future research.

5. Summary of the Law on Vertical Restraints

Public policy concerning vertical business relationships has been one of the most controversial areas in competition policy. One view, often associated with the Chicago School, recommends *per se* legality of vertical restraints. The other position, often attributed to the Harvard School, has taken a more critical view of vertical restraints, in particular of *resale price maintenance* (RPM).

In most countries, such as Canada and the U.S., *resale price maintenance* is *per se* illegal, while other vertical restraints, such as *tied selling* (TS), *exclusive dealing* (ED) and *exclusive territories and customer restraints* (ETCR), and certain vertical *franchising* (FA) practices are accorded partial or complete rule of reason legal treatment. Section 4 has covered these practices at length, while Annex I briefly explains the issue of exemptions in the three jurisdictions. Here, we summarize our findings.

Resale Price Maintenance

<u>RPM is virtually unlawful in most jurisdictions.</u> All countries are extremely suspicious of vertical price restrictions. Very limited price indications, such as the use of suggested price lists, are tolerated. There is somewhat greater tolerance for <u>non-price</u> restraints.

In Canada and the U.S., two main considerations related to vertical price control policies are important in analyzing their effect on economic efficiency.

The first to be noted is the distinction between price and non-price vertical restraints. The U.S. Supreme Court has focused on three types of economic efficiency effects: (i) non-price vertical controls can improve the efficiency of distribution and retailing networks; (ii) non-price vertical restraints may be beneficial in promoting entry and increased inter-brand competition in the long run; and (iii) vertical price restrictions are much more likely to reduce inter-brand competition.

The second is the difference in economic effects of price floors or minimum resale prices and price ceilings or maximum resale prices. The U.S. treats price ceiling schemes (as well as price floors) as *per se* illegal, like any other kind of price restriction. In contrast, Canada has adopted a more permissive position towards the use of price ceilings. In Canada, competition law only prohibits restrictions that prevent reductions in price or influence prices upward.

In Japan, interpretive uncertainties preclude the application of the tests for "unreasonable restraint of trade". Thus, RPM is tested as an "unfair business practice" as specified in the Antimonopoly Law (AML) and is designated as such by the Fair Trade Commission of Japan (FTCJ). The wording of the legal proscription, however, suggests an approach analogous to the rule of reason in that, where the practice is not shown to impede "fair competition" and is reasonable, antitrust liability will not be found. Among the three jurisdictions examined in this Paper, Japan is the only country where there are a number of products that have been exempted from the application of RPM provisions. A list of the Japanese RPM exempted products is found in Annex I of this Paper.

Vertical Exclusive Territorial and Customer Restraints

Exclusive territorial and customer restrictions (ETCR) are often acceptable under the competition laws examined in this Paper where they do not have an adverse effect on competition. The general acceptance of ETCR is illustrated by the U.S. case law. The U.S. Supreme Court found in *Continental TV v. GTE Sylvania* that ETCR should be judged under the rule of reason, rather than be regarded as *per se* illegal as in the earlier *Schwinn* case. The Court also stressed the adverse effects that a *per se* rule may have on small and independent business.

In Japan, ETCR have been considered justifiable if they promote *inter-brand* competition (for example, among Toyota, Honda, Mazda and Mitsubishi brands of automobiles) or if they assist new or weak retailers to become fully competitive. However, ETCR will be found to violate the AML: (i) if the restriction is imposed by an "influential" manufacturer, and (ii) if the restriction has the effect of maintaining a price of the commodity supplied by the manufacturer.

Exclusive Dealing Arrangements

In Canada, the Competition Act exempts ED provisions for a reasonable period, when these provisions mainly serve to facilitate the entry of a new firm or of a new product. In its *Bombardier* decision, the Restrictive Trade Practices Commission (RTPC), predecessor to the current Competition Tribunal, suggested an analytical framework which included Bombardier's market share, financial strength and record of innovation, the evolution of relative market shares, the availability of other distributors for competing manufacturers, the choice offered to consumers in remote locations, etc..

ED practices in the U.S. are normally tested by the rule of reason standard. Here it is the presence or absence of dominant sellers who foreclose a substantial amount of commerce in the relevant market that appears to be a critical factor in U.S. law. U.S. jurisprudence on ED still retains an element akin to a *per se* illegality approach, but the qualitative (rule of reason) alternative has gathered considerable strength over the last few decades.

In Japan, ED is proscribed as an unfair business practice by the AML. The relevant factors are considered on a case-by-case basis. It is an unfair business practice for a manufacturer, and an "influential" manufacturer in particular, to require dealers to limit the commodities they trade in or to place restrictions that may make it difficult for new entrants or competitors to secure alternative distribution channels easily. As in Canadian and U.S. law, the core of the ED issue in Japan is market foreclosure.

Tied Sales

Depending on circumstances, tied sales (TS) may be either harmful or beneficial. Competition laws in most countries apply a flexible rule of reason treatment to TS.

One important exception has been the U.S., where tying practices have been considered *per se* illegal. However, considerable market analysis is required and a number of conditions must be satisfied before the *per se* rule is applied. Courts have focused particularly on the seller's power in the market for the tying product, foreclosure of a substantial volume of commerce in tied-product markets, and the anti-competitive effect in the tied-product market.

In Canada, TS are tested against the rule of reason standard. The case law indicates an approach that attempts to balance the efficiency effects in the joint production of the tying and tied products and the quality-enhancing arguments used to justify tying arrangements for inputs. It also suggests that, if the aforementioned market conditions indicate a threat to competition, an attempt should be made to ascertain whether alternative methods with similar efficiency-enhancing effects, but less threatening to competition, are available or not. In the absence of such alternatives, TS arrangements are less likely to violate the law.

In Japan, FTCJ designates TS as a potential unfair business practice. In evaluating the TS practice, market- and competition-based analysis, as in ED and ETCR cases, is used. A TS arrangement by an "influential" seller of a commodity that results in reducing business opportunities for firms and competitors unable to buy the product will be unlawful. However, tying may be justifiable in Japanese law where it is necessary to combine commodities for quality control or for the promotion of efficiency.

Franchising Arrangements

Franchising arrangements illustrate the nature of the debate between competition policy and intellectual property (IP) rights. Although IP rights generally lie beyond the scope of this Paper, the discussion of the specific restraints examined noted several defences available when the restraint was imposed as incident to the exercise of IP rights.

5.1 Summary of Exemptions From Competition Law

The pace at which economic activity is becoming internationalized exposes those business practices that have been sheltered from the application of competition law in a jurisdiction. However, an assessment of exemptions for vertical arrangements in any one country is best done by considering all other significant practices that are also exempt from competition law. Annex I of this Paper juxtaposes a whole variety of (horizontal and vertical) exemptions in Canada, the U.S. and Japan.

In both Canada and the U.S., there is a defence available for activities that run afoul of competition laws but flow from compliance with government-imposed regulations. In both the U.S. and Japan, exemptions from the application of competition law are sometimes accorded to entire sectors. In contrast, such sectoral exemptions exist for only three situations in Canada. In Canada, exceptions are provided more generally for specified activities and appear to be based on preserving efficiency and competition enhancing considerations rather than outright carveouts.

A comparison of the exemptions in the U.S. and Japan is striking. Exemptions in the U.S. are numerous, if not more numerous than Japan. Perhaps the most glaring exemption in the U.S. from the perspective of trade policy is the "Safeguarding U.S. Balance of Payments Position" exemption, which has the potential of distorting and limiting trading opportunities in the U.S. for its trade partners such as Canada. In Japan, in addition to the licensing of specific depression and rationalization cartels by the FTCJ pursuant to provisions of the AML, there are a number of sectors where one or another type of cartel activity is entirely exempt.

6. Policy Implications

We discuss two sets of policy issues. The first set deals with the competition policy treatment of vertical restraints in national markets functioning in an increasingly liberalized trading system. Second, within the general set of issues concerning access to national markets, we evaluate the policies contemplated with regards to the Japanese distribution system in the seemingly interminable saga of U.S.-Japan trade frictions.

In sub-sections 6.1 through 6.3, we integrate the discussion on the legal treatment of price and non-price vertical restraints in section 4 in light of the theoretical economics discussion of section 3, and suggest means by which our recommendations with regards to competition policy can be implemented in a multilateral trading system. As a longer term proposal, we suggest the development of new multilateral institutional arrangements to cope with the emerging agenda.

In the remainder of this section we discuss market access issues with regards to distribution systems.

