

International Antitrust Law and Policy

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Classes 2 & 3: Horizontal Agreements in the US and the EU

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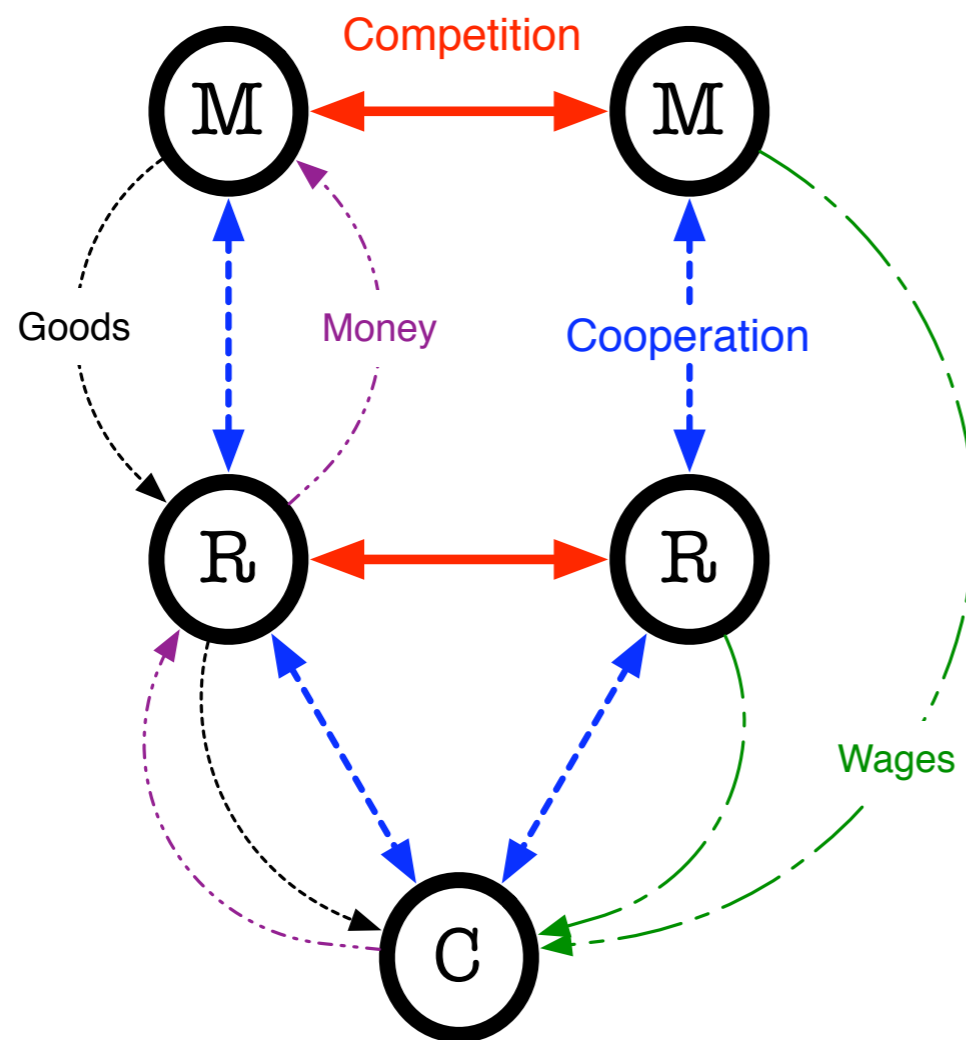


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DRAFT

The normative premise: Compete horizontally, cooperate vertically



- Among the key normative design decisions for a market economy is the “compete horizontally, cooperate vertically” principle
- Firms at the same stage of production, e.g., manufacturers (M) and retailers (R) are supposed to compete
- Firms at different stages of production (M and R) are supposed to cooperate, to move goods from less finished to more finished states
- As a result, antitrust laws treat horizontal agreements with much greater suspicion than vertical agreements
- Competition is usually “competition for cooperation”
- M1 and M2 are both vying for the services of the best retailer, i.e., they compete horizontally for vertical cooperation

“Every contract ... in restraint of trade ... is ... illegal” (§1)

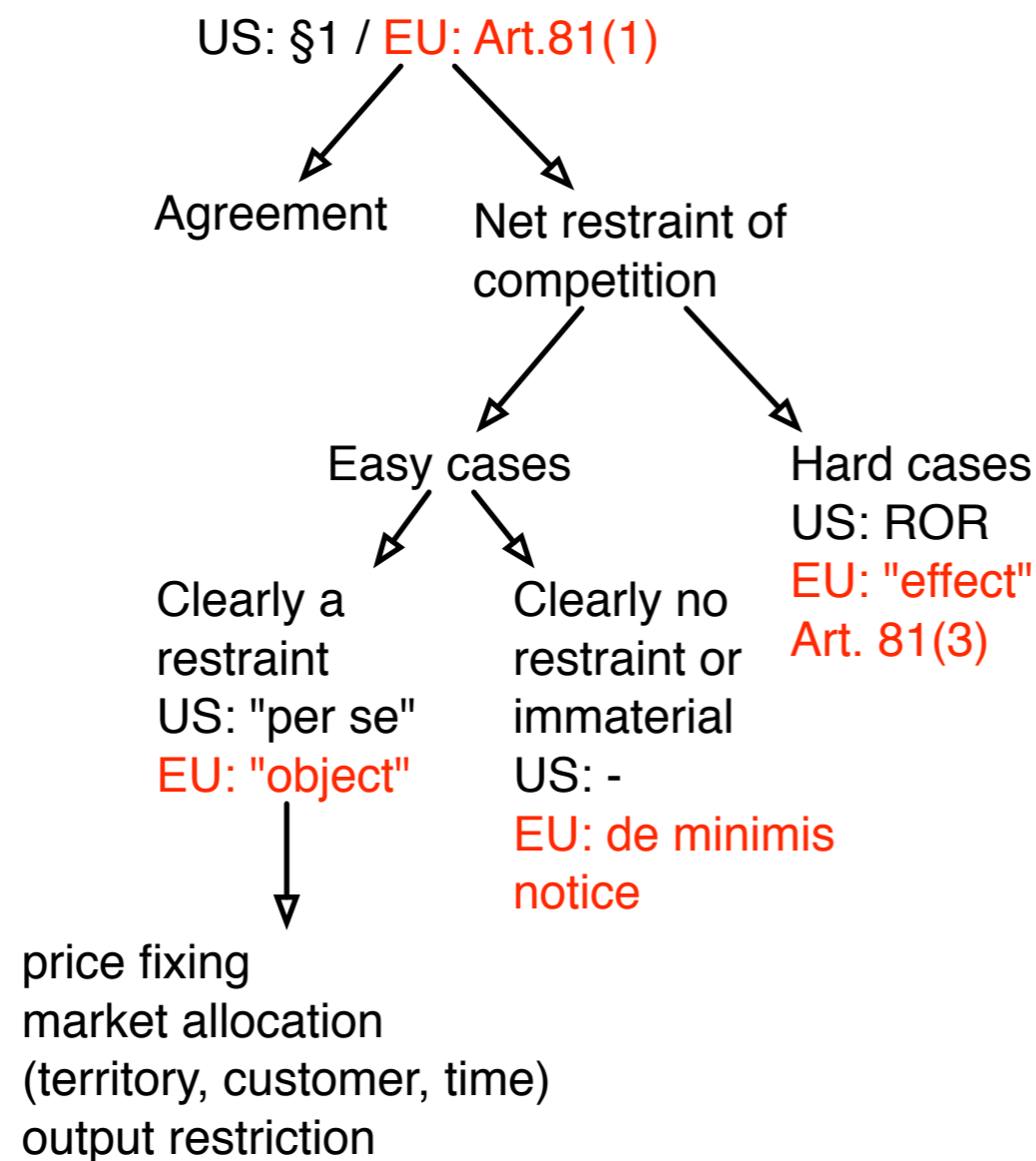
- Agreement (express or implied)
 - Conscious parallelism is not sufficient, e.g., two gas stations across from each other track each others' price movements and make their own judgments with the anticipated reaction of the other in mind. No “agreement.”
- In *unreasonable* or *net* restraint of trade
 - Compare anticompetitive effects (AE) with procompetitive effects (PE)
- Modern reading of §1: “Every agreement for which AE > PE is unlawful.”

