NEW WINE INTO NEW WINESKINS: ANALYZING HUB-AND-SPOKE ANTITRUST CASES IN CHINA

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I. INTRODUCTION

The antitrust legal and economic communities have traditionally treated anticompetitive behaviors as dichotomized along horizontal and vertical dimensions. Horizontally, such behaviors are called "collusion" or "conspiracy" among industry competitors, whereas otherwise they are called vertical restraints between an upstream firm and a downstream firm. In China, the Anti-Monopoly Law ("AML") has Article 13 and Article 14 to deal with horizontal and vertical antitrust offenses respectively. But in the real world, a firm's potential alleged anticompetitive behavior sometimes encompasses both dimensions. For example, a manufacturer may implement policies to coordinate among its distributors that may be subject to scrutiny of Article 13.[2] Such coordination may involve the distributors appearing to collude on price or quantity. A powerful distributor in a particular region may also coordinate activities of several manufacturers it represents to achieve a certain collusive goal. These types of activities involving both horizontal and vertical angles represent the focus of some recent developments in antitrust law enforcement in China. This article attempts to provide a brief introduction to the hub-and-spoke theory, highlight some relevant cases in China, and provide economic analysis to compare the Chinese courts' and competition authorities' approaches to such behaviors.

The reason why the kind of behavior at issue in this paper is called "hub-and-spoke" is because there is usually a key player, using the analogy of a wheel, acting as the "hub," and vertical agreements with other associated players in a different layer of distribution acting as the "spokes" of a wheel. The basic thrust of the theory about such conspiracy is that fundamentally vertical agreements could have horizontal anticompetitive implications, and thus need to be brought into the realm of antitrust law enforcement.

However, how that vertical-horizontal link works is not entirely obvious, nor is it obvious that the actors involved would have clear motivations and incentives to be engaged in anticompetitive behaviors, and that said behaviors would always result in actual harm to competition. In the AML context, there are quite a lot of debates on how hub-and-spoke cases should be approached and if they would cause competition harm. In the proposed amendment of the AML, hub-and-spoke conspiracy was raised as an important issue and a new Article 17 was intended to be introduced to prevent undertakings from organizing and facilitating other undertakings to engage in monopoly agreements.[3] We start our analysis by first classifying hub-and-spoke conspiracies into three categories.

2 See more detailed discussion on horizontal monopoly agreements in Vanessa Yanhua Zhang and Xinzhu Zhang, "New Wine into Old Wineskins: Recent Developments of China's Competition Policy against Monopolistic/Collusive Agreements," Review of Industrial Organization, Vol. 41, Issue. 1 (2012), pp. 53-75.

3 SAMR Draft Amendments to the Anti-Monopoly Law (Open for Public Comments), January 2, 2020, available at http://www.samr.gov.cn/hd/zjdc/202001/t20200102_310120.html; the consultation draft (in Chinese) can be accessed at http://www.samr.gov.cn/hd/zjdc/202001/P020200102375329388627.docx.

The first category includes conspiracies that would enhance market power or reduce competition at the level where the hub operates. For example, Toys "R" Us once had vertical agreements with its upstream manufacturers that limit their supplies to warehouse club stores competing with Toys "R" Us.[4] In this case, Toys "R" Us was also found to have coordinated horizontal agreements among its manufacturer suppliers. This kind of arrangement clearly is meant to strengthen Toys "R" Us' market dominance.

The second category covers conspiracies that would enhance market power or reduce competition at the level where the spokes operate. This would be common in scenarios where a manufacturer coordinates among its distributors via vertical agreements with its distributors. In this case if the manufacturer holds a small market share, it is not entirely clear how limited competition within a brand would fester into limiting competition across the entire relevant market.

The last category, as expected, refers to conspiracies that would increase market power or reduce competition at both levels. For example, a distributor sitting in the hub coordinates collusion among its upstream manufacturer suppliers, who in turn agree to take some actions that help the hub distributor reduce competition with rival distributors. The anticompetitive nature of this type of hub-and-spoke conspiracy and the resulting harms to competition are less controversial, since the incentives of the participants and the grounds for their liability tend to be fairly obvious.

In short, not all hub-and-spoke cases are created equal, and thus they, according to the usual analytical framework under China's AML, naturally call for a certain degree of economic analysis to discern their participants' incentives and resulting extent of competition harms before their illegality can be established. Below we review two representative cases in China to understand the courts' and the competition authority's approaches to such matters, followed by some caveats to conducting relevant antitrust economic analysis.

II. HUB-AND-SPOKE CASES IN CHINA

In China, hub-and-spoke cases have been treated as vertical restrictions on price which is articulated in Article 14 and horizontal monopolistic agreement which is prohibited by Article 13. Although the AML does not elaborate the situation, the main principles which were laid out in both Articles 13 and 14 provide the legal foundation for the competition agencies and the court to treat it differently.

