DISTRIBUTION

THE NEWSLETTER OF THE DISTRIBUTION AND FRANCHISING COMMITTEE

Antitrust Section — American Bar Association
Vol. 18, No. 1 — March 2014

In this Issue

MESSAGE FROM THE CHAIR

Welcome to the latest edition of *Distribution!*

This issue includes articles on two very different topics: an analysis of automobile dealer incentive programs in the United States, and recent developments in resale price maintenance law in China. We hope you find these articles informative and useful, and we welcome any suggestions (or article submissions) for future editions of Distribution!

I also hope to see many of you at the Spring Meeting at the end of the month. As always, the D&F Committee will have a table at the networking reception on Wednesday, March 26 at 5:00pm, so please stop by and say hello. We also are sponsoring the following programs during the meeting:

Wednesday, March 26 at 1:45-3:15: "Can We Apply the Rule of Reason Reasonably?" *co-sponsored with the Pricing Conduct Committee and Economics Committee.*

Thursday, March 27 at 8:15-9:45: "Vertically Challenged: Distribution Agreements in the U.S. and Abroad," *co-sponsored with Compliance & Ethics.*

Friday, March 28 at 8:15-9:45: "Retreat from Trinko: Revisiting Refusals to Deal," *co-sponsored with Unilateral Conduct and Health Care.*

Look forward to seeing you there! In the meantime, thanks for reading.

Best regards,

Erika L. Amarante
Chair, Distribution & Franchising Committee

DISTRIBUTION is published by the Distribution and Franchising Committee of the American Bar Association Section of Antitrust Law. The views expressed in Distribution are the authors' only and not necessarily those of the American Bar Association, the Section of Antitrust Law, or the Distribution and Franchising Committee. If you wish to comment on the contents of **DISTRIBUTION**, please write to the American Bar Association, Section of Antitrust Law, 321 North Clark, Chicago, IL 60610.

Submission of Materials:

DISTRIBUTION welcomes submissions of articles and case summaries involving significant or interesting decisions, trials, or developments in antitrust law affecting all types of distribution arrangements.
Please send all submissions to:

Gary W. Kubek, Vice Chair
Debevoise & Plimpton LLP
919 Third Avenue
New York, NY 10022-3902
212.909.6267
gwkubek@debevoise.com

Craig G. Falls, Vice Chair
Dechert LLP
1900 K Street, NW
Washington DC 20006-1110
202.261.3373
craig.falls@dechert.com

THE DISTRIBUTION AND FRANCHISING COMMITTEE LEADERSHIP

Rainbow v. Johnson & Johnson: RPM Litigation in China

by Fei Deng, Edgeworth Economics, and Su Sun, Economists Incorporated

On August 1, 2013, the fifth anniversary of China's Antimonopoly Law (AML) taking effect, the Shanghai High People's Court (the High Court) delivered its long awaited appellate decision on the resale price maintenance (RPM) case involving Johnson & Johnson Medical China Ltd (J&J).[1] Prior to this decision in *Rainbow v. Johnson & Johnson*, the appropriate antitrust policy to apply to RPM had been controversial in China. The AML itself does not clearly specify whether RPM should be treated as a per se violation or whether it should be analyzed under the rule of reason,[2] and the Supreme People's Court's (the SPC) judicial interpretation (JI) of the AML did not clarify this issue.[3]

When the Shanghai No. 1 Intermediate People's Court (the Intermediate Court) initially ruled that J&J did not violate the AML,[4] it provided the first sign that Chinese courts might consider RPM cases under the rule of reason in the same way U.S. federal courts have treated the issue since the Supreme Court's 2007 decision in *Leegin Creative Leather Products v. PSKS*.[5] However, the recent aggressive crackdown on RPM practices in the white liquor industry and the infant milk formula industry by the National Development and Reform Commission (NDRC), China's antitrust agency in charge of enforcement against price-related cartels and abuse of dominance, prompted speculation that the NDRC might differ from Chinese courts in approaching RPM cases.