Agreements with the object or effect of restraining competition are unlawful. Art. 81(1)

The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:

- (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
- (b) limit or control production, markets, technical development, or investment;
- (c) share markets or sources of supply;
- (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

§1 and Art.81(1)(3) share the same basic structure



See ___ for a discussion of Art. 81(3)

- §1 and Art.81(1)(3) share the same basic two prong structure: agreement, AE>PE test
- The AE>PE test is conceptually simple but very hard to apply in practice as AE and PE are virtually impossible to measure
- A sells his bakery to B and B insists on a non-compete agreement for 5 years. The sale is procompetitive, the non-compete anticompetitive. Looking at the combined agreement is AE>PE or AE<PE?
- To simplify the application of the AE>PE test, courts have grouped agreements into two buckets: easy cases and hard cases
- Only the hard cases deserve an in depth inquiry (rule of reason, discussed later)

No need to prove AE or consider PE for certain “hardcore restraints”

- For certain *categories* of hardcore restraints, the law conclusively presumes that AE > PE (= *per se* illegal)
 - Price fixing, market division (territory, customer, time), naked output restraint, group boycott to defend a cartel
 - This list is virtually identical in the U.S. and in the EU
- Courts and agencies will (generally) consider neither PE nor whether there are, in fact, any AE (*Socony Vacuum, Northern Pacific Railway, Polypropylene*)
 - Double AE + PE presumption in the U.S. Somewhat weaker presumption in the EU.
 - Example: If two hot dog vendors in Central Park agree to charge \$4/dog, they engage in a *per se* illegal price fixing agreement, even though it has virtually no effect. (Note: Could this be the rare case that fails the interstate commerce requirement?)

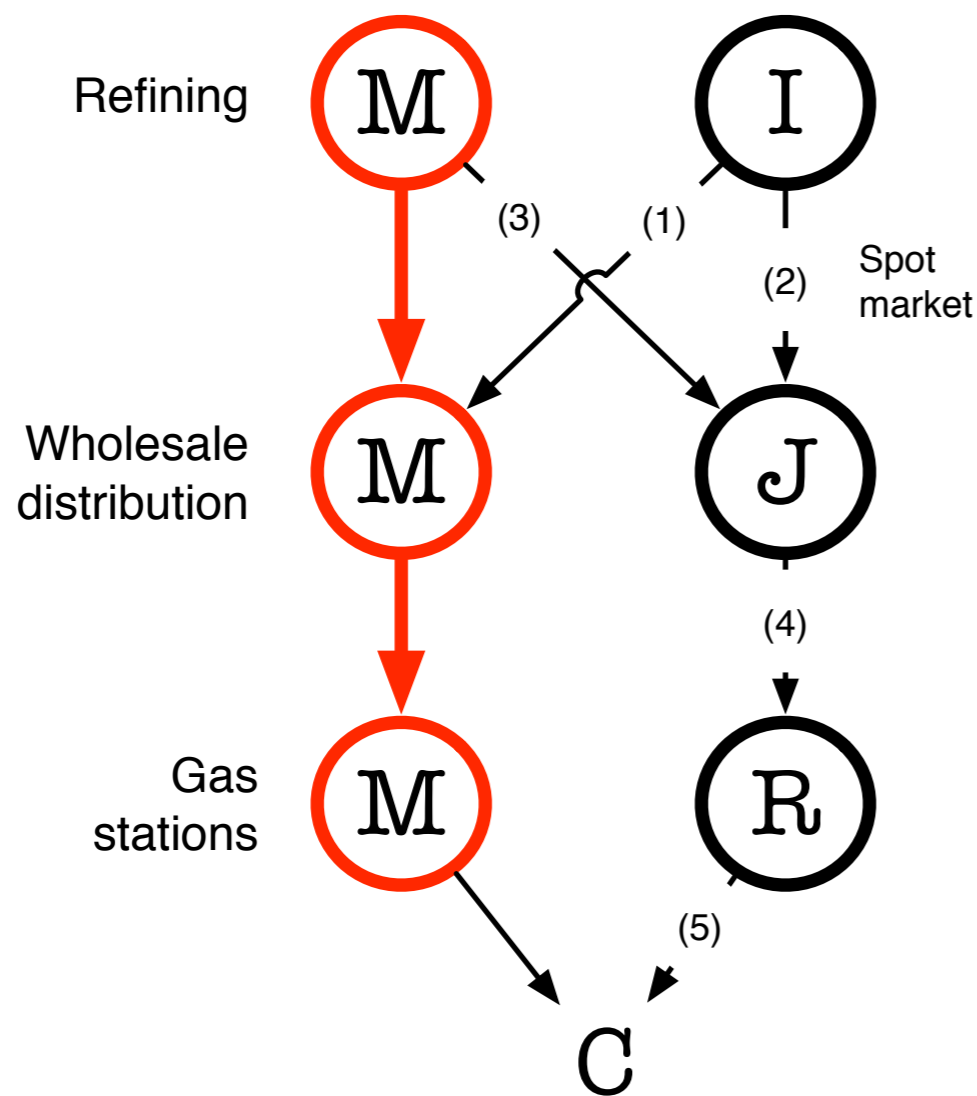
Presumed illegality: US and EU

"[T]here 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." *Northern Pacific Railway Comp., v. U.S.*, 356 U.S. 1, 5 (1958).

