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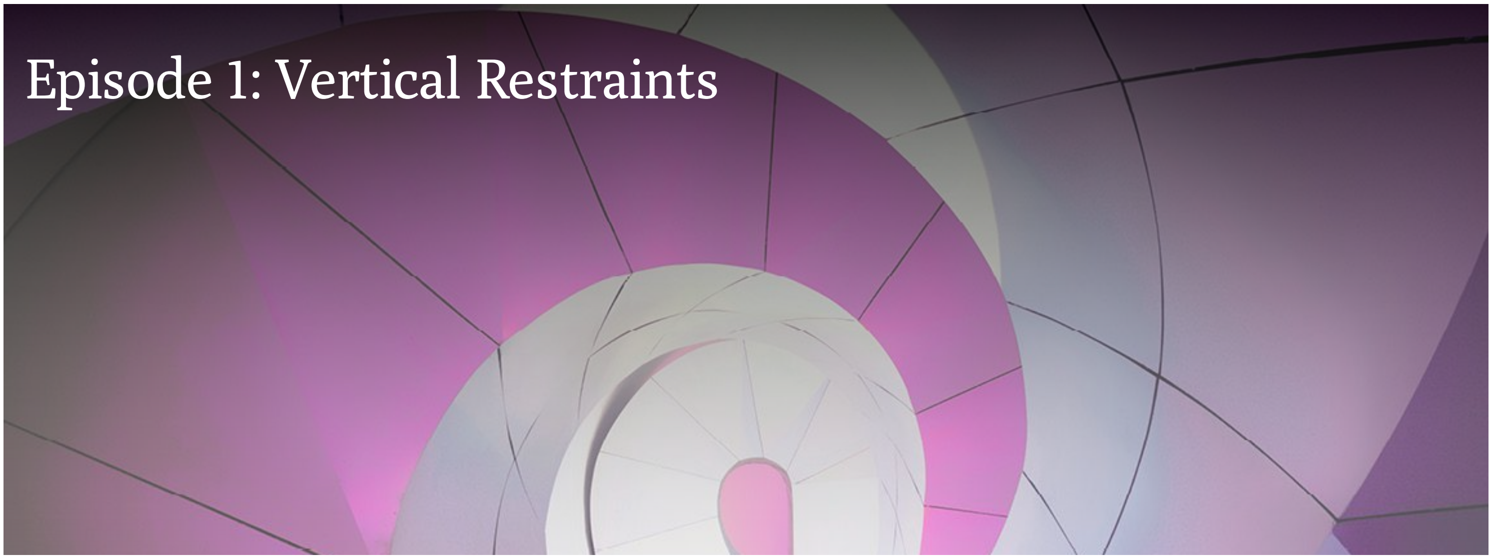
Episode 1: Vertical Restraints



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We are focusing our first episode on vertical restraints, as we understand this as an area of concern particularly for foreign companies trying to make sense of what types of vertical restraints are okay or not okay from a U.S. perspective. My name is Molly. I'm today's host and a partner in the New York office of Winston & Strawn.

Today we'll be speaking with Susannah Torpey. She has extensive experience in the area of vertical restraints. Susannah is also a partner in the New York office. She has over a decade of experience representing major U.S. and multinational corporations in high stakes antitrust class actions, high-tech competitor disputes, and international investigations. Susannah also counsels businesses regarding the minimization of antitrust risk, and evaluates board and other corporate activities for antitrust compliance. Susannah joins us today to share her expertise on vertical restraints under U.S. law and recent developments in this area. Susannah, thanks so much for joining us.

Susannah Torpey: My pleasure.

Before we jump into the latest antitrust developments, could you give us a quick overview on what are vertical restraints?

Susannah Torpey: Sure. Broadly speaking, within antitrust law, there are two types of agreements, understandings, or other anti-competitive measures that can have the effect of restraining trade. These are vertical restraints and horizontal restraints. A vertical restraint is an agreement undertaken at different levels of production, distribution, or supply. If you have an anti-competitive agreement between a manufacturer and distributor, for example, that would be a vertical restraint. This is different from a horizontal restraint, which is an agreement between competitors at the same level of production, distribution, or supply. For example, one manufacturer entering into an anti-competitive agreement with another manufacturer.