Although the High Court overturned the Intermediate Court's decision and ruled that J&J's RPM practices violated the AML, it affirmed the rule of reason approach and established a framework under which courts should analyze four factors in applying the rule of reason: (1) the competitiveness of the relevant market; (2) the defendant's market power; (3) the defendant's purpose for implementing the RPM; and (4) the competitive effect of the RPM.

The High Court's opinion is significant for several other reasons, including its embrace of economic analysis, its decision on the burden of proof in an RPM case, its approach to admissibility and weighting of certain types of evidence, and its holdings on the standing of a distributor to challenge RPM agreements and how the contract between the distributor and the supplier influences how damages are determined.

History of the Case

J&J sells medical equipment and products to hospitals in China, including suture thread used in surgeries. The plaintiff and appellant, Beijing Ruibang Yonghe Science and Technology Trade Company (Rainbow), had been a J&J distributor for fifteen years until March 2008, when it submitted bids to a hospital in Beijing that were lower than the minimum resale price J&J had stipulated in an appendix

1 The appellate decision (in Chinese) is available at http://www.hshfy.sh.cn:8081/flws/text.jsp?pa=ad3N4aD01JnRhaD2jqDIwMTKjqbumuN/D8cj9KNaqKdbV19a12jYzusUmd3o9z. The defendants and appellees included Johnson & Johnson Medical China Ltd and Johnson & Johnson Medical Shanghai Ltd, together abbreviated as J&J.

2 The official Chinese version of the AML is available at http://www.gov.cn/ziliao/flfg/2007-08/30/content_732591.htm.

3 The official Chinese version of the JI of the AML is available at http://www.court.gov.cn/qwfb/sfjs/201205/t20120509_176785.htm. A JI in China is a way for courts to interpret how a law should be applied in adjudicating cases, especially when the law has some ambiguities. A JI issued by the SPC is generally considered legally binding for the lower courts to follow, and lower courts often cite such interpretations in their case decisions. Some refer to the JI of the SPC as "secondary law." *See* Ronald C. Keith and Zhiqiu Lin, *Judicial Interpretation of China's Supreme People's Court as 'Secondary Law' with Special Reference to Criminal Law*, 23-2 China Information 223 (2009).

4 The Intermediate Court's initial decision is available (in Chinese) at http://www.hshfy.sh.cn:8081/flws/text.jsp?pa=ad3N4aD0xJnRhaD2jqDIwMTCjqbum0rvW0MPxzuUo1qops/XX1rXaMTY5usUmd3o9z.

5 Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

contained in the parties' 2008 distribution agreement. As a consequence of this action, J&J revoked Rainbow's right to distribute J&J products to two other Beijing hospitals in July, 2008, one month before the AML became effective.[6] In September 2008, after the AML became effective, J&J refused to supply its products to Rainbow in response to Rainbow's request. When it came time for the annual renewal of the distributorship at the beginning of 2009, J&J refused to renew the distributorship agreement.

J&J, however, stopped imposing RPM conditions in 2009. It was not until August 2010 that Rainbow brought the current RPM suit against J&J to the Intermediate Court. The Intermediate Court issued its decision in May 2012, finding in favor of J&J. Rainbow appealed soon afterwards to the High Court, which issued its opinion on August 1, 2013.

Rule of Reason Applies to Analysis of RPM Agreements

Importantly, the High Court addressed whether minimum RPM agreements are per se unlawful under the AML or whether they should be analyzed under the rule of reason.