6.1. Recommendations for the Treatment of Vertical Practices

The most important conclusion that has emerged from recent economic analysis of vertical restraints is that these restraints are used in most cases unilaterally by a manufacturer to change the mix of price and non-price competition conditions among retailers of its product. Restrictions on distributors are a means of competing on product quality. Hence, this Paper finds that there is not sufficient justification for *per se* illegality of either vertical price restraint practices, such as resale price maintenance, or non-price vertical restraints, such as tying and exclusive dealing. We summarize our reasoning as follows.

Resale Price Maintenance

Should RPM be prohibited? This question is the same as asking if vertically integrated firms should be prevented from competing on service provisions. Competition among manufacturers will tend to yield the service and pricing decisions (whether implemented through vertical restrictions or not) that best meet consumer demand. A number of analysts, including Green, and Mathewson and Winter,[91] have argued that a prohibition on RPM is not generally welfare increasing. The rule of reason approach for RPM is preferable. This would require changes in the generally *per se* approach taken in two of the three jurisdictions (Canada and the U.S.) reviewed in this Paper. Moreover, the outright RPM exemptions still accorded in Japan to products listed in Annex I of this Paper should be abolished forthwith.

Vertical Exclusive Territories

Exclusive territories, like RPM, are best viewed as an instrument used by manufacturers to elicit the appropriate balance between price and service by the retailers.

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[91] G. Frank Mathewson and Ralph A. Winter, "The Competitive Effects of Vertical Agreements: Comment", *American Economic Review*, (77) 1987: 1057-62; Christopher Green, *Canadian Industrial Organization and Policy*, 3rd edition, Toronto: McGraw-Hill Ltd., 1990, p. 347:

> The question now is whether, from an economic standpoint, the *per se* prohibition has begun to outlive its usefulness. A case can be made that it has, and that some sort of rule of reason might be more appropriate.

Also see Stylianos Perrakis, *Canadian Industrial Organization*, Scarborough: Prentice-Hall Canada, 1990, p.285:

> The arguments for the beneficial effects of RPM are more convincing when it can be demonstrated that it supports quality improvements which would not be available without it ... Thus it would seem advisable to allow RPM in such cases, with the burden of proof placed on the firm. The only disadvantage of such an approach is that it would place rather heavy analytical demands upon the trial judge.

Even ardent advocates of the Harvard School, such as Scherer and Ross, *op. cit.* (1990), agree that a case for the rule of reason treatment of RPM cannot be rejected:

> Chicagoans' claims that strictly vertical RPM cannot impair economic efficiency are plainly wrong... The overall balance between benefits and costs is probably close. The remaining question is whether the courts are able to sort out desirable from harmful conduct under a rule of reason approach without excessive litigation cost and error rates... Unless the [price] ceilings are used as focal points to discourage undercutting, and hence support price-*raising* collusion, it is hard to see how such [RPM] behaviour could harm competition or consumers. Quite clearly, it should not be illegal per se.

Externalities otherwise distort the retailers' incentives to achieve this proper balance. Territorial protection accorded to retailers protects retailers' sunk investments from appropriation by the manufacturer. The rule of reason treatment of exclusive territories is the appropriate approach.

Exclusive Dealing

Exclusive dealing (ED), even when retailers are unique and the market is foreclosed completely to other manufacturers, can be efficiency enhancing. The key consideration here is that manufacturers lower their wholesale price to compete for the retail outlets. This process can yield retailer prices sufficiently low that consumers are compensated for any reduction in their product choice. Any other positive effects from ED, such as enhanced incentives for dealers to supply services or better manufacturer control and lower distribution costs realized by manufacturers, reinforce the efficiency enhancement argument. The rule of reason treatment of exclusive dealing should be the legal practice. This would require some further adjustment in U.S. practice.

Tied-sale

There are many explanations for tied sales. Some are efficiency enhancing, while others are not. Where market power is otherwise absent, tying contracts will not create market power. Since not all tying contracts reduce welfare, not all tying contracts should be struck down as illegal. A careful examination of the facts of each case is required to assess the relevancy of the argument. The rule of reason approach in tied sales arrangements is preferable. This would require a further shift in U.S. and Japanese practice.

Franchising

Franchising contracts contain provisions that may have pro- or anti-competitive economic effects, depending on the function of those provisions within the market. Those practices that constitute vertical restrictions cannot be presumed always to have either a negative or a positive effect on competition. Consequently, franchising agreements that incorporate vertical restraints are best treated on a case-by-case basis under the rule of reason approach.

In sum, all five major vertical arrangements examined in this Paper are most appropriately judged on a case-by-case, rule of reason basis.

6.2 A Case for the Rule of Reason Treatment of Vertical Restraints in Dynamic World Markets

In section 6.1, we have emphasized the importance of the rule of reason approach to competition policy in dealing with vertical arrangements in a multilateral trading system. We now discuss how the rule of reason treatment would impact on players in the vertical chain operating in global markets.

The Manufacturers

The major distortion that vertical restraints can inflict is market foreclosure which blocks entry in the long run. The efficiency argument for vertical restraints is that they provide a healthy retail margin to both the manufacturer and to retailers. Are such margins permissible in international markets, even though they often translate into higher consumer prices?

The quasi-rents that the manufacturer pockets by using vertical restraints are, as was argued above in sections 3 and 4, to be counted as a return on his investment in inventing and introducing products and processes. In today's post-industrial society, a good number of goods are produced by employing knowledge intensive techniques and skilled workers. Companies often have to incur substantial sunk costs in doing research and development (R&D) and product development. One property of products that are knowledge and skill intensive to produce is that, once they are introduced on the markets, they may be copied within the space of a few years, if not months. The protection that intellectual property (IP) rights confers on such products can be effectively porous long before the formal expiry of the legal right.[92]

If not domestic, then foreign, rivals ready themselves to enter these new markets. In concentrated world markets, there is intense oligopolistic competition. The quasi-rent that the innovator enjoys as a first mover is contested by these rivals. In theory, it is true that the manufacturer, having a vertical restraint agreement with its dealers, appears to transfer a part of the consumer surplus to itself. Yet, this inducement may be necessary for him to continue to invest in R&D and product innovation on a continuous basis and does not necessarily (or

[92] This analysis, however, does not address the legal capacity of owners of intellectual property rights to utilize those rights to foreclose import competition in certain circumstances. A discussion of these issues, inter alia, can be found in R.D. Anderson, P.J.Hughes, S.D. Khosla and M.F. Ronayne, "Intellectual Property Rights and International Market Segmentation: Implications of the Exhaustion Principle", A Working Paper, Bureau of Competition Policy, Hull, Quebec, October 1990; and Nancy T. Gallini, "An Economic Analysis of Grey Market Imports in Canada", A Paper Prepared for the Bureau of Competition Policy, Hull, Quebec, November 1992.

even likely) create long term-market power. Most international product markets are, in general, too dynamic to let solid market entry barriers remain in the way of keen rivals.

The upshot is that, in the dynamic environment of rivalry among strong oligopolists in international markets, vertical restraints are not likely to be efficiency reducing for long, provided a small number of manufacturers do not come to dominate the global market place, tying up retailers as their vassals.

The Retailers

The retail margin that the dealer appropriates, on account of vertical restraints, often turns out to be a necessary instrument for getting him to provide pre- and after-sale services to customers. In resource and commodity markets, the role of such promotional activities is usually not crucial.[93] If Canadian farmers want to sell wheat in Asia, they do not have to motivate a local retailer there to advertise in glossy magazines or on TV. However, for knowledge intensive and complex goods or even for processed food products aimed at the middle to high range of a market, product and brand name promotion is indispensable. For example, a foreign manufacturer wanting to enter a busy Japanese market will have to make its presence felt despite the density of other competing products in that market. In addition to promoting the product through the print, audio and video media, in-store promotion by well-trained sales persons will usually be necessary.

To enter a foreign market that is characterized by existing long-term manufacturer-retailer relationships (e.g., the Japanese market), a company should have the option to offer a retail margin inducement to build its distribution network. In a society where knowledge intensive products dominate the market, the service sector is ever increasing in importance. A successful penetration of foreign markets will have to be consolidated by quality after-sale service. Some vertical restraints may be necessary to launch and sustain sales in domestic and foreign markets.