You mentioned anti-competitive agreements. Could you elaborate on what exactly you mean by that?

Susannah Torpey: I say "anti-competitive" because vertical restraints can influence competition in different ways. They can increase competition between competitors, or they can restrain competition. Antitrust law focuses on the vertical restraints that are anti-competitive in that, on balance, they hurt competition more than they help competition.

Vertical agreements can raise prices, limit output, restrain or exclude competitors, or decrease the available variety of products or services. Any agreement, understanding, or measure that unreasonably restrains competition in this way could be anti-competitive.

So it seems that you're categorizing vertical restraints into price-based restraints and then restraints that are not based on price.

Susannah Torpey: Generally, yes.

Okay. So let's start with the price-based restraints. Could you provide some common examples?

Susannah Torpey: A common type of price-based vertical restraint is something known as resale price maintenance. Resale price maintenance refers to an agreement between a manufacturer and a distributor or another reseller, or an agreement between other resellers in a distribution chain, that sets or affects the price at which products must be sold. This would include situations where the manufacturer or distributor is in Taiwan, and the Taiwanese entity agrees with the retailer in the U.S. about the price at which products must be sold.

Are resale price maintenance agreements illegal?

Susannah Torpey: They can be but are not always, depending on where the products are being sold. Resale price maintenance agreements can set either a minimum or maximum price for resale. U.S. antitrust laws are typically concerned with an agreement that sets a minimum price. Anytime an agreement sets a minimum price, it can run afoul of U.S. competition laws, but not necessarily anymore. This is because of a 2007 decision from the United States Supreme Court that changed the law in the United States. The original rule, which the Supreme Court established in 1911, was that a minimum resale price agreement was *per se* illegal under Section 1 of the Sherman Act. That means the existence of an agreement automatically means there is an antitrust violation. It doesn't matter if the agreement actually stimulates competition or has pro-competitive effects that are in the consumers' best interest. Under a *per se* rule, as long as there's an agreement, there's an antitrust violation.

Okay, but the *per se* rule is no longer in effect. Is that what you said?

Susannah Torpey: Under federal U.S. law, that is correct. The *per se* rule no longer applies to resale price maintenance agreements. In 2007, the Supreme Court revisited its 1911 decision and overturned it. This happened in a case called *Leegin Creative Leather Products v. PSKS*.

In *Leegin*, the Court announced a new rule to replace the *per se* rule for courts to use when evaluating whether resale price maintenance agreements violate Section 1 of the Sherman Act. Under the new rule, resale price maintenance agreements should be judged by what's known as the "rule of reason," which is the standard that usually applies when evaluating whether some vertical restraints violate Section 1.

And how does the rule of reason work in this context?

Susannah Torpey: A resale price maintenance agreement is now illegal only if it imposes an unreasonable restraint on competition. This is similar to the law in several other jurisdictions, including Taiwan. The Taiwan Fair Trade Act, for instance, prohibits restrictions on resale prices, but makes an exception for those with justifiable reasons. The Fair Trade Commission can therefore evaluate evidence from businesses to decide if a restriction is justified, for instance, if the restriction stimulates downstream business, encourages new market entrants, or promotes inter-brand competition.

The considerations in the U.S. are similar. The Supreme Court has repeatedly held that Section 1 of the Sherman Act prohibits only unreasonable restraints on competition, not all restraints on competition. So under the rule of reason, when deciding whether some agreement, understanding, or other practice violates Section 1, the fact finder weighs all of the circumstances of a case to determine whether the restrictive practice imposes an unreasonable restraint on competition and should therefore be prohibited. Circumstances that the fact finder should consider, for example, include information about the relevant business, the history, nature, and effect of the restraint, and whether the businesses involved have market power.

The rule of reason basically allows courts to distinguish between restraints that have anti-competitive effects and harm the consumer on the one hand, and restraints that actually stimulate competition and are in the consumer's best interest on the other hand.

So when evaluating vertical constraints, do courts simply use the same rule of reason analysis they would use in the context of a restraint that's horizontal?