"It is not strictly necessary, for the application of Art. [81] (1), given the overtly anticompetitive object of the agreement, for an adverse effect upon competition to be demonstrated." Commission Decision of 23 April 1986 No 86/398/EEC, Polypropylene, O.J. 1986, L 230/1

**Naked horizontal restraints:
Price fixing and
Market allocation**

Socony Vacuum: “Gentlemen’s agreements” and “dancing partners”



- (1) Pursuant to a gentlemen’s agreement with other vertically integrated majors, M buys excess gasoline from its independent “dancing partner” I.
- (2) Spot market prices for gas increase
- (3) Because long term supply contracts between M and jobber J are pegged to spot market prices, long term supply prices increase as well
- (4) J is upset, because J’s “cost plus” distribution agreement with R is more profitable the greater the quantity sold
- (5) Consumer C is upset, because she is paying higher prices at the pump

U.S. v. Socony Vacuum Oil., 310 U.S. 150 (1940) (“Madison Oil”)

The legal analysis: FN. 59

- Strict *per se* rule with double AE>PE inference in FN. 59. If the agreement falls into a “per se” category, then
 - (1) AE – Anticompetitive effects are presumed (§1 is violated “though it is not established that the conspirators had the means available for accomplishment of their objectives”); and
 - (2) PE – No evidence of procompetitive effects may be introduced. (“Whatever economic justification particular price-fixing agreements may be thought to have, the law does not permit an inquiry into their reasonableness.”) Rationalizing overcapacity is no excuse.
- Price “fixing” does not require a determinable dollar amount (e.g., “no less than \$2/barrel”)
 - Even though prices were neither uniform nor inflexible, “[a]ny combination which tampers with price structures is ... unlawful.”

Socony is a simple case with a troubling backstory

- During the (previous) Great Depression, the oil industry was plagued by structural overcapacity
 - ↓ demand → overcapacity → ↓ prices → ↓ profits → layoffs ... repeat
 - Once an oil well has been opened, it cannot be closed temporarily
- At the direction of the FDR administration (Harold Ickes), the majors instituted the dancing partner program and stabilized the industry
- In 1935 the Supreme Court declared NIRA unconstitutional
- The majors continued the (government initiated) dancing partner program and were criminally prosecuted for it in 1937 by the same administration

Polypropylene: “Target prices”

- Price fixing and market allocation cartel among most European polypropylene (PP) manufacturers that lasted for almost a decade
 - PP is a commodity, traded on the London Metal Exchange. It is used in plastic moldings, fabric, ropes, insulation, trash cans, water canisters, etc.
- The cartel agreement involved
 - Target prices (by grade and currency)
 - Annual production quotas for members with allowances for newcomers (e.g., A: 15,000 t/year, B: 10,000 t/year, etc.). Without production quotas, agreements on price won't stick. Thus, price fixing usually goes hand in hand with some form of production quota or capacity agreement.
 - Information exchange, regular meetings

Commission analysis: Art. 81(1)

- Hardcore restriction by object: no proof of AE required
- Overcapacity rationalization is not a defense
 - "The fact that the [PP] market was characterized over a period of several years by under-utilization of capacity, with attendant losses by the producers, does not relieve the agreement of its anticompetitive object."
- Flexibility of target prices, incomplete cartelization, and ineffectiveness are no defenses
 - It does not matter that "the achieved price levels generally lagged behind the 'targets' and that price initiatives tended to run out of momentum sometimes eventually resulting in a sharp drop in prices." p. _____
 - "The fact that the cartelization of the market was incomplete and did not entirely exclude the operation of competitive forces does not preclude application of Art. [81]" p. _____