To give another example, if RPM is *per se* illegal in the international marketplace, a foreign manufacturer may find it difficult to recruit existing retailers. The local retailers would be used to dealing with local manufacturers. They may even have long-established business relationships. The foreign company may be daunted by the sunk (or irrecoverable)

[93] Although promotional activities may be helpful in encouraging customers to associate a commodity with high quality: for example, the marketing of "Canadian" bacon (back bacon) and Canadian wheat as premium quality products in the U.S. market.

costs it has to incur in setting up an altogether new distribution network.[94] In this scenario, if RPM is not *per se* illegal, more potential entrants will be willing to challenge the incumbents and, overall, one could expect to see more competition over time.

Vertical Restraints and Multinationals

In a knowledge-based economy, the production of new knowledge does not necessarily follow a neat linear pattern. Leading the pack of frontier-level knowledge producers are the firms who put together specialized parts, produced with precision and specific skills. One such knowledge-based producer depends on the others for customized components. In this context, cooperative vertical contracts between suppliers and buyers facilitate the flow of information about the needs and requirements of the parties involved. This is particularly relevant in the exchange of information that is proprietary.

In the international context, when parties located in different countries and dealing with each other at arm's length cannot put beneficial exclusionary restrictions on each others' behaviour, they will have incentives to integrate those activities within one corporate structure. In other words, illegality of vertical restraints would, partly, encourage firms to transfer information internally and go multinational. Rather than providing the rule of reason treatment to beneficial inter-firm vertical restraints, countries first welcome multinational enterprises (MNEs) for their advantages and then try to control the less welcome aspects of MNEs. By withdrawing the remaining *per se* illegality aspects of vertical restraints law, countries would encourage many transactions to be subject to market discipline rather than slithering under the cover of MNEs.

Positive Investment Environment and Spillovers

Not only are some vertical restraints a bait to elicit additional investment in R&D and product innovations, such activities themselves are the source of beneficial externalities that fan out in the rest of the economy. If vertical restraints facilitate R&D and product innovation activities, they should not be *per se* illegal.

[94] Moreover, for manufacturers who face quotas and voluntary export restraints (VERs) for their products in the West and per se illegality of RPM, the quota charge they receive on their sales in the West can be likened to a fat retail margin. In other words, exporters from quota-restrained countries are able to offer their retailers a margin that they could not legally provide through the use of RPM. It is well known that quota-restrained exporters often move up the value-added chain in their export markets by providing useful pre- and after-sale product services.

If the price and non-price terms of these market transactions are kept *per se* illegal in statutes, society will not be providing an optimal environment that is conducive to the growth of such beneficial activities. Entrepreneurs will restrain their propensity to invest in innovative activities. As firms producing knowledge intensive services and products expand, in the current environment of *per se* illegality of some important vertical restraints, these firms are led to engage in vertical integration. With the growth in the size of the firm comes coordination problems that could very well have been solved by cooperative market transactions between firms. In such an environment, cooperative vertical supplier-buyer restraints should not be *per se* illegal.

Moreover, a country which has a more permissive regime for vertical supplier-buyer arrangements than other countries will increasingly become an attractive site for firms to locate their production. The country attracting such an inward flow of investment will find other related industries, such as parts manufacturers, willing to locate there as well. Countries that maintain and enforce the illegality of beneficial vertical restraints will complain about the unfair and lax use of competition policy by countries attracting such investment. Rather than demanding a level playing field in competition policy in the image of the former countries, at least part of the appropriate policy response is to treat vertical restraints with the rule of reason approach in all jurisdictions.

In sum, this Paper recommends that countries should adopt the rule of reason treatment for all the vertical manufacturer-retailer practices, including resale price maintenance agreements and tied sales, *without any exemptions.*

6.3 A Multilateral Framework for the Rule of Reason Treatment of Vertical Relations

One central requirement for open access to the distribution network across national markets is that this access exist on a reciprocal basis. Suggesting that all countries take an exemption free, rule of reason legal approach to both price and non-price vertical restraints requires further thinking in a number of important directions. Some of the factors are:

- A common set of rules or guidelines by which the rule of reason approach will be implemented.

- The scope of both positive and negative comity will have to be expanded and national laws pertaining to extraterritoriality will have to be reconciled.[95]

- The range of exemptions, whether specific or general, to the application of competition law.

The crucial question that remains is how to devise the common set of competition guidelines that the international community could agree on and use in implementing the rule of reason approach. No matter how arduous and long the prospect for such international competition policy negotiations, it is worth pursuing. The search for some fundamental and central factors that should be taken into consideration in all jurisdictions in applying the rule of reason approach can begin by considering some of the important factors that emerge from the discussion in sections 3 and 4. To begin with, the following factors are suggested:[96]

- the definition of a relevant international market,
- market concentration,
- the market's information structure,
- risk characteristics in the relevant market (e.g., size of sunk investments as an ease of entry proxy), and
- the degree to which parties become locked-in to one another (e.g., the amount of capital each party brings to a joint project).

International rules formulated to apply the rule of reason approach may have the benefit of not being easily captured and modified by special interest groups. Yet this

[95] The concept of comity means that a nation refrains from extending its own legal or administrative activities into jurisdictions of another nation state. Under positive comity, a national government which holds a grievance against another nation that could be reached via competition policy (e.g., private practices that create barriers to imports or direct investments) would request the authorities of that nation to investigate and, if appropriate, to take action to address the grievance under the competition laws of that nation. In responding to the complaint under the terms of the comity agreement, these authorities would be obliged to consider carefully the interests of the complaining nation. For example, it would be useful to explore whether a Quadrilateral (Canada, the U.S., the EU and Japan) positive comity agreement might be negotiable, in part to encourage greater transparency in Japanese enforcement practices. Such an approach would echo similar agreements between Canada and the U.S., and the EU and the U.S. See Keith H. Christie, "Globalization and Public Policy in Canada: In Search of a Paradigm", *Policy Staff Paper* No. 93/1, Department of Foreign Affairs and International Trade Canada, Ottawa, January 1993.

[96] For a parallel study that explores the guidelines issue further, see Keith H. Christie, "Damned If We Don't: Some Reflections on Antidumping and Competition Policy", *Policy Staff Paper No. 94/15*, Foreign Affairs and International Trade, Ottawa, July 1994.

approach is flexible enough to accommodate changes in technology and the changes in the nature of business organizations in a dynamic world economy.

Finally, such guidelines would ultimately require monitoring and dispute settlement mechanisms of some sort. A few observers have pointed to the creation of a new international competition tribunal,[97] although this may seem exceedingly ambitious at this time. In any event, the more appropriate fora might be the newly established World Trade Organization (WTO) and the North American Free Trade Agreement (NAFTA) which will likely begin to address the competition and trade policy connection (including the prospects for some common standards) over the next several years. Both these institutions already include binding international dispute settlement mechanisms, although neither one currently embraces competition law enforcement issues. Another, perhaps more interim option, might be to develop, among a limited set of countries (in the Quadrilateral context? in NAFTA?), a NAFTA-like side agreement dispute settlement mechanism that would focus on the enforcement of <u>domestic</u> competition standards (<u>not</u> the harmonization or convergence thereof). The dispute settlement mechanism could be triggered if there were an alleged "persistent pattern of failure to effectively enforce" a country's <u>own</u> law. This approach would require careful work on definitions (e.g., the scope of "law", the meaning of "enforce" and "effectively").

6.4 Vertical Practices and Access to National Distribution Systems

The second set of policy issues we discuss pertain to access to national markets.

The crucial question concerning manufacturer-retailer relations in international markets is whether manufacturers from one country can enter the distribution network in a foreign country. If they are unable to line up retailers in foreign markets, their entry into those markets is effectively blocked. In such a circumstance, foreign firms would enjoy less than full access to a foreclosed national market because of difficulties related to penetrating the local distribution system and to the high costs associated with establishing new, parallel networks.

The phenomenon of a closed distribution system emerges when three main factors come into play. First, vertical cartel arrangements can enable a large firm in the market to

[97] For some examples, see F.M. Scherer, *Competition Policies for an Integrated World Economy*, The Brookings Institution, Washington, D.C., 1994, chapter 5; and "Draft International Antitrust Code as a GATT-MTO-Plurilateral Trade Agreement" prepared by International Antitrust Code Working Group, *Antitrust and Trade Regulation Report*, Vol. 65, No. 1628, August 1993.

exploit its dominant position. Most damaging is the combination of vertical distribution cartelization by producers of similar goods, which have also formed a horizontal cartel. Second, even if a country has competition laws that aim to promote efficiency and competition in the economy, lax enforcement of those laws may encourage existing companies not only to foreclose the production but also the retailing of goods and services.