Susannah Torpey: The analysis is similar, but a recent decision from the Supreme Court, *American Express*, highlights one difference. The first step in a rule of reason analysis is for the plaintiff to show that the restraint has a substantial anti-competitive effect that harms consumers. Whereas plaintiffs could previously meet this burden by showing harm, such as price increases, without necessarily having to show market power in a relevant market, the court clarified in *American Express* that in the vertical restraint context, plaintiffs must first establish the existence of market power in a relevant market. This is because the court recognized that vertical restraints often pose no risk to competition unless the entity imposing them has market power, which is not necessarily true in the context of horizontal restraints.

So then under U.S. Law, what is a "relevant market"?

Susannah Torpey: The relevant market in an antitrust case consists of a product market and a geographic market. Generally speaking, the relevant product market includes all the firms selling a product or service and any close substitutes for that product or service that would be reasonably interchangeable in the eyes of the consumers. The relevant geographic market is generally the geographic area in which the firm in question and its competitor firms compete for customers of the particular product that is the focus of the case.

Susannah Torpey: The *Texaco v. Dagher* case decided by the Supreme Court in 2006 provides an example of how relevant markets can vary depending on the type of competition in the market. In that case, two gas companies—Texaco and Shell—collaborated in a joint venture to refine and sell gasoline in the Western United States. The joint venture would market gasoline products under the Texaco and Shell brands, and the gas would be priced the same under both brands, which led to a class action alleging unlawful price-fixing.

Susannah Torpey: The court identified the relevant market as the market for gasoline sales to gas stations in the Western United States. The market was limited to the Western United States because, as a practical reality, the competitive forces and competitors were different in other parts of the United States. So for example, customers who were in the Midwest would not travel across a mountain range to look for alternative gas suppliers in the Western U.S.

So that's helpful. And I'm understanding by what you're saying that *American Express* does clarify to some extent how the rule of reason, would apply to a vertical restraint, but I also understand there's still quite a bit of uncertainty. So what's the uncertainty that remains?

Susannah Torpey: You know, that's right. And *American Express* doesn't entirely clear up the confusion, so some still remains. Going back to resale price maintenance, which is not the type of agreement involved in *American Express*, courts and scholars have debated the contours of a rule of reason analysis since *Leegin* was decided over 10 years ago. On the federal side, courts have certainly discussed *Leegin*, but there actually haven't been many district court decisions analyzing resale price maintenance agreements under the rule of reason.

The Department of Justice's Antitrust Division and the Federal Trade Commission, which are the U.S. antitrust enforcement authorities, have acknowledged the need for clarity in this area but have provided little guidance. In

2009, the then head of the Antitrust Division proposed a new structured rule of reason approach to guide courts, but she acknowledged the possibility that a framework for analyzing resale price maintenance under the rule of reason might not ultimately succeed. More recently in 2014, a former FTC commissioner stressed the need for a structured rule of reason analysis that matches the economic evidence.

There has even been uncertainty as to when the rule of reason applies. So take, for example, the Second Circuit's split decision in a 2015 case involving Apple's agreements with major book publishers to raise prices of eBooks. The majority in that case recognized that horizontal agreements are *per se* unlawful, while vertical agreements are subject to a rule-of-reason analysis. The majority, however, noted that the distinction is sharp in theory, but figuring out whether an agreement is horizontal or vertical can be difficult as a matter of fact in terms of more than simply identifying whether the participants are at the same level of the market structure. The majority ultimately concluded that Apple's agreements were *per se* unlawful because the vertical agreements were used to facilitate horizontal cartel activity. In the dissent's view, however, the vertical agreements fell squarely within *Leegin* and should have been analyzed under the rule of reason even if the vertical agreements facilitated horizontal agreements.

The most important thing to keep in mind when entering into vertical agreements is that they could still be treated as *per se* unlawful if they're used to facilitate So it sounds like the federal courts are still struggling with the application of *Leegin*. Have the states weighed in at all?

Susannah Torpey: On the state side, several states have actually rejected *Leegin* altogether, like Maryland and California. Maryland has amended its antitrust statute to treat resale price maintenance agreements as *per se* illegal. California's antitrust statute has always treated resale price maintenance agreements as *per se* illegal. And since *Leegin*, the California attorney general has consistently taken the position that *Leegin* did not change the law in California.