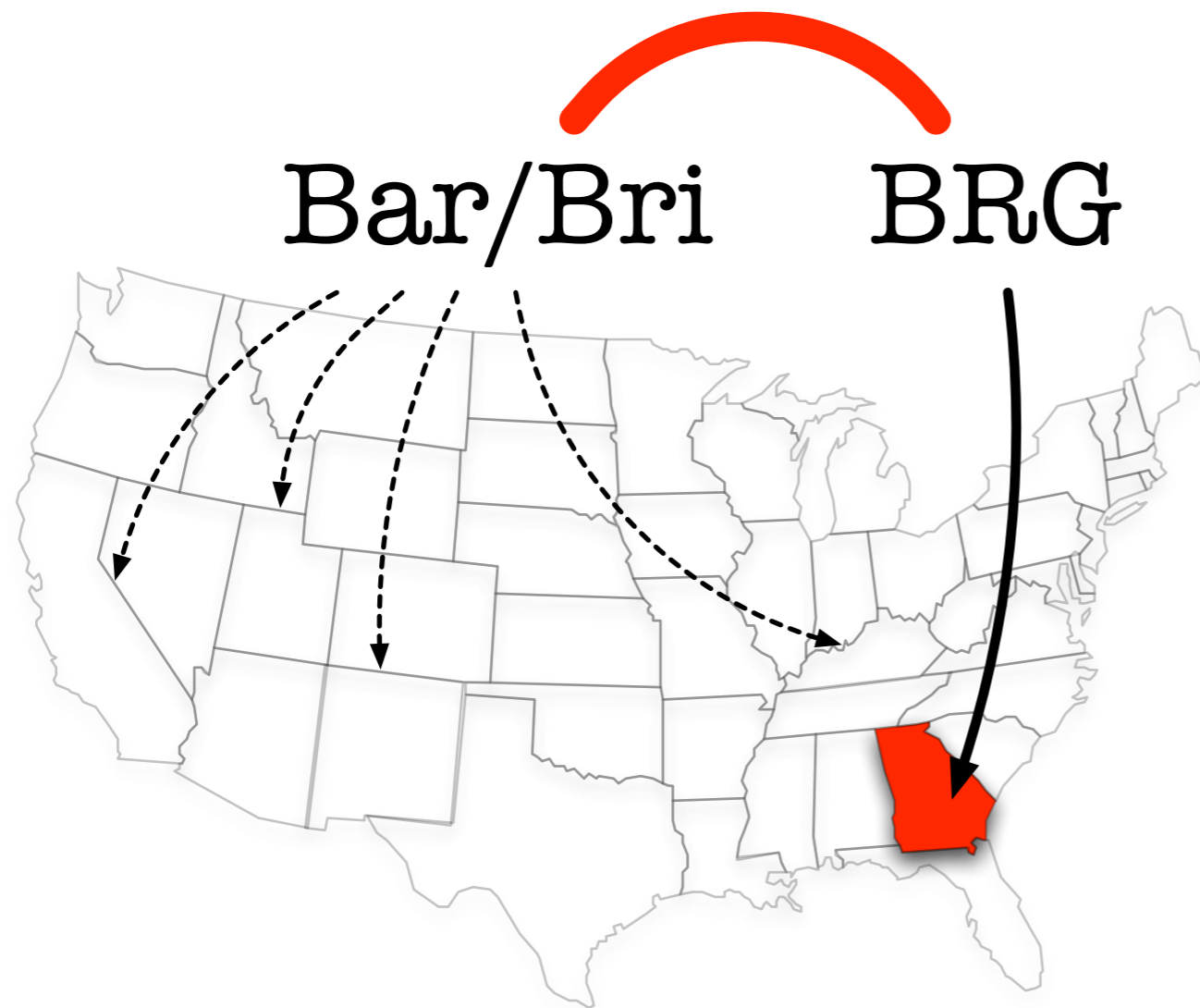
Price fixing is a “tampering” offense, not a “price determination” offense

- No *private* override of the *public* (legislative) decision that “free competition is the rule of trade.”
 - "The Sherman Act reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services." The statutory policy underlying the Sherman Act "precludes inquiry into the question whether competition is good or bad." *Natl. Soc. of Professional Engineers v. U.S.*, 435 U.S. 679, ____ (1978)
 - “[T]he producers were aiming at the organization of the polypropylene market on a basis which substituted for the *[legislatively mandated]* free operation of competitive forces an institutionalized and systematic collusion between *[private]* producers and amounted to a cartel.” *Polypropylene*, p.____
- Basic marketplace design rules are mandatory and cannot be modified by private agreement
 - No tinkering with the “central nervous system of the economy.” *Socony*, FN. 59.

Market allocation v. price fixing

- There are three basic forms of market allocation
 - By territory: “You get Greece, I get Spain.”
 - By customer: “You sell to universities, I sell to businesses.”
 - By time: “You bid for this project, I bid for the next.” (bid rigging)
- Market allocation is worse than price fixing
 - Market allocation rules out *all* competition, while price fixing allows for competition on quality and other non-price dimensions
 - Market allocation is much easier to police than a price fixing agreement. Sales into someone else’s territories or “house accounts” are easier to detect than price shaving via intransparent discounts
 - Territorial market allocation delays the formation of a common market, which is a “trade law” objective of many antitrust regimes (EU, China)

A seemingly simple case of market allocation: *Palmer v. BRG*



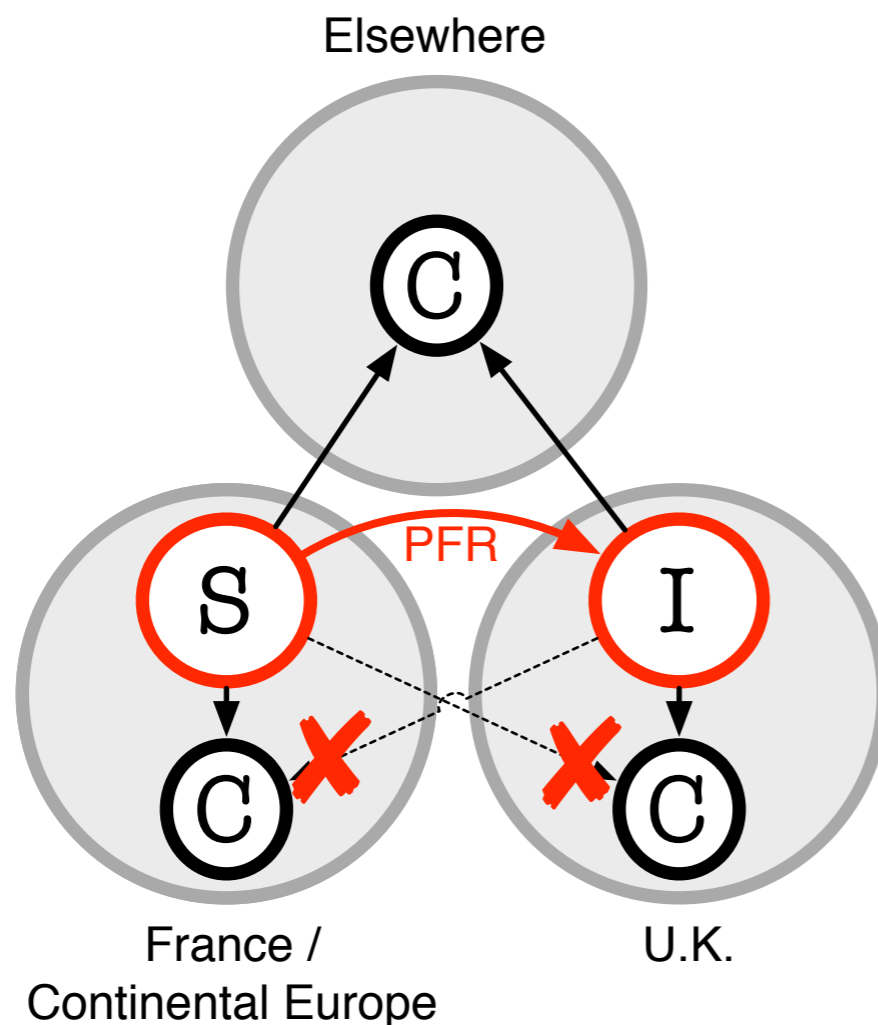
Palmer v. BRG of Georgia, 498 U.S. 46 (1990)

- BRG was the only bar review course in Georgia. In 1977, Bar/Bri (BB) entered. Prices went down. In 1980 BB and BRG agreed as follows:
 - BRG gets Georgia as its exclusive territory, BB the rest of the U.S. (= market allocation)
 - For every student BRG enrolled in Georgia, BB gets \$100 (= price floor, BRG has no incentive to offer its course for less than \$100)
 - For every dollar above \$350/BRG student, BB gets 60 cents. (60/40 split) (= incentive to keep prices in a “reasonable” range to discourage entry into Georgia by third parties)
- The Supreme Court found the agreement to be per se illegal
 - Justice Marshall dissented: SJ inappropriate

Did the Supreme Court get it wrong?