With regard to efficiency reducing vertical cartel practices, legal and economic analysis in this Paper is unmistakably clear: they should be struck down by the courts. A rule of reason approach would be consistent with the view that the national market should be cleared of inefficient vertical or horizontal cartel arrangements that block new entry to the market. For instance, if it can be ascertained that cartel-like arrangements prevail in some national markets, then these arrangements will have to be eliminated in order to accommodate open access to the respective national distribution systems and markets.

The enforcement of existing competition laws in all jurisdictions is important for maintaining open access to national markets. In countries where the breaking of competition laws goes unchallenged or is mute due to ineffective monitoring, or if the penalty for violating the laws only amounts to a minor inconvenience, enforcement would have to be beefed up and fines set high enough to discourage companies from breaking the law again. In this area, in order to identify the dimensions of the role played by enforcement as well as those criteria by which its practical effectiveness can be assessed, further research and analysis is required.

Finally, the theory of vertical arrangements, discussed in section 3, teaches us that firms have recourse to a number of vertical restraints to achieve a given objective. In evaluating vertical arrangements in a distribution system, it is essential that we consider the entire package of vertical practices. If you analyze one vertical practice, such as tying, firms will move out of tying through the front door and enter, equally through the front door, into other vertical practices, such as exclusive dealing. Opening doors to all the vertical practices under the rule of reason standard, without any exemptions, would help encourage nondiscriminatory access to national markets.

6.5 International Markets, Exemptions and the Policy Debate

This Paper has emphasized the importance of fully analyzing activities and sectors that are exempt from the application of national competition law. Exemptions from competition laws on a sectoral basis rather than on economic efficiency grounds are bound to be captured by interest groups. Over time, these lobbies become entrenched and are hard to dislodge. Carveouts, such as the exemptions listed in Annex I below, can become bones of contention among trading partners. Eliminating automatic exemptions and establishing full-scope rule of reason treatment is a better alternative. Let firms defend their vertical arrangements on the basis of the efficiencies their transactions enhance.

- *The State Action Defence and Deregulation*

The salience of the distribution networks also pops up in the deregulation debate. First, there are a number of activities or sectors that countries have exempted from the application of competition laws. Second, in addition to the sectoral carveouts, national competition law itself provides for various defences for actions purportedly taken to abide by government regulation. We address both these points in the Annex below.

Competitive markets cannot be expected to develop in economies that want to cling to industrial regulation. It is essential that corporations be deprived of the opportunity to run for the protectionist cover of "the regulated industry defence". Consequently, keeping the deregulation ball moving forward is one of the necessary conditions for truly open markets to thrive.

- *Foreign Competition, Market Access and the Competition Policy Debate*

Some policy analysts have argued that the phenomenon of globalization and increased foreign competition effectively disciplines the exercise of market power in domestic markets. To give an example in the context of this Paper, consider two points. First, under tariff protection a dominant firm may monopolize the market, but free trade will whittle down the share of such players. The domestic market will see more competition as a result of free trade. Second, vertical arrangements deployed by companies with small market shares will not raise prices and will not generally be a competition policy problem. Can we exclusively rely on free trade accords to assure open market access to national markets?

Not really. Access to foreign distribution, perhaps to foreign markets in general, is not a foregone consequence of a free trade agreement. The presence of exempted sectors and regulated industries will turn out to be a roadblock to that quest. Consequently, vigorous enforcement of competition laws to demolish the carved out sectors and to push ahead with deregulation is essential.

The upshot is that a strong domestic competition policy must continuously complement and support a free trade policy.

In this context, it should be noted that the deregulation process (i.e., the elimination of exemptions to competition) does not imply that one or a few foreign firms are accorded some numerical share of the domestic (regulated) market. The major thrust of this Paper is that vertical business arrangements should develop among firms in a natural process as determined in a competitive marketplace. If the authority of a foreign government is used to dictate that domestic firms have to do their distribution business with specific foreign corporations, the process of deregulation is pushed back and competitive markets recede further on the horizon.

6.6 Vertical Practices in Japan: How Not to Open Up the Distribution System

The importance of a transparent national distribution system in maintaining open access to national markets is well illustrated by the ongoing saga of Japan-U.S. trade frictions, where the U.S. position appears to be the claim that U.S. companies are shut out of the Japanese market on account of the relatively closed distribution network in Japan. Another manifestation of this problem exists in the context of market access to the European Union. As the potential in the newly industrializing countries to absorb a wide variety of imports expands with economic growth, concerns about limited access to their national distribution systems from advanced countries could surface as well.

In order to explore fully the distribution system in Japan, a detailed analysis of vertical relations within and without the *keiretsu* network is required, which is outside the scope of this Paper. However, two points seem obvious.

First, exemptions for some vertical restraints, such as RPM, are not based on efficiency arguments judged on a rule of reason basis; rather, blanket exceptions are extended to specific industries. A rule of reason approach would be consistent with the view that Japan's market should be cleared of vertical or horizontal cartel arrangements that block entry, including foreigners, to the market. Enforcement should be reinforced. This, however, is not to endorse a wholesale dismantling of the *keiretsu* system in Japan. We need a better understanding of the various components and features of the *keiretsu* before we pass such a judgement.

Second, the current U.S. practice appears to rely on picking specific Japanese practices and then demanding either tightening of competition laws or proper enforcement of the existing ones. A process that relies on dismantling collusive practices in bits and pieces is most likely to run into difficulties.The only logical strategy is to deal with the entire package of vertical practices. Consequently, this Paper does not endorse the strategy of picking and targetting specific vertical restraints for negotiations with Japan.

In Japan's case, this Paper suggests abolishing all the automatic exceptions and establishing full-scope rule of reason treatment. The recommendation of this Paper would be to expose all vertical practices to the rule of reason treatment, *without any exemptions.*

ANNEX I: Antitrust Exemptions

In contrasting competition policy regimes across countries, not only are the differences in legal treatment of various activities striking, but equally riveting are the practices that national competition policies have authorized to remain beyond the reach of competition laws. The carveouts (or exemptions) provided can be a source of concern and may lead to frictions between trading partners. In this annex, we briefly list examples of some activities that are exempted from competition laws in Canada, the U.S. and Japan. Exemptions are relatively limited in Canada. Not so in the U.S. and Japan.

A1. Canada

In Canada, there are two main types of exemptions and one type of defence for certain activities.

First, there are activities that are exempt from the *Competition Act* itself. Two such categories are identified in section 4 and are as follows:

(i) *Collective Bargaining Activities*

(a) Combinations or activities of workmen or employees for their own reasonable protection as such workmen or employees.

(b) Contracts, agreements or arrangements between or among fishermen or associations of fishermen and persons or associations of persons engaged in the buying or processing of fish relating to the prices, remuneration or other like conditions under which fish will be caught and supplied to those persons by fishermen.

(c) Contracts, agreements or arrangements between or among two or more employers in a trade, industry or profession, whether effected directly between or among the employers or through the instrumentality of a corporation or association of which the employers are members, pertaining to collective bargaining with their employees in respect of salary or wages and terms or conditions of employment.

(ii) *Amateur Sport*

(a) Agreements or arrangements between or among teams, clubs and leagues pertaining to participation in amateur sport.

Second, the Act itself contains "exceptions" to many provisions and specifies the situations where the particular subsection of the competition law may not apply. For example, section 4 declares that the following activities of **underwriters** are not subject to sections 45 and 61 of the Act:

> An agreement or arrangement between or among persons who are members of a class of persons who ordinarily engage in the business of dealing in securities or between or among such persons and the issuer of a specific security, in the case of a primary distribution, or the vendor of a specific security, in the case of a secondary distribution, where the agreement or arrangement has a reasonable relationship to the underwriting of a specific security.

Third, there is the so-called "regulated activities defence". The regulation of some activities by governments in Canada can potentially lead private parties to engage in conduct that violates the Canadian competition law. Such activities and practices are exempt from the criminal, and may also be exempt from the civil, provisions of the Act.

A2. The U.S.

Over time, as the number of antitrust and trade regulation laws in the U.S. has grown, so has the importance of a significant number of exemptions carved out from those laws. These exemptions have either been created by U.S. Congress or judicially conferred.

A2.1 The principles and issues in the U.S.