Competition agencies have adopted the per se illegal doctrine when dealing with hub-and-spoke cases. The representative administration investigation case was held by Hubei Price Bureau. The provincial agency discovered that the Audi sales division of FAE-Volkswagen had coordinated its ten Audi dealers in Hubei province to implement monopoly agreements since 2012.[5] This conduct involved both horizontal agreements and vertical restriction on automobile and maintenance services prices. These ten dealers were Hubei Ding Jie, Hua Xing Han Di, Hubei Zhong Ji, Hubei Ao Ze, Wuhan Ao Long, Wuhan Ao Jia, Xiangyang Dong Fu, Yichang Ao Long, Huangshi Ao Long and Shiyan Ao Long. Those ten Hubei dealers had signed the Audi Restricted Price Program of Wuhan District, Guarantee to the Price Program of Central China under the coordination of the Audi Sales Division. Meanwhile, the Audi Sales Division had released the Notice on Strictly Implementing the Audi Standard Price System in Hubei province and Hubei Service Marketing Management Rules and further set up the supervision groups to monitor the implementation of the internal rules.

The provincial antitrust agency also discovered that several Hubei dealers mentioned above had set up the monopoly agreement regarding automobile sales, which left the evidence in the meeting memorandums of Unified Price Program for Dealers of Wuhan. Deemed per se illegal by the provincial agency, Volkswagen was found manipulating the resale prices of automobiles and prices of maintenance services between Audi dealers and third parties. The agency found that Volkswagen had eliminated and restricted the competition in the automobile and auto parts markets by fixing and restricting the minimum resale prices and coordinating on the monopoly agreements. For those ten Hubei dealers, they were deemed violating Article 13 by price conspiracy while playing secondary role in execution of the monopoly agreement. Therefore, in September 2014, Volkswagen was fined 248.58 million RMB by the Hubei Price Bureau under the direction of the National Development and Reform Commission ("NDRC") and Hubei Dingjie, Hubei Zhongji as well as other 6 dealers received 29.96 million RMB fine which was comparably much lower than Volkswagen's.

4 *Toys "R" Us, Inc v. FTC*, 221 F. 3d 928 (7th Cir. 2000).

5 "Hubei Punished FAW-Volkswagen Co., Ltd. and some Audi Dealers for Price Monopoly," Hubei People's Government, September 11, 2014, available at http://www.hubei.gov.cn/xxbs/bmbs/swjj/201409/t20140911_1204351.shtml.

The court system, however, takes a completely different approach from that of the competition agencies. The court normally adopts the rule of reason doctrine when dealing with the hub-and spoke-cases. The Rijin v Panasonic case ruled by the Shanghai No. 1 Intermediate People's Court is a representative one to illustrate the difference.[6] Panasonic Electronics, manufacturer of a set of factory automation control equipment including mostly programmable logic controllers, low voltage electric transformers and generic sensors, has a contractual relationship with its distributors. The document called "Panasonic Eastern China End Customer Management Charter," in fact establishes a client protection system, through which valuable and important clients are protected from being approached by other distributors who previously do not have an existing business relationship with these clients. Before approaching a prospective client, a distributor needs to refer to the client database to ensure that this prospective client has not worked with another distributor. This client protection mechanism takes the form of Resale Price Maintenance ("RPM") where other distributors' price quotes to a protected client have to be at least 15 percent higher than the standard distributor-suggested-price by Panasonic. This client protection mechanism ensures that the quoted price of an unrelated distributor is incompetent, therefore, protects the incumbent distributor.

In 2014, Rijin Electric Co., one of Panasonic's regional distributors, brought an antitrust lawsuit against Panasonic along with two other distributors for allegedly forming a monopoly agreement for a market division scheme. Initially the plaintiff did not make it clear what particular type of monopoly agreement it was referring to, and did not specify whether it was a vertical monopoly agreement ruled by Article 14 of the AML or the horizontal monopoly agreement ruled by Article 13 of the AML. Later on, the plaintiff switched to a horizontal agreement allegation during the rest of the trial. The court determined that the case involved a conduct in the realm of vertical monopoly agreement and dismissed all anti-competitive allegations and damage claims brought by the plaintiff.

On June 29, 2016, the court dismissed all the plaintiff's allegations. The judge clearly stayed with the defendants' position that Article 13 of the AML did not apply in this case. By applying the rule of reason doctrine, the judge further stated that even if a horizontal agreement among parallel members (meaning distributors) within a vertical relationship possibly precluded and limited intra-brand competition, meaning the competition among distributors of the same producer, such an agreement might not extend to harm inter-brand competition of the entire market. Therefore, such a hub-and-spoke agreement where a horizontal agreement within a vertical relationship may not be such a kind of horizontal monopoly agreement prohibited in Article 13 of the AML. He further stated that only competing parties owning different brands and forming a horizontal agreement could possibly preclude and limit competition, and Article 13 of the AML should only apply to those circumstances.