- The Supreme Court brushed aside important facts
 - Bar/Bri argued that it decided to leave Georgia before the 1980 agreement
 - In connection with the 1980 agreement, Bar/Bri granted BRG a license to use Bar/Bri materials in Georgia
- Isn't the 1980 agreement just an exclusive franchise?
 - The “Georgia only” limitation is to entice BRG to focus its attention on the Georgia market. The \$100/student fee is a franchise/IP royalty, and the 60/40 split above \$350 is to keep BRG from harming the brand by charging too much.
- **History matters.** To assess whether an agreement is *per se* illegal or AE>PE, one cannot just focus on the end state but must understand *how the firms got there*

Soda-Ash-Solvay: “Home markets” and “purchases for resale”



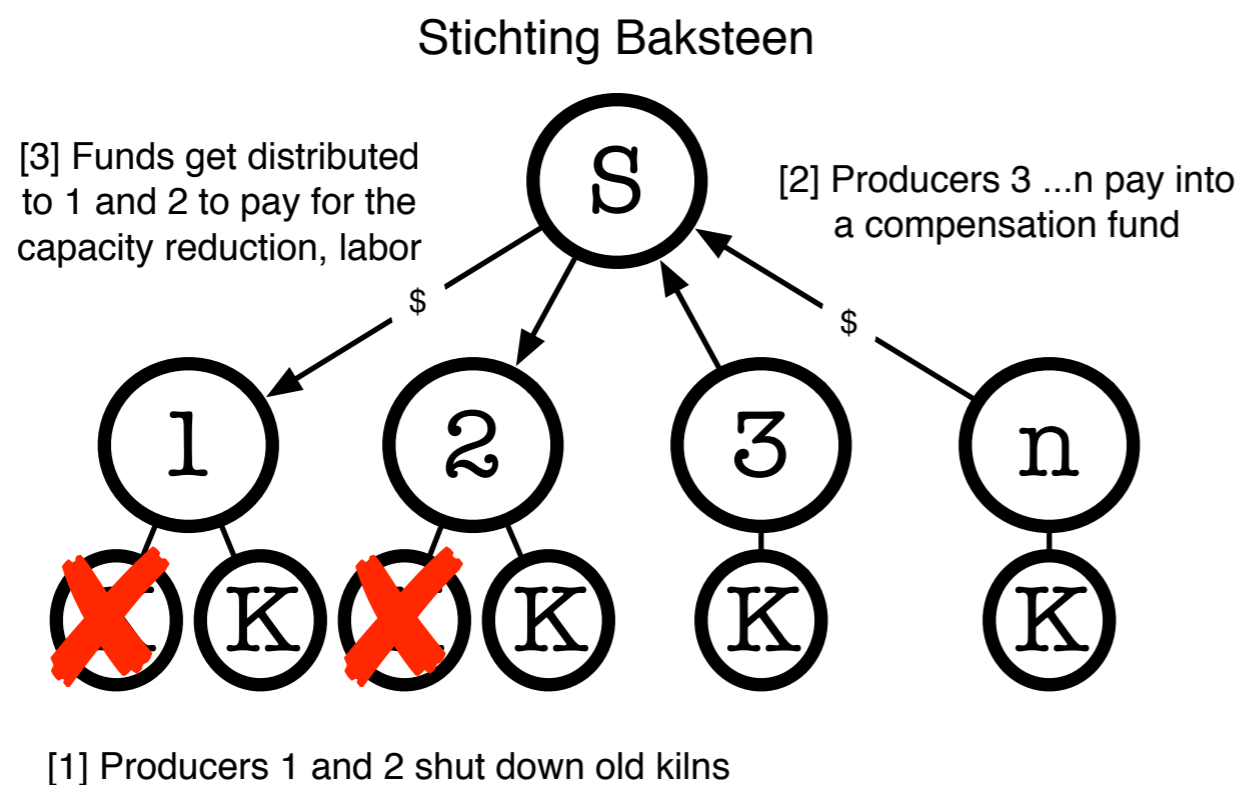
Commission Decision 91/227 of 19 December 1990,
Soda-Ash-Solvay, ICI, O.J. 1991

- Solvay (S) and ICI (I), along with others, participated in a market sharing scheme, dating back to 1945
- “Home markets” or “spheres of influence” principle, i.e., I stays in the U.K. and S in France and continental Western Europe
- Deviations from the scheme result in retaliation, i.e., sale of the same tonnage into the offender’s home market
- Export markets are fair game for competition, as long as no member claims the market as its “home market”
- Significant market shares
 - I = 90% in the U.K.; S about 60% elsewhere
- Purchase for resale (“PFR”)
 - After closing a plant in the U.K., ICI purchased substantial tonnage for resale from Solvay for resale in ICI’s “home market” and in South Africa.

National market divisions are particularly troublesome in the EU

- The market division is a clear restriction by object, Art. 81(1)(c)
- Under Art. 81(1), market divisions along national lines are punished more harshly than other market divisions
 - Unlike the Sherman Act, the EU Treaty is not only a competition law but also a trade law (e.g., it includes State Aid provisions)
 - “The division of markets on national lines ... is contrary to the most fundamental objectives of the EEC Treaty, namely the creation of a single market between Member States.” (Id, ____)
- The PFR arrangement relieves ICI from having to expand capacity in Britain
 - I.e., PFR is (in part) a “no entry” payment from Solvay to ICI

Stichting Baksteen: Should crisis cartels be permissible?