The U.S. Supreme Court has stated that immunity from the antitrust laws is not to be inferred lightly. That is why, in many instances, the appropriate regulatory agency is empowered to deal with various aspects of antitrust problems, including the granting of exemptions, subject to final review by the courts (this is known as the doctrine of primary jurisdiction).

When the regulatory agencies in the U.S. create exemptions, they can be in conflict with state, city, county or municipal laws. First, a defendant may justify its conduct (contrary to the federal regulator's directives) on the grounds that it was taken in order to comply with state laws or laws of one of its political subdivisions. In this respect, the U.S. Supreme Court has enunciated the "state action" doctrine in *Parker v. Brown*[98]. In that case, private parties did not follow directives issued pursuant to the California Prorate Act because, the defendants

[98] 317 U.S. 341, 63 S. Ct. 367, 87 L. Ed. 315 (1943).

contended, the state Act conflicted with the Sherman Act and, therefore, was unconstitutional.

The *Parker* Court rested its decision on two foundational blocks. One involved statutory interpretation. The U.S. Supreme Court found that the U.S. Congress did not intend the antitrust laws to reach legislative activity, but only to ban anticompetitive conduct by "business combinations". The U.S. Supreme Court said that "official action directed by a state" did grant immunity to private persons and *Parker* portended immunity for private parties, and not just the states themselves. Subsequently, the state action doctrine was expanded by the Local Government Antitrust Act of 1984, which protects municipalities against antitrust damage claims.[99] In essence, the state action defence in the U.S. is similar to the regulated industry defence in Canada. Note that exemptions are usually strictly construed by the courts and should not be confused with defences.

The second doctrine is that of "preemption", which involves principles of federalism and state sovereignty. The issue is whether a U.S. state statute that is inconsistent with U.S. federal antitrust laws will be invalid. The *Parker* Court found that the federal interests embodied in the federal antitrust laws did not always displace state laws. In this context, antitrust actions brought against a state directly also implicate the eleventh amendment of the U.S. constitution, which precludes U.S. citizens from suing a U.S. state.

Numerous groups and industries, and business activities and practices in the U.S. are currently immune from criminal and civil antitrust liabilities. The businesses, industries or groups that may be exempted under one or more statutes generally fall in the following categories:[100]

- agricultural cooperatives and associations,
- banking,
- communications (radio, television, telephone, telegraph and newspapers),
- export trade associations,
- fisheries,
- insurance,

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[99] The Local Government Antitrust Act of 1984 provides that "no damages, interest on damages, costs, or attorney's fees may be recovered under 4, 4A or 4C of the Clayton Act" for claims against local governments, their officials or employees acting in their official capacity, or any other person based upon an official action directed by a local government or by its official or employee acting in an official capacity. One implication of the 1984 Act is that it preempts treble damage actions by private parties against local governments.

[100] Source: Julian O. von Kalinowski, Peter Sullivan and Maureen McGuirl, *Antitrust Laws and Trade Regulation*, Volume 6, New York: Matthew Bender, 1994.

- labour,
- learned professions,
- marine insurance companies,
- natural gas transmission,
- professional sports,
- securities and commodity exchanges,
- small businesses,
- transportation (air, motor, rail and water carriers), and
- designated industries or groups in time of war or national emergency.

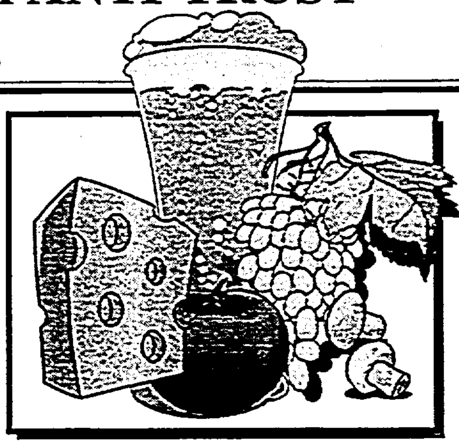
With the passage of time and from changing judicial interpretations, exemptions can lose their certainty. The effort to keep exemptions applicable is an evolving process. The new legislation simply builds on the well-established precedent of granting exemptions to sectors of the U.S. economy or to groups viewed as requiring special attention. For example, the Shipping Act of 1916 was updated by the Shipping Act of 1984. The 1984 Act allowed shipping companies to fix prices, coordinate schedules and share revenues based on the premise that there existed an inelastic amount of available tonnage. A large number of companies quickly opted for the protection offered by the revamped carveouts.[101]

A2.2 Exemptions contained in U.S. antitrust laws generally and in specific trade regulation statutes[102]

[101] Theodore P. Kovaleff, "The Reagan Revolution", in T.P. Kovaleff, ed., *The Antitrust Impluse: An Economic, Historical and Legal Analysis*, Vol. I, New York: Sharpe, 1994, p.222.

[102] Note that exemptions in this sub-section are drawn from U.S. antitrust laws generally and are not just limited to vertical practices. Source: Julian O. von Kalinowski, Peter Sullivan and Maureen McGuirl, *op. cit.*, 1994.

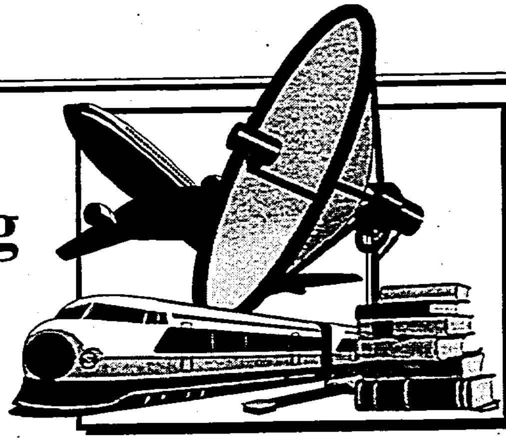
INDUSTRIES EXEMPTED from ANTI-TRUST LAWS in the U.S.



Agriculture

Popular Name	Citation	Type of Business or Practice Affected
Agriculture Adjustment Act of 1933, Sec. 8(b), & 1935 Amendments, Sec. 57	7 U.S.C. § 608 (b) § 852	Exempt are specific marketing agreements or orders made by the Secretary of Agriculture under the Act.
Agriculture Fair Practices Act of 1967, Sec. 5	7 U.S.C. § 2304	Handlers and producers permitted to select their customers and suppliers on the basis of producer's membership in or contract with an association of producers; handler not required to deal with an association of producers.
Agriculture Marketing Agreement Act of 1937, Sec. 3	7 U.S.C. § 671	Exempt are meetings, awards and agreements approved by the Secretary of Agriculture.
Capper-Volstead Act	7 U.S.C. § 291, 292	Limited antitrust exemption for agriculture cooperatives
Clayton Act, Sec. 6	15 U.S.C. § 17	Existence and operation of labour, agricultural and horticultural organizations - general exemption from antitrust laws.
Cooperative Marketing Act of 1926, Sec. 5	7 U.S.C. § 455	Dissemination of crop, marketing, statistical and similar information by cooperative marketing associations authorized.
State Tobacco Compacts Act	7 U.S.C. §§ 515-515(k)	State permitted to negotiate compacts "for the purpose of regulating and controlling the production of or commerce in" tobacco in order to "enable growers to receive a fair price for such tobacco"; provided that such compacts are not "for the purpose of fixing prices thereof, or to create or perpetuate monopoly, or to promote regimentation".

Transportation, Publishing and Communications



Popular Name	Citation	Type of Business or Practice Affected
Automobile Dealer Franchise Act, Sec. 4	15 U.S.C. § 1224	Franchise automobile dealers can bring suit in federal district courts to recover damages from automobile manufacturers for wrongful termination of franchises / bad faith dealings.
Automotive Products Trade Act of 1965, Sec. 503	19 U.S.C. § 2033	Not available
Clayton Act, Sec. 7 (fourth paragraph)	15 U.S.C. § 18	Common carrier's right to own stock of branch lines exempt from Sec. 7 prohibitions.
Federal Aviation Act of 1958, Secs. 408, 409, 412 and 414	49 U.S.C. §§ 1378, 1379, 1382 1384	Sec. 408 refers to air carrier consolidation, merger and acquisition of control. Sec. 409 refers to inter-locking relationships. Sec. 412 refers to pooling and other agreements. Sec. 414 exempts persons affected by orders made under Sections 408, 409 and 412; such persons are "relieved from the operation of the antitrust laws".
Interstate Commerce Act Sec. 5(1)	49 U.S.C. § 5(1)	Interstate Commerce Commission (ICC) may approve certain poolings or divisions by-laws of traffic, service or earnings which will be in the interest of better service to public or economy.
Interstate Commerce Act	49 U.S.C. § 5(2)(a)	If ICC approves, carriers may consolidate or merge with other carriers; or purchase properties of another, or acquire control of another.

