

PUTTING CHINA ON THE MAP

Date: 4 April 2018

U.S. Antitrust, Competition & Trade Regulation Alert

By: Michael R. Murphy, Yujing Shu, Christopher S. Finnerty, Caiti A. Zeytoonian

Product manufacturers are always looking to increase revenue by tapping into new markets. In recent years, they've begun to focus their efforts on driving sales in Asia. In particular, the People's Republic of China ("China" or "PRC") offers a unique opportunity for manufacturers to expand their business; while much of the world's consumer sales growth has slowed, China's consumer market continues to grow at a steady pace.

In 2000, less than 1 percent of households in China were considered middle class. [1] A snapshot of the country today offers a stark contrast: the modern Chinese market is comprised of a rapidly growing mass of middle class consumers, poised and ready to engage with the international marketplace. In fact, China boasts the largest middle class population in the entire world, surpassing the United States in 2015. [2] In 2017, China's online retail sales approached US \$1 trillion, solidifying the country as the world's largest e-commerce market. [3] Undoubtedly, China's market promises profitable gains and untapped growth for product manufacturers willing to establish distribution channels in this region. [4]

However, product manufacturers too often delegate control to third-party distributors in this region. Instead of relying on Chinese distributors, manufacturers must proactively establish and monitor direct control over their brands. China's market may be different, but it presents the same dangers of price erosion that product manufacturers face in the United States and the EU. Potential online price erosion in the PRC could have negative impacts on manufacturers both regionally and globally.

To succeed in China, product manufacturers must develop effective and lawful distribution strategies. Most competition law enforcement in China is carried out under the country's Anti-Monopoly Law ("AML"), which was first implemented in 2008. This article aims to address the potential distribution and pricing policies that manufacturers may adopt to combat price erosion under China's newly established regulatory framework.

ADOPTING KEY DISTRIBUTION STRATEGIES IN CHINA

While the PRC offers consistent sales growth for product manufacturers, the nuances of product distribution remain the same: narrow margins, price erosion, and shrinking product life cycles may pose disastrous implications for manufacturers on a global scale. Product manufacturers can combat these risks by implementing thoughtful, tailored distribution strategies that comply with Chinese law. Specifically, this article discusses loss-minimizing distribution and pricing strategies that product manufacturers can use to prevent and offset price erosion. There are three essential components to an effective distribution program: an authorized reseller network, a price maintenance policy, and monitoring and enforcement.

Authorized Dealer Program

By adopting an authorized dealer program, product manufacturers can limit which dealers are permitted to sell their products. This allows manufacturers to increase control over the manner in which their products are sold.

Similarly, through internet authorization, product manufacturers can further control the websites and e-commerce platforms that authorized dealers use to sell their products. Product manufacturers in the United States and Europe routinely use authorized dealer programs and selective distribution strategies to gain control of their online presence and mitigate price erosion. In the United States, manufacturers have the ability to choose *who* they authorize to sell their products and *where* those authorized resellers can sell their products. In the EU, manufacturers may implement authorized dealer networks, albeit with limitations – manufacturers must use objective criteria when selecting distributors; compared to the United States, manufacturers in the EU have far less control over distributors' sales methods. The recent case of *Coty Germany GmbH v. Parfümerie Akzente GmbH* (commonly known as the "Coty" case), decided by the European Court of Justice ("ECJ") in December 2017, suggests that manufacturers of luxury products in the EU may be permitted to prohibit authorized dealers from selling products through third-party internet platforms, so long as policies of this nature are executed uniformly, fairly, and in the least-restrictive manner possible. [5]

There is no prohibition on the use of selective distribution networks or authorized dealer programs in China. China's Anti-Monopoly Law and Anti-Unfair Competition Law ("AUC") suggests that manufacturers will be able to execute these strategies more liberally in the PRC, like we see in the United States currently. [6]

Price Maintenance

Resale price maintenance, or "RPM," allows a product manufacturer to obtain a certain level of control over the price at which its products are advertised and sold. Generally, RPM is achieved through an agreement between a manufacturer and its resellers, or by way of a manufacturer's announcement of a unilateral pricing policy. The AML prohibits "undertakings" that "fix or change commodity prices," "restrict the amount of commodities manufactured or marketed," or "restrict the lowest prices for commodities resold to a third party." [7] In practice, Chinese enforcement agencies have scrutinized resale price maintenance practices under the AML with considerable censure. However, Chinese courts have issued several key decisions suggesting that the use of resale price maintenance agreements in the region is permissible, subject to the court's flexible inquiry.

When the Shanghai Higher People's Court ruled on China's very first vertical monopolistic agreement action – *Rainbow Medical Equipment v. Johnson & Johnson* – onlookers analogized the case to the groundbreaking U.S. antitrust decision, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* [8] Before *Leegin*, vertical price restraints had long been held "per se" illegal in the United States. *Leegin* revolutionized the U.S. antitrust framework by establishing that the legality of such restraints should be evaluated under a flexible "rule of reason" analysis. [9] *Johnson & Johnson* appears to establish a similar shift in China, suggesting that courts will employ a fact-specific "rule of reason" approach when analyzing the legality of resale price maintenance agreements. [10] Still, the use of resale price maintenance agreements carries some risk due to the infancy of China's competition law. [11]

Courts are likely to be less critical of unilateral policy implementation, especially in instances where a product manufacturer does not have a dominant market share. [12] Thus, if product manufacturers are inclined to adopt a pricing policy in China, the safest and most effective strategy available is a unilateral pricing policy. Under a unilateral policy, a manufacturer can announce a minimum advertising or resale price for selected products and refuse to work with resellers who do not acquiesce with the policy. Unilateral policies are not "per se" illegal in China. In fact, because unilateral policies involve only one actor, it seems that they may fall entirely outside the scope of the AML, which focuses on bilateral agreements. As such, the implementation of a unilateral policy

appears to be the most attractive resale price maintenance strategy available to manufacturers. [13] As with any pricing policy, manufacturers must ensure that unilateral polices are implemented and enforced properly in order to maintain legality.