Commission Decision, Case IV/34.456 O.J. L 131/15
(May 26, 1994) – Stichting Baksteen

- The Dutch brick industry is plagued by structural overcapacity
 - Alternative building materials (e.g., concrete)
 - A kiln (K) must continuously run at full capacity and cannot be shut down temporarily
- The brick makers (1...n) agree that those with more than one kiln (1, 2) dismantle old, high cost kilns. No one is allowed to add capacity.
- Everyone else (3...n) pays into a compensation fund, whose assets are distributed to 1, 2 by a foundation (S)
 - The funds pay for the loss in sales (1, 2) and for the social costs of shutting down the old kilns (e.g., labor, severance, retraining)
- Textbook example of a “structural crisis” cartel (Germany, Japan)

Legal analysis: The rationalization agreement is justified

1. Art.81(1): Clear violation by object (capacity reduction)

2. Art.81(3): Justification

a. Agreement improves allocative, productive, or dynamic efficiency?

a. Yes. (i) “By reducing capacity, firms throw off the financial burden of maintaining unused surplus capacities and, by increasing utilization of the capacity utilization of the capacity retained, do not have to reduce output.” (ii) The least viable kilns will be shut down. (iii) “[I]t is possible to predict a future increase in the profitability of the Dutch brick industry and, therefore, a return to normal competitiveness.” (iv) Restructuring can be carried out in acceptable social conditions.

b. Agreement passes on a "fair share" of the benefits to consumers as a group

a. Yes. Consumers benefit in the long run from a healthy brick industry. Lower capacity will be offset by lower financing costs. Many alternative suppliers.

c. Restraints are indispensable to achieve the PE. (Yes.)

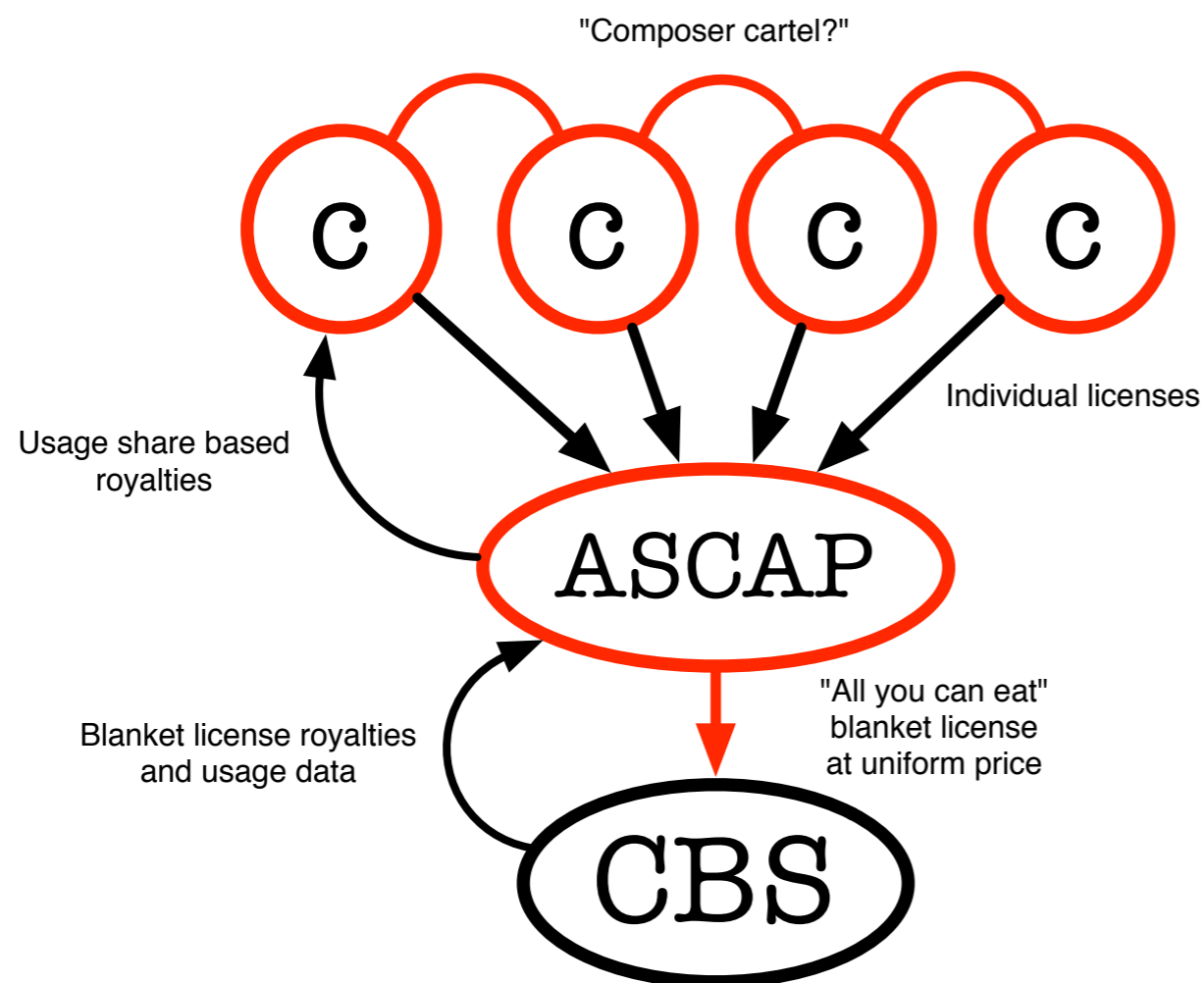
d. No complete elimination of competition (Yes.)