To give an idea of how states view *Leegin*, Congress considered legislation in 2011 to overturn *Leegin* and declare minimum resale price maintenance agreements *per se* unlawful. This legislation wasn't enacted, but 41 state attorneys general wrote to Congress supporting the legislation.

What does all of this uncertainty mean in practical terms for foreign businesses and the law firms that represent them?

Susannah Torpey: From a U.S. perspective, given the uncertainty in the law and potential differences between state and federal law, businesses should carefully evaluate the antitrust risks anytime they're considering implementing a resale price maintenance policy or entering into a resale price maintenance agreement if it involves products sold in the United States. For instance, how would a resale price maintenance agreement stimulate competition? What are the pro-competitive reasons for the resale price maintenance agreement? Are there any illegal motivators behind this decision, like artificially elevating prices or facilitating some horizontal conspiracy? Businesses should also be prepared to defend any resale price maintenance agreements and policies with economic evidence.

It sounds like businesses need to tread pretty carefully in this area when it comes to resale price maintenance agreements. Are there examples of resale price maintenance agreements that the courts or the enforcement authorities have considered fairly recently?

Susannah Torpey: The DOJ recently turned its attention to resale price maintenance agreements in the movie industry. Last year, the DOJ announced that it had opened a review of Paramount consent decrees that have been in place for decades. Paramount, the film studio, is one of the oldest in Hollywood. In the 1930s, the government began investigating potential antitrust violations in the movie business, and the DOJ ended up suing five major film studios, including Paramount. The government's case was settled in 1940, with consent decrees known as the Paramount consent decrees.

So for over 70 years, the Paramount consent decrees have regulated how certain movie studios distribute films to movie theaters. The decrees ban various practices in film distribution, including resale price maintenance practices, like a movie studio setting a minimum price that a movie theater must charge for movie tickets. The decrees don't have a sunset provision or termination date, and the DOJ opened a review of them as part of a broader initiative to sunset legacy antitrust judgments. In November, the DOJ filed a motion for court approval to terminate the

Paramount consent decrees, which the DOJ believes are no longer necessary for protecting competition in the motion picture industry. So we will need to watch what the court decides to do.

Other than the Paramount consent decrees, there has not been much recent activity from the U.S. antitrust enforcement authorities surrounding resale price maintenance agreements.

Are you aware of any resale price maintenance investigations or lawsuits involving Taiwanese companies?

Susannah Torpey: None come to mind in the U.S., but a Taiwanese electronic manufacturing company, ASUS, was recently fined in the EU for fixing online resale prices along with three other companies from Japan and the Netherlands. These companies manufacture consumer electronics such as kitchen appliances, electric toothbrushes, and computer notebooks and displays, and they sell their products through online retailers. After a year of investigations, the European Commission found that the four companies had engaged in resale price maintenance by setting minimum prices that online retailers must charge for their products. The companies then monitored the resale prices being charged, so when prices dropped below the minimum, they could intervene and request price increases. For this conduct, the companies were fined €111 million in total. Over half of this amount, around €63 million, was fined to ASUS. Notably, this case was the first time in 15 years that the European Commission had fined a company for resale price maintenance activity.

Okay, so we've been talking about price vertical restraints, but I want to use the rest of our time to talk about non-price vertical restraints. If a vertical restraint isn't limiting the prices that can be charged, what is it limiting?

Susannah Torpey: A non-price vertical restraint can limit any kind of activity surrounding competition. One example of a non-price restraint is exclusive dealing, which is when an agreement between a manufacturer and a distributor prevents the distributor from selling the products of a different manufacturer, or when an agreement between a supplier and a manufacturer prevents the manufacturer from buying inputs from a different supplier.

One exclusive dealing case that was recently in the news was the *Qualcomm* case. In 2017, the FTC filed the lawsuit against Qualcomm, the chip manufacturer, claiming that Qualcomm had required Apple to use its chips exclusively in exchange for lower licensing fees, which excluded competitors and harmed competition. This case is still being litigated, but outside of the U.S. lawsuit, Qualcomm has faced scrutiny from antitrust authorities globally. Chinese authorities have fined Qualcomm almost $1 billion for anti-competitive conduct. The European Commission fined Qualcomm $1.2 billion for its exclusive dealing with Apple. And Qualcomm reached a $93 million settlement with the Taiwan Fair Trade Commission to resolve the TFTCs investigation of Qualcomm.