Monitoring and Enforcement

Even the greatest authorization programs and resale price maintenance policies are useless without consistent monitoring and enforcement. Once product manufacturers establish their authorized dealer networks, they must take the necessary steps to monitor and remove unauthorized resellers. Authorized dealer networks provide manufacturers with the tools to remove unauthorized resellers on the market, and resale price maintenance policies enable manufacturers to have additional control over their brand.

CONCLUSION

Competition law in China continues to evolve; however, a variety of options are available for product manufacturers who wish to establish control over their online brand presence today. Manufacturers would be wise to adopt flexible global distribution and pricing strategies that enable growth not just in China, but throughout the world. K&L Gates' Antitrust, Competition & Trade Regulation group has experience designing and implementing coordinated strategies throughout different regions of the world, including Asia, to combat online price erosion.

For more information on the firm's global antitrust and competition law practice, contact Michael R. Murphy (michael.r.murphy@klgates.com) or Christopher S. Finnerty (chris.finnerty@klgates.com).

[1] Dominic Barton, Yougang Chen, and Amy Jin, *Mapping China's middle class*, MCKINSEY QUARTERLY (June 2013), <https://www.mckinsey.com/industries/retail/our-insights/mapping-chinas-middle-class> ("In 2000, less than 1,000 households out of 70,000 were middle class.").

[2] Agency, *China's middle class overtakes US as largest in the world*, TELEGRAPH (Oct. 14, 2015, 7:37 AM), <http://www.telegraph.co.uk/finance/china-business/11929794/Chinas-middle-class-overtakes-US-as-largest-in-the-world.html>.

[3] Zhang Jie, *China's online retail sales near \$1t mark in 2017*, CHINA DAILY (Nov. 14, 2017, 3:25 PM) http://www.chinadaily.com.cn/business/2017-11/14/content_34521308.htm.

[4] On January 18, 2018, the National Bureau of Statistics announced that China's economy expanded 6.9 percent in 2017. See Keith Bradsher, *China's Economic Growth Looks Strong. Maybe Too Strong*, NEW YORK TIMES (Jan. 18, 2018), <https://www.nytimes.com/2018/01/18/business/china-gdp-economy-growth.html>.

[5] See *Coty Germany GmbH v Parfümerie Akzente GmbH*, Case C-230/16 (ECJ Dec. 6 2017), available [here](#).

[6] However, the AUCL does contain an internet-related unfair competition clause, Article 12, which prohibits internet companies from unfairly misleading consumers to buy certain products or services. This could be relevant to the issue of selective distribution on e-commerce platforms. While China's judicial authorities have not yet specifically addressed the issue of selective distribution networks, it seems likely that Chinese courts will give the green light to selective distribution networks absent any unique anticompetitive circumstances.

[7] See People's Republic of China Ministry of Commerce, "Anti-monopoly Law of the People's Republic of China" (Aug. 3, 2008), available [here](#).

[8] See *Beijing Rainbow Yonghe Science and Technology Trade Company v. Johnson & Johnson Medical (Shanghai) Ltd., Johnson & Johnson Medical (China) Ltd.*, (2012) Hu Gao Min San (Zhi) Zhong Zi No.63; see also *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

[9] See generally *Leegin*, 551 U.S. 877.

[10] In *Johnson & Johnson*, the court looked to four factors in order to determine the legality of the resale price maintenance agreement in question: (1) the existence of sufficient competition in the relevant market; (2) whether the defendant has a strong market position (generally met by either a 50 percent share or a combined dominant share with a fellow competitor in smaller, more specific markets); (3) the intentions and purpose behind Defendant's RPM; and (4) the overall effect of the relevant RPM on competition (weighing anticompetitive harm against procompetitive benefits).

[11] While the case suggests a shift in China's judicial framework, cases in local courts are not technically binding in China unless the Supreme Court issues judicial interpretation. Still, the case is likely to be referenced by peer courts. Another recent local case in China suggests that some courts may be more hesitant to employ a fact-specific "rule of reason" approach when analyzing the legality of resale price maintenance agreements. On December 11, 2017, the Hainan Higher People's Court clearly departed from the flexible analysis in *Johnson*, and instead seemed to adopt a "per se" illegality standard in the case of *Hainan Yutai Technology Feed Co., Ltd. v. Hainan Price Bureau*, (2017) Qiong 01 Xing Chu No. 681. In *Hainan*, the Hainan Higher People's Court held that resale price maintenance agreements are prohibited by Article 14 of the AML, and found that the clauses in the plaintiff manufacturer's distributor agreements constituted monopoly agreements. The case suggests that courts may also find resale price maintenance clauses as strictly prohibited monopoly agreements under the AML.

[12] In instances where a manufacturer holds a market dominant position, the implementation of a unilateral policy carries a significant increased risk of violating China's AML.

[13] However, when it comes to unilateral policies, Chinese authorities (such as China's National Development and Reform Commission) seem to be more aggressive than antitrust regulators in the United States.

KEY CONTACTS



MICHAEL R. MURPHY
PARTNER
BOSTON
+1.617.261.3132
MICHAEL.R.MURPHY@KLGATES.COM



YUJING SHU
PARTNER
BEIJING
+86.10.5817.6100
YUJING.SHU@KLGATES.COM



CHRISTOPHER S. FINNERTY
PARTNER
BOSTON
+1.617.261.3123
CHRIS.FINNERTY@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.