Good and bad excuses for cartels

	US	EU
“The price wasn’t really fixed” (Socony, PP)	No excuse	No excuse
“The fixed price was reasonable” (Socony)	No excuse	No excuse
“The price fixing agreement had no effect” (PP)	No excuse	No excuse
“We had to rationalize overcapacity to protect the marketplace.” (Socony, PP)	No excuse	Usually no excuse (PP), but EU law allows for some rationalization cartels (S. Baksteen)
“Uncontrolled competition would lead to a race to the bottom in terms of quality and safety.”	Usually no excuse, but some allowances for professionals	Usually no excuse, some exceptions
“The cartel only harmed foreigners.”	A valid (albeit limited) excuse	A valid (albeit limited) excuse

**Ancillary horizontal restraints:
The Rule of Reason
in §1 and Art. 81(3)**

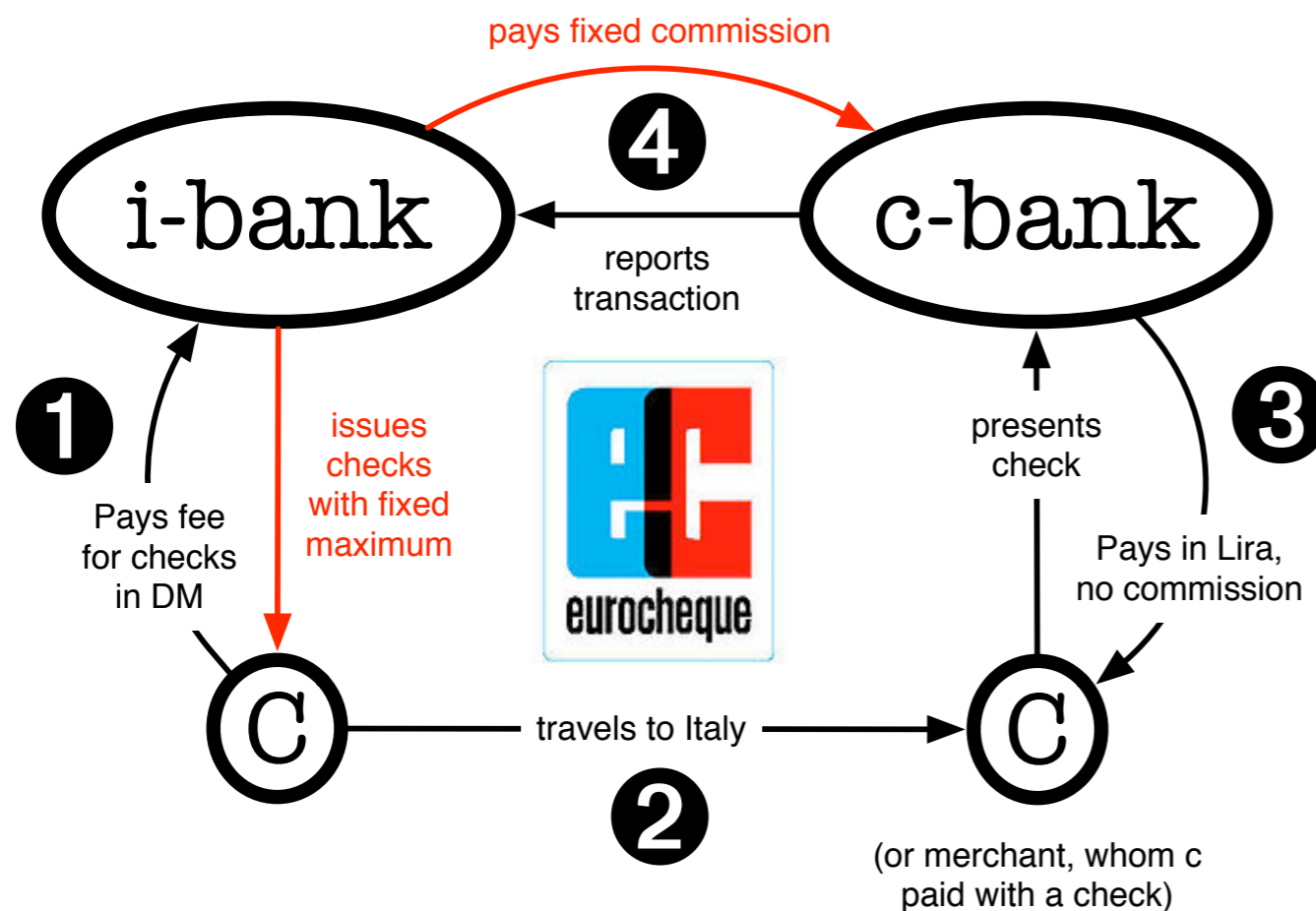
“Easy labels do not always provide ready answers.” On avoiding false positives in applying the *per se* rule



BMI v. CBS, 441 U.S. 1 (1979)

- Literally “price fixing” by a composer cartel, but:
 1. The restraint is *absolutely necessary* for the venture to work
 - w/o the blanket license, costs for composers to monitor outlets and cost for outlets of finding composers would be excessive
 - The flat rate ensures that stations report usage truthfully (no incentive to underreport the playing of more expensive songs)
 2. The venture also involves the *creation of a new product*, with which the composers don’t compete
- New market option added, output increased: ROR

“Price fixing” as a means to create the Eurocheque system



- The Eurocheque (EC) system
 - The EC system fixes the maximum amount banks in a given country can issue a check for (e.g., DM 300) and the commission paid by the issuing bank to the cashing bank
- Art. 81(1) (+), restriction by object
- Art. 81(3) (+)
 1. Improvement of the payment system: cross-currency, centralized clearing
 2. Benefits to consumers: creation of de facto “legal tender” in all currencies, better exchange rate, interest free credit
 3. Indispensable restraints: (i) fixed commissions, or else 15,000 banks would have to negotiate bilateral agreements; (ii) fixed maximum amount/check, or else costs of evaluating the guaranteed amount would be prohibitive
 4. No elimination of competition, because there are other means of payment

The ancillary restraints doctrine: When a restraint is *really per se* illegal

Figure 1: "Naked non-compete agreement"

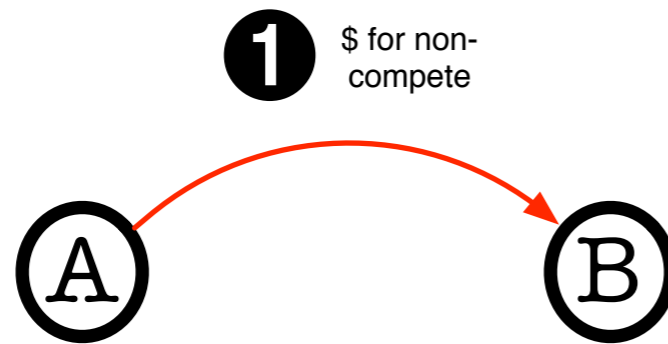
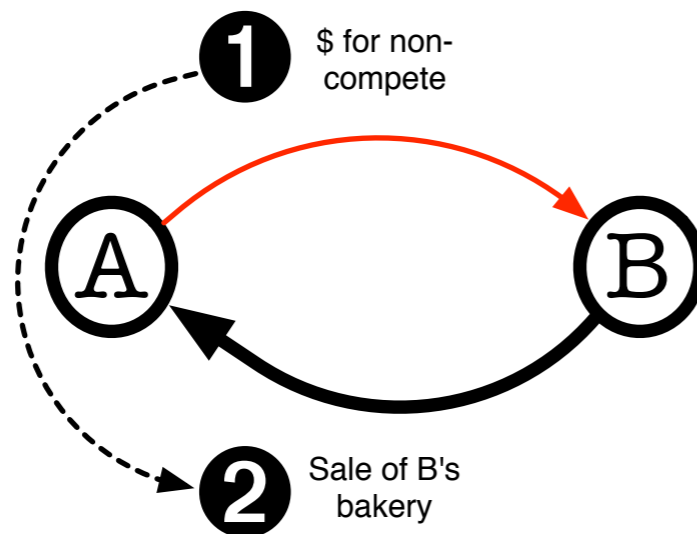