Well, one thing I don't understand about this situation is, aren't exclusive dealing arrangements like the one at issue for Qualcomm, pretty common?

Susannah Torpey: They are common and they're generally lawful, but they can be anti-competitive and must therefore be judged under a rule of reason standard. The same is true for other types of non-price restraints like anti-steering rules which recently garnered the attention of the legal community because they were at the center of the *American Express* case decided by the U.S. Supreme Court in June 2018.

Before we go into the issues in *American Express*, I'll start with some background on credit card transactions. When a merchant makes a sale and the customer pays using a credit card, the merchant pays a fee to the credit card company. Some credit card companies charge higher fees than others, but these companies, of course, still want people to use their credit cards when making a payment rather than using a credit card with a lower fee for the merchant. So some credit card companies that charge higher merchant fees, like American Express, write provisions into their merchant contracts to prohibit the merchant from steering customers to use a credit card with a lower merchant fee.

What this means is, if you go to a convenience store to buy a gallon of milk, the store clerk can't say to you, "We prefer if you use a different credit card," or "If you use a particular credit card, you'll get a 5% discount," or anything like that. Those would be examples of steering, which American Express's contracts prohibit. So the anti-steering provision in American Express's merchant contract is an example of a vertical restraint that is not based on price. It's a vertical restraint because we're talking about an agreement between a credit card company and a merchant, rather than, say, between two credit card companies or between two merchants. And it's a non-price restraint because the provision restricts something other than price. Here it's restricting the merchant's ability to influence a customer's decision to use a particular credit card at the point of sale.

Interesting background. So how did this play out in the courts?

Susannah Torpey: The federal government and several states sued three of the major credit card companies alleging the anti-steering provisions in their merchant contracts unreasonably restrained trade in violation of the antitrust laws. Two of the defendants settled, leaving only American Express. The district court held a seven-week bench trial and ultimately sided with the government plaintiffs. It held that the American Express anti-steering provisions violated Section 1 of the Sherman Act by stifling competition among credit card companies for merchant fees and by stifling competition among credit card companies for consumer purchases.

But on appeal, the Second Circuit reversed. The Second Circuit held that to show harm to competition, it wasn't enough for the government plaintiffs to demonstrate anti-competitive effects on the merchant side alone. They also needed to show that the anti-competitive effects outweighed any benefits on the cardholder side as well.

The Supreme Court affirmed. It agreed that the credit card market is two-sided and both sides—meaning the merchant side and the cardholders side—must be considered. Applying the rule of reason framework, the majority held that the government plaintiffs had not carried the burden of proving anti-competitive effects in the relevant market because they showed only that the anti-steering provisions raised fees to merchants, without addressing any offsetting benefits to cardholders.

So, ultimately, the courts held that the government plaintiffs had not shown that the anti-steering provisions in American Express's credit card contracts with merchants violated Section 1 of the Sherman Act.

What are some takeaways from the *American Express* decision for businesses to keep in mind?

Susannah Torpey: Well, the *American Express* decision is certainly good for defendants as it clarifies that plaintiffs challenging vertical restraints must define the relevant market and presumably show market power in that market before the burden shifts to the defendant to demonstrate a pro-competitive rationale. But businesses should be cognizant that the reach of *American Express* is limited. Not all two-sided platforms will require a court to consider both sides of the market.

One example from the court was the market for newspaper advertisement. The platform is arguably two-sided because the value of an advertisement increases as more people read the newspaper. But this market would still be analyzed as a one-sided market because it behaves like one. Specifically, readers are generally indifferent to the amount of advertising in a newspaper, so the indirect network effects operate in only one direction.

So while it will be tougher for plaintiffs to make a showing of anti-competitive facts in multi-sided markets, that is true only for certain multi-sided markets.

I see we're out of time, but Susannah, I want to thank you so much for joining us today. The information you've provided has been really interesting, and I hope useful to our audience. Thank you for listening, and goodbye.

Speaker

Susannah Torpey

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