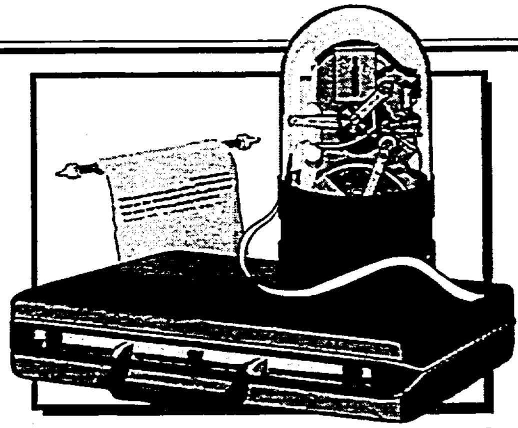
Continued ....

Popular Name	Citation	Type of Business or Practice Affected
Interstate Commerce Act Sec. 5(10)	49 U.S.C. § 5(10)	ICC's approval not required for Sec. 5(2) transactions when only parties are motor carriers operating not more than twenty vehicles of street, suburban or interurban railways.
Interstate Commerce Act Sec. 5(11)	49 U.S.C. § 5(11)	Parties to transactions approved pursuant to Sec. 5 are "relieved from the operation of the antitrust laws and of all other restraints, limitations and prohibitions of law, Federal, State or municipal, insofar as may be necessary to enable them to carry into effect the transaction so approved.
Merchant Marine Act of 1920, Sec. 29(b)	46 U.S.C. § 885(b)	Transactions by marine insurance associations of marine insurance and reinsurance business not illegal under antitrust laws.
Shipping Act of 1916, Secs. 14b, 15	49 U.S.C. §§ 813a-814	Agreements by water carriers must be submitted to the Federal Maritime Board and are exempted from the Sherman Act, Wilson Tariff Act and "amendments and Acts supplementary thereto".
Rail Passenger Service Act of 1970, Secs. 306(e)	Pub. L. 91-518, 84 Stat. 1327	Sec. 306(e) exempts from all prohibitions of existing law, including the antitrust laws, all persons contracting with the National Railroad Passenger Corporation for the joint use or operation of such facilities and equipment as may be necessary for the provision of efficient and expeditious passenger service.
Reed-Bulwinkle Amendments, Sec. 5a(6), (9)	15 U.S.C. § 5a(6), (9)	If Interstate Commerce Commission approves agreements between two or more carriers relating to rates, fares, etc., then such carriers are "relieved from the operation of the antitrust laws with the respect to the making of such agreement in conformity with its provisions".

Continued ....

Popular Name	Citation	Type of Business or Practice Affected
Reed-Bulwinkle Amendments, Sec. 22(26)	49 U.S.C. § 22(2)	Applies Sec. 5a(9) antitrust immunity to agreements relating to quotation of reduced rates for transportation of property or persons for United States Government.
Newspaper Preservation Act (of July 24, 1970)	Pub. L. 91-353, 84 Stat. 466	Sec. 4(a) of the Act provides that it shall not be unlawful under any antitrust law (including the FTC Act) for any person to perform, enforce, renew or amend any joint newspaper operating arrangement entered into prior to July 24, 1970 if at the time of the arrangement not more than one of the newspaper publications involved was likely to remain or become a "financially sound publication". Similar arrangements entered into on or after July 24, 1970 are made unlawful except with the prior written consent of the Attorney General. The Attorney General is authorized to grant such approval only if he determines that not more than one of the newspapers involved is a publication other than a failing newspaper.
Communications Act of 1934, Secs. 212, 221(a), 222(b), (c), 313(a), 314	47 U.S.C.	Section 212 prohibits interlocking directorates among common carriers except as authorized by order of Federal Communications Commission (FCC). Sec. 221(a) authorizes the FCC to rule on consolidations or acquisitions of property or securities of telephone companies. Sec. 222(a) and (c) give the FCC similar authority with respect to transactions involving telegraph carriers.
Professional Sports Telecasting Act	15 U.S.C. §§ 2291-1295	Sec. 1 provides limited exemption for certain professional team sports (football, baseball, basketball and hockey) by authorizing member clubs of a league to negotiate as a package. Additionally, Sec. 1 exempts, under certain specified conditions, professional football mergers from the application of the same antitrust laws.

Finance and Insurance

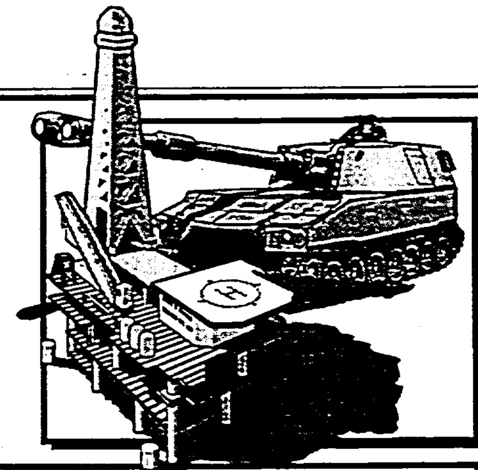


Popular Name	Citation	Type of Business or Practice Affected
Clayton Act, Sec. 7 (third paragraph)	15 U.S.C. § 18	Purchases solely for investment — exempted from Sec. 7 merger provisions.
Federal Reserve Act, Sec. 25(a)	12 U.S.C. § 615	The Act regulates banking corporations in their foreign banking business. Sec. 25(a) provides that nothing in the Act shall prevent such corporations "from purchasing and holding stock in any corporation where such purchase shall be necessary to prevent a loss upon a debt previously contracted in good faith".
McCarran-Ferguson Act (Insurance Antitrust Moratorium Act)	15 U.S.C. §§ 1011-1015	Insurance activities regulated by state law exempt from Sherman, Clayton and Federal Trade Commission Acts — except the agreement or act to boycott, coerce or intimidate not exempt from Sherman Act prohibition.
Public Utility Holding Company Act of 1935	15 U.S.C. § 79a *et seq.*	Sec. 3 of the Act authorizes the Securities and Exchange Commission to make particular exemptions regarding holding companies, subsidiary companies and affiliates. Sec. 10 authorizes the Commission to approve certain acquisitions of securities, utility assets and other interests.

Food,
Fisheries and Beverages

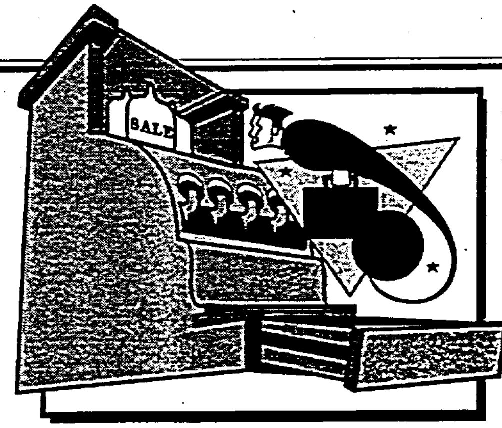
Popular Name	Citation	Type of Business or Practice Affected
Federal Alcohol Administration Act Sec. 5 and 8	27 U.S.C. §§ 205, 208	Sec. 8(a) prohibits certain interlocking directorates between affiliates. Exceptions to this are in sec. 8(b), which prescribes four situations in which an individual may take office as an officer or director of two or more affiliated distillers.
Fishermen's Collective Marketing Act	15 U.S.C. §§ 521-522	Independent fishermen's organizations of cooperative associations exempt from antitrust laws.
Soft Drink Interbrand Competition Act of 1980	15 U.S.C. ss. 3501-3503	The Act authorizes use and enforcement of territorial restrictions in trademark licensing agreements for the manufacture, distribution and sale of trademarked soft drink products. Territorial restrictions may be found unlawful if the products covered by the agreements are not in "substantial and effective competition with other products of the same general class in the relevant market or markets" (s. 3501).