Figure 2: "Ancillary non-compete agreement"



- The *per se* categories are overinclusive. To avoid false positives, a second level test is required: whether the *per se* illegal restraint is naked and thus *really per se* illegal or ancillary and thus analyzed under the ROR
- Suppose A pays B \$100k not to compete with A's bakery. Without more, this is *per se* illegal. (Fig. 1)
- If, however, the non-compete agreement is merely a means to enable an underlying bona fide transaction, e.g., the sale of B's bakery to A, then the PE from the sale may outweigh the AE from the restraint and the ROR is applied to both agreements. (Fig. 2)
- The ancillary restraints test requires (1) a restrictive agreement; (2) an underlying transaction; and (3) a causal relationship between (1) and (2).

Both U.S. and EU law employ the ancillary restraints doctrine

- “To be ancillary ... an agreement eliminating competition must be subordinate and collateral to a separate, legitimate transaction. The ancillary restraint is subordinate and collateral in the sense that it serves to make the main transaction more effective in accomplishing its purpose.” *Rothery Storage & Van Co. v. Atlas Van Lines*, 792 F.2d 210, 224 (D.C.Cir. 1986)
- “The provisions of [Art.81(1)] may ... be declared inapplicable [to] ... any agreement ... which contributes to ... economic progress ... which does not ... impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives”
Art. 81(3) EC Treaty

Ancillarity can be strong or weak

Assuming that the rivals are engaged in a *bona fide* productive venture or sale (the “primary transaction”), and:

1. The restraint is a *conditio sine qua non* for the primary transaction (e.g., *CBS v. BMI*), then ROR applies.
2. The restraint *promotes* the primary transaction (e.g., partnerships; seller non-compete clause in the sale of a business), then ROR applies (*Rothery Storage*).
3. The restraint is *basically unconnected* to the primary transaction (*Palmer v. BRG*) – then we’re dealing with a “naked restraint” and the *per se* rule applies
 - Exception: Most self-regulation of professionals comes under the ROR (*Professional Engineers; Indiana Fed. of Dentists*)

The two ways into ROR-land: Directly or via the ancillary restraints test

1. Most cases do not involve *per se* illegal restraints. The ROT applies.
2. If there is a restraint that falls into a *per se* category, step back and apply the ancillary restraints test
 - a. Isolate the *per se* restraint (e.g., “fixed prices for blanket licenses”)
 - b. Is there a second, underlying agreement between the same parties? (e.g., “setting up a joint venture to sell music to radio stations”)
 - c. If so, is there a causal relationship between (a) and (b) such that (a) is a means to support the procompetitive ends of (b)? If so, is the causal relationship *sufficiently strong* (from “making more effective” to “reasonably necessary” to “indispensable”)
3. If ancillary, then ROR. If not, then “really” *per se* illegal.

The ROR is the default standard for analyzing “restraints of trade”

- The ROR is conceptually simple: If $AE > PE$, then the restraint is unreasonable and illegal
- The problem lies in the application of the $AE > PE$ test, as measuring and balancing AE and PE is difficult, time consuming, expensive, and not particularly accurate
 - A full blown ROR requires: market definition, econometric studies, extensive review of company documents, depositions, etc.
 - In contrast, applying the ancillary restraints doctrine only requires categorizing the restraint, identifying the underlying transaction, and a determining a plausible relationship between the two.
- The ROR evolved to reduce the evidentiary burden
 - The original ROR was an unweighted, multi-factor test (*Chicago Board of Trade*). The modern ROR employs a structured, burden shifting approach (*Calif. Dental*)

The modern, structured ROR

1. Plausible theory of harm (*motion to dismiss*)

a. π : Plausible AE

AE without market power (< 30% share) are not plausible

b. Δ : Plausible PE for which the restraint is reasonably necessary

2. Proof of harm (*summary judgment*)

a. π : Proof of AE (direct or circumstantial, i.e., market power)

b. Δ : Proof of PE and that the restraint is reasonably necessary to achieve them

3. Balancing (*trial*)

a. Court: AE > PE?

See Elhauge & Geradin, *Global Antitrust*, p.190-91 (2007)

A violation of Art. 81(1) may be justified under Art. 81(3) (ROR)

- Special tests (if not, apply general test)
 - Block exemption on specialization (20%) or R&D (25%) agreements?
 - Horizontal cooperation guidelines (joint purchasing, selling, standard, environment – 15%)
- General test
 1. Agreement improves allocative, productive, or dynamic efficiency (= PE)
 2. Agreement passes on a "fair share" of the benefits to consumers as a group (= consumer welfare considerations)
 3. Restraints are indispensable to achieve the PE (= ancillary restraint)
 4. No elimination of substantial part of competition (not clearly defined)
- Art. 81(3) is applied by EC, NCAs, and national courts

When the cure would be worse than the disease: *de minimis* notice

- In the EU (unlike the U.S.) non-hardcore restraints that are likely to be immaterial are *per se* lawful
- A restriction of competition must be “appreciable” to trigger Art. 81(1) Case 5/69, Völk v. Vervaecke [1969] E.C.R. 295.
- The *de minimis* notice defines what’s not appreciable
 - Small firms: < 250 employees and (< € 50m sales or €43m assets)
 - Small market shares:
 - Combined share of no more than 10% for horizontal/mixed agreements
 - Combined share of no more than 15% for vertical agreements (etc.)
 - Not applicable to hardcore restraints, such as price fixing, market allocation, output limitations
- The < 250 employees test makes little economic sense