III. ECONOMIC ANALYSIS FRAMEWORK OF HUB-AND-SPOKE CASES

Above all, the analytic framework we would have in mind with respect to hub-and-spoke cases follows the traditional antitrust economic thinking where incentives, acts and consequences of harm to competition need to be established in the process. This almost invariably calls for a rule of reason approach to such cases. But the issue of rule of reason versus per se illegal is not without controversy, and as we have demonstrated earlier that it is not even consistently applied via administrative versus judicial venues in China.

In the Audi Dealer case, the competition authority took the per se illegal position, whereas the court presiding over the Panasonic case resorted to rule of reason. We take the position that, under the current AML legal environment, most hub-and-spoke cases should be viewed as cases of derivative extensions of vertical monopoly agreements, as they almost always involve some kind of vertical agreements. Consequently, litigations under Article 14 should adopt the rule of reason approach as mandated by court precedents. Economic theories in this regard postulate both harms and benefits associated with vertical restraints and thus analysis is warranted to detect its net effect in real industry settings.

Second, incentives and motivations of participating in a hub-and-spoke conspiracy on the part of all players usually need to be established in a typical rule of reason analysis. But sometimes it is not obvious nor reasonable for spoke players to demonstrate such incentives. In the first type of hub-and-spoke conspiracy, while the anticompetitive incentive of the hub distributor is easily understandable, it is hard to answer the question as to why the spoke manufacturers would be complicit in conduct that only increases the market power of the hub distributor, when doing so could result in the hub distributor exerting buyer power or charging a higher resale markup at the expense of the manufacturers' sales volume. In addition, the exclusive dealing requirement with the hub distributor would further forego sales opportunities to other distributor competitors. In the analysis, how much the hub distributor's market power plays a role in the dealings might be an important factor to consider.

6 *Shanghai Rijin v. Panasonic Electronics*, Civil Judgment of Shanghai No. 1 Intermediate People's Court, (2014) HU YI ZHONG MIN WU (ZHI) CHU ZI No. 120, June 29, 2016, available at http://cclp.sjtu.edu.cn/Show.aspx?info_lb=672&info_id=3943&flag=648. A detailed discussion of the case is included in Gong, John J. and Vanessa Y. Zhang, Vertical Restraints versus Horizontal Agreements in the Manufacture-Distributor Relationship, CPI Antitrust Chronicle, March, Volume 3, Winter 2017, available at https://www.competitionpolicyinternational.com/vertical-restraints-versus-horizontal-agreements-in-the-manufacturer-distributor-relationship/.

Another important incentive issue in the second category of hub-and-spoke cases is with respect to the motivations behind distribution coordination, which may not be solely driven by price or quantity oriented collusive purposes. A manufacturer may have other pro-competition and legitimate considerations, for example, to serve its industry clients better, in which case it ultimately aims to intensify inter-brand competition, although apparently it may reduce intra-brand competition. For example, in a public or private tender setting, a manufacturer may select its most competitive and representative distributor to participate in terms of its service track record, financial standing, cost efficiency, supply chain capacity, and a slew of other considerations. In this case, sending one most competitive distributor bidder to the tender effectively intensifies inter-brand competition in the market, especially in the relevant market where the manufacture does not hold any dominant position.

Third, analysis of market power associated with participants is important in assessing any anticompetitive harm. In the second category of hub-and-spoke cases, the hub's market power is of particular importance. The anticompetitive theory is basically premised upon a theory of limitation on intra-brand competition can possibly spill over to the entire relevant market to cause any competition harm. But how this actually works appears to be in lack of any theoretical economic foundation and more importantly rigorous empirical evidence. As we have mentioned earlier, distribution coordination could be motivated by pro-competitive and legitimate considerations other than price or quantity driven collusive purposes, in which case it actually intensifies inter-brand competition. In our opinion the hub player is supposed to play a central role in the hub-and-spoke conspiracy theory, and thus how that role translates into harm to competition in the entire relevant market is critical to analyzing such cases.

Last but not least, we propose that the legislation body might consider setting aside a separate clause or a provision under the proposed Article 17 of the draft amendments to the AML to deal with such instances of violation in the next round of legislative revision. Hub-and-spoke cases are indeed quite different from horizontal and vertical violations as regulated under Article 13 and Article 14. It may require a place of its own in the upcoming newly revised statute. And the statutory texts should reflect its unique and complex characteristics and prescribe an enriched set of legal solutions to deal with it.

IV. CONCLUSION

Our paper introduces the concept of hub-and-spoke anticompetitive conspiracy, which is quite problematic in China, and some cases in China that fit this category. We are of the opinion that a rule of reason doctrine needs to be considered when discussing these cases in court. And we propose an economic analysis framework that looks at the incentives, the market power of participants and the resulting harm to competition in analyzing these cases. The AML in China is under a new round of legislative revision. It might be a good opportunity to introduce an independent clause to deal with prospective hub-and-spoke antitrust violations that encompass both horizontal and vertical relations in the marketplace.

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