Defence and Energy



Popular Name	Citation	Type of Business or Practice Affected
Federal Power Act, Sec. 10(h)	16 U.S.C. § 803 (h)	Exemption is contained in sec. 7 of Clayton Act (sixth paragraph), which exempts from that statute's anti-merger provisions "transactions duly consummated pursuant to authority given" by certain specified agencies, such as the Federal Power Commission's authority to issue licenses for developing water power.
Defence Production Act of 1950, as amended, Sec. 708	50 U.S.C. § 2158	President of the United States may encourage defence suppliers to enter into voluntary agreements and programs to promote national defence.
Small Business Act, Secs. 7, 9, 11	15 U.S.C. §§ 636, 638, 640	Permits small businesses to pool their defence supply activities upon finding that such pooling would promote U.S. national defence; exempts certain loans to small business concerns (exemption from prohibition of anti-trust laws as well as of Federal Trade Commission Act); exempts certain R&D agreements; exempts certain voluntary agreements and programs.

Wholesale, Retailing and Trade



Popular Name	Citation	Type of Business or Practice Affected
Fair Packaging and Labelling Act	15 U.S.C. §§ 1451-1461	Exemptions are available for certain wholesale or retail distributors, and certain commodities which the Secretary of Health, Education and Welfare or Federal Trade Commission deems do not have to be regulated under the Act "for good and sufficient reasons"
McGuire Fair Trade Act (Amendment to Sec. 5 of Federal Trade Commission Act)	15 U.S.C. § 45 (a) (2)-(5)	Resale price maintenance contracts and agreements — limited exemption under FTC Act.
Miller-Tydings Act (Amendment to Sec. 1 of Sherman Act)	15 U.S.C. § 1	Resale price maintenance contracts and agreements — limited exemption under Sherman Act.
Safeguarding U.S. Balance of Payments Position	31 U.S.C. §§ 931-937	Purpose of Act is to provide for exemptions from the anti-trust laws and the Federal Trade Commission Act to assist in safeguarding the balance of payments position of the U.S.
Webb-Pomerene Act	15 U.S.C.	Limited exemption for cooperative activity among American exporters for purpose of promoting American foreign trade.

A3. Japan

A3.1 Products exempted from the illegality of resale price maintenance[103]

As discussed in the Chapter 4, in Japan 40 years ago a number of products were declared exempt and unchallengeable as a RPM violation of the AML. The list of exempted products was revised in 1973. In April 1993, the RPM exempted designations for 13 "cosmetics" and 12 "general non-prescription drugs and remedies" products were removed. The following is a list of the remaining RPM exempt products.

RPM Exempt Cosmetics

- Hair conditioners
- Hair sprays
- Creams
- Foundations
- Cosmetic water
- Lipsticks
- Lip creams
- Hair removers

RPM Exempt "General Non-Prescription Drugs and Remedies"

- Fever and pain killers
- Ordinary cold remedies
- Eye medications
- Cardiotonic drugs
- Dental and other oral medications
- Stomach medications
- Laxatives and enemas
- Bowel regulators
- General digestive medications
- Hemorrhoidal medicines
- Skin antiseptics
- Painkillers, rash ointments, astringents, antiphlogistics
- Parasitic skin disease drugs

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[103] Fair Trade Commission of Japan, Annex to "Revision of Designated Resale Products", April 15, 1992 (in Japanese).

- Other skin medications
- Multiple vitamin complexes (excludes Vitamin A and D complexes)*
- General metabolic formulations*

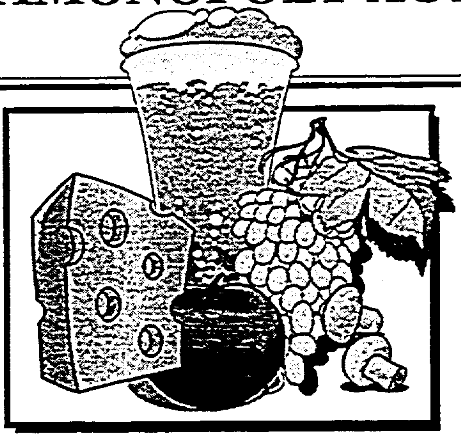
Note that the last two products marked with an asterisk (*) are scheduled to go off the RPM exempt list on 1 January 1995. All other products in the above list will be reviewed in 1998.

A3.2 Sectoral-related exemptions from the Antimonopoly Act

Exemptions listed in this sub-section are drawn from all sorts of business practices, and not just vertical arrangements, relevant for the Japanese Antimonopoly Law. Note that, in the following pages, the column entitled "Ministry/Business" means that a Ministry concerned has to be contacted by a company wishing to apply for the exemption in the manner specified in the column. Similarly, the column entitled "Ministry/FTC" outlines the exemption process that may be initiated by the Ministry concerned with the FTCJ. Asterisks (*) indicate one of the following two points: (i) either a company may contact the concerned Ministry <u>or</u> the Ministry gets in touch with the company in the exemption process; (ii) either a Ministry concerned contacts the FTCJ <u>or</u> the FTCJ may contact the Ministry.

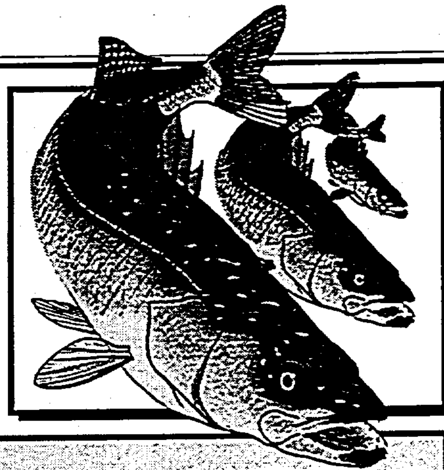
INDUSTRIES EXEMPTED from ANTIMONOPOLY ACT in JAPAN

Agriculture, Food and Beverage



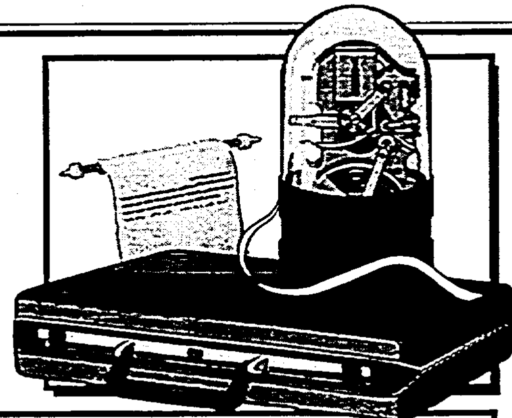
Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Agriculture Cooperative Societies Act (Nov. 19, 1947 / No. 132)	1. Joint Economic Business (9)	1947	None	None
Staple Food Control Act (Feb. 21, 1942 / No. 40)	2. Practices based on processing, manufacturing, and other directives (9)	1947	None	None
Tobacco Producers Cooperative Societies Act (May 2, 1958 / No. 135)	3. Joint Economic Business (9)	1958	None	None
Law for Special Measures to Promote Fruit Culture (May 30, 1961)	4. Decision concerning marketing of fruit (5(3))	1966	Prior - notice	Notification
Law Concerning Stable Prices for Sugar (Jun. 2, 1965 / No. 109)	5. Recession cartel (17)	1965	Indication Notice	Consultation Notification
Law Concerning Preservation of Liquor Tax and Liquor Cooperatives (Feb. 28, 1953 / No. 7)	6. Excessive competition ban cartel (93)	1953	Permission	Agreement
	7. Rationalization cartel (93)	1959	Permission	Agreement
	8. Consolidation of resale price maintenance contracts	1959	Permission	Agreement

Fisheries



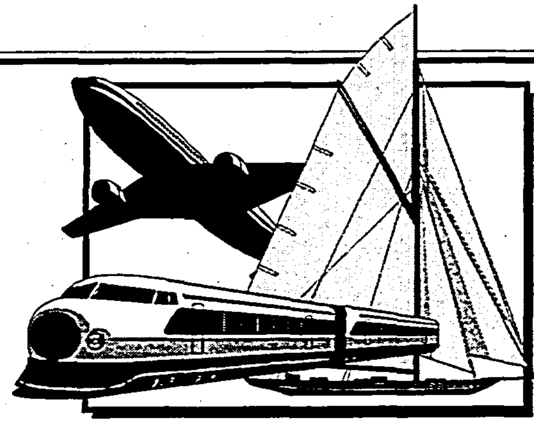
Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Fisheries Cooperative Societies Act (Dec. 15, 1948 / No. 242)	9. Joint Economic Business (7)	1948	None	None
Law Concerning Promotion of Export Fisheries (Jun. 2, 1954 / No. 154)	10. Primary resource purchasing cartel (27)	1957	Permission	Consultation
	11. Export competition ban cartel (27)	1954	Prior - Notice	Notification
	12. Specified institutions (27)	1957	Permission	Consultation
Cooperative Societies for Fishing Productions Adjustment Act (Jun. 13, 1961 / No. 128)	13. Excessive competition ban cartel (79)	1961	Permission	Consultation
Law for Temporary Measure for Pearl Cultivation and Other Adjustment (Dec. 18, 1969 / No. 96)	14. Excessive competition ban cartel (98)	1969	Permission	Consultation (Agreement for price and quantity)
	15. Quality assurance and improvement cartel (98)	1969	Permission	Consultation
	16. Equipment restriction cartel (98)	1969	Instructive Notice	Consultation Notification
Law for Special Measures for Reconstruction and Adjustment of Fishing Industry (Jun. 1, 1976 / No. 43)	17. Equipment restriction cartel (15)	1976	Permission	Consultation

Finance and Insurance



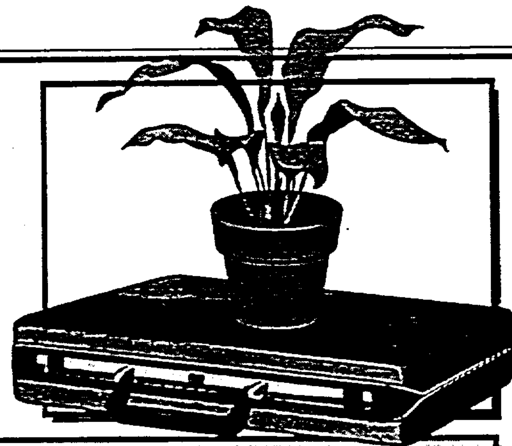
Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Credit Association Act (Jun. 15, 1951 / No. 238)	18. Joint Economic Business (7)	1951	None	None
Workers' Credit Union Act (Aug. 17, 1953 / No. 227)	19. Joint Economic Business (9)	1953	None	None
Law Concerning Non-life Insurance Actuarial Groups (Jul. 29, 1948 / No. 193)	20. Insurance premium cartel	1948	Permission	None
Fishing Boat Accident Relief Act (Mar. 31, 1952 / No. 28)	21. Insurance premium cartel (Chapter 4 Section 1)	1952	None	None
Insurance Act (Mar. 29, 1939 / No. 41)	22. Insurance cartel (12(3))	1951	Notice for decreed items	Consultation for decree
Law Concerning Foreign Insurance Companies (Jun. 1, 1959 / No. 184)	23. Insurance cartel (19) (Application of Insurance Act regulations)	1951	Notice for decreed items	Consultation for decree
Securities Investment Trust Law (Jun. 4, 1951 / No. 198)	24. Trust companies use trust assets to acquire or own stock (25)	1951	None	None
Stock Company Reorganization and Rehabilitation Act (Jun. 7, 1952 / No. 172)	25. Acquiring stock of reorganized companies (265)	1952	None	None
Small Business Development and Joint Stock Company Act (Jun. 10, 1963 / No. 101)	26. Trading and ownership of stock of small business	1977	None	None

Transportation



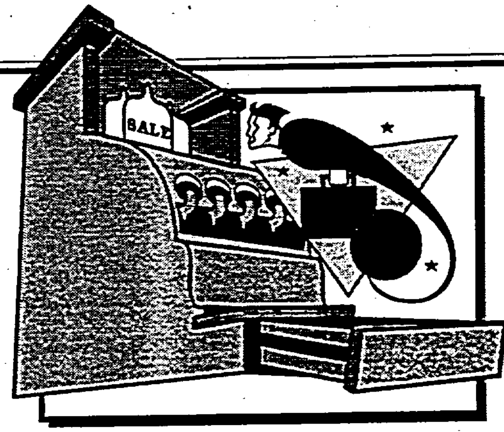
Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Surface Transport Business Adjustment Act (Apr. 2, 1938 / No. 71)	27. Transport cartel (2(1)(vi,vii);2(2))	1947	Decree Permission	None
Road Transport Act (Jun. 1, 1951 / No. 183)	28. Transport cartel (19)	1951 (1947)	Permission (Can be decreed)	None (None)
Merchant Marine Act (Jun. 1, 1949 / No. 187)	29. Shipping cartel (28)	1949	Pre-notice	Remitted (Regulations)
	30. Harbour-related cartel (30(2))	1951	Pre-notice	Remitted (Regulations)
Aviation Act (Jul. 15, 1952 / No. 231)	31. Airline cartel (111,122(1))	1952	Permission	None
Harbour Transportation Act (May 29, 1951 / No. 161)	32. Harbour Transportation cartel (19)	1953	Permission	Agreement
Coastal Transport Cooperative Societies Act (Jun. 1, 1957 / No. 162)	33. Shipping cartel (18(1))	1957	Permission	Notification
Automotive Terminal Act (Apr. 15, 1959 / No. 136)	34. Transport cartel (28) (Application of regulations of Road Transport Act)	1959	Permission	None
Truck Carrier Act (Dec. 19, 1989 / No. 83)	35. Transport cartel (16)	1989	Permission	None

Small
Medium Enterprises



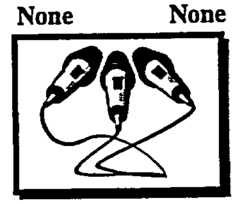
Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Cooperative Societies of Miner Enterprises Act (Jun. 1, 1949 / No. 181)	36. Joint Economic Business (7)	1949	None	None
Matters related to Article 2 of Exemption Act (Sep. 1, 1953 / No. 259) (law 1 System 1)	37. Practices of specific organizations (2(3),(4)) (Groups formed under statute 30, small business mutual aid organizations, and small trade promotion associations)	1953 (1948)	None	None
Law Concerning Organization of Small Enterprises (Nov. 25, 1957 / No. 185)	38. Business stabilization cartel (89(1))	1958 (1952)	Permission	Consultation (Agreement for prices)
	39. Rationalization cartel (89(1))	1962	Permission	Consultation
	40. Special contracts (89(1))	1964	Permission	Consultation
	41. Joint Economic Business (89(3))	1957	None	None
Law Concerning Optimization of Operations of Businesses that Affect environmental Health (Jun. 3, 1957 / No. 164)	42. Excessive competition ban cartel (10(56))	1957	Permission	Consultation

Wholesaling, Retailing and Trade



Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Matters relating to decrees based on the Potsdam Declaration	43. Fair practices according to legal decree or decree as stipulated by a law	1947	-----	-----
Wholesale Market Act (Apr. 3, 1971 / No. 35)	44. Transfers or mergers among wholesalers (29)	1971	Permission	Consultation
	45. Excessive competition ban cartel (29)	1971 (1956)	Permission	Consultation
Cooperative Societies for Retail Store Promotion (May 17, 1962 / No. 141)	46. Joint Economic Business (80)	1962	None	None

Broadcasting



Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Copyright Act (May 6, 1970)	47. Decision on Secondary usage fees of commercial records (95,97)	1970	None	None

Textiles

Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Sericulture Act (Dec. 22, 1945 / No. 57)	48. Decision concerning low prices	1953	Prior- and notice after the fact	None

General

Law (Date of Enforcement)	Nature of Exempted System (Article/Clause of Basic Law)	Year of Exemption	Ministry / Business	Ministry / FTC
Antimonopoly Act (Apr. 14, 1947 / Law 54) (Law 1 System 8)	49. Natural monopoly (21)	1947	None	None
	50. (Fair practices as per Business Act (22)	1947	-----	-----
	51. Intangible property rights (23)	1947	None	None
	52. Uniform union practices (24)	1947	None	None
	53. Resale price maintenance contracts (24(2))	1953	* Notice (No legal resale)	* None
	54. Recession cartel (24(3))	1953	* Permission	* Consultation
	55. Rationalization cartel (24(4))	1953	* Permission	* Consultation
	56. Legal reorganization plan as per business Reconstruction and Adjustment Law (103)	1947	None	None
	57. Reorganization plan as per Financial Institution Reconstruction and Adjustment Law (103)	1947	None	None
Law Concerning Optimization of Operations of Businesses that Affect Environmental Health (Jun. 3, 1957 / No. 164)	58. Excessive competition ban cartel (10(56))	1957	Permission	Consultation
	59. Special contracts (13(14))	1964	Permission	Consultation

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