Vertical price agreements are governed by Article 14 of the AML:

> *Undertakings are prohibited from entering into the following monopoly agreements with their transaction counter-parties that:*
>
> *(1) fix the price of products resold to third parties;*
>
> *(2) restrict the minimum price of products resold to third parties; or*
>
> *(3) other monopoly agreements as determined by the Antimonopoly Law Enforcement Authority under the State Council.*

Rainbow argued that the language of Article 14 should be interpreted to mean that RPM clauses are per se illegal, just like the horizontal agreements prohibited under Article 13. Article 13 provides:

> *Undertakings with a competitive relationship are prohibited from entering into the following monopoly agreements:*
>
> *(1) fix or change the price of a product;*
>
> *(2) restrict the production quantity or sales quantity of a product;*
>
> *(3) allocate the sales market or the raw materials purchase market;*
>
> *(4) restrict the purchase of new technology or new equipment, or the development of new technology or new products;*
>
> *(5) jointly boycott transactions;*
>
> *(6) other monopoly agreements as determined by the Antimonopoly Law Enforcement Authority under the State Council.*
>
> *Monopoly agreements referred to herein are agreements, decisions or other concerted conducts that eliminate or restrict competition.*

J&J argued that it first had to be determined whether the specified agreements were monopoly agreements, and the last sentence in Article 13 provides a definition of such monopoly agreements. J&J argued that if these agreements were in fact per se illegal, there would be no need to provide a definition of monopoly agreements. Thus only those agreements that satisfy this definition should be considered to be monopoly agreements subject to AML sanctions. The Intermediate Court apparently agreed with J&J's interpretation and stated in its decision that, to analyze vertical RPM agreements, courts need to look at the market share of the product to which RPM applied, the competitiveness of the upstream and downstream relevant

6 According to the High Court's decision, in a letter from J&J to Rainbow on July 1, 2008, J&J also accused Rainbow of bidding for a hospital outside its authorized territory, which was limited in the parties' 2008 distribution agreement. However, the issue of exclusive territories was not part of the plaintiff's antitrust claim in this case.

markets, and how the resale clause affects the quantity and price of the supplied products.

The High Court affirmed the Intermediate Court's interpretation that minimum RPM is not per se unlawful under the AML. It first reasoned that the way specific terms are defined in the AML implies that the definition of monopoly agreement in Article 13 also applies to Article 14. The High Court then cited Article 7 of the JI, which states that "if the sued monopoly conduct falls under the monopoly agreements provided in Article 13, then the defendant has the burden of proof to show that the agreement does not have the effect of eliminating or restricting competition." The High Court reasoned that since Article 13 requires a determination of whether horizontal monopoly agreements, which are often thought to be more harmful than vertical agreements, eliminate or restrict competition, before declaring them illegal, such determination must also be required for vertical agreements covered by Article 14.

Burden of Proof

Rainbow argued that the defendant has the burden of proof in RPM cases, because Article 7 of the JI provides that defendants have the burden of proof to show that a horizontal agreement, as specified in Article 13 of the AML, does not eliminate or restrict competition. Since vertical price agreements are similarly specified in Article 14 of the AML, Rainbow argued that J&J should have the burden of proof. J&J argued in response that the Intermediate Court was right to rule that the plaintiff had the burden of proof, and that such a ruling is consistent with principles specified in China's Civil Litigation Law. The High Court agreed that the burden of proof on the plaintiffs cannot be reversed unless specifically provided for in the law or regulation. The shift of the burden of proof to the defendants for horizontal agreements (as specified in the JI) was not applicable to vertical agreements. Rainbow therefore was required to provide evidence of the existence of the RPM agreement and its anticompetitive effects, after which J&J would have the opportunity to rebut such claims with its own evidence.

It is peculiar that the published JI did not specify explicitly who has the burden of proof in vertical price agreement cases. Indeed, an earlier draft of the JI that the SPC used to solicit comments specified that plaintiffs have the burden of proof in cases involving monopolization agreements, except in cases involving agreements specifically listed in Articles 13 and 14, where defendants have the burden to show the agreements do not eliminate or restrict competition. So it appears that the SPC initially contemplated that the defendants would bear the burden of proof in RPM cases.[7] However, this provision changed when the JI was finalized and vertical price agreements were deleted from the exceptions. It seems the SPC changed its mind and wanted the plaintiffs to have the burden of proof in RPM cases.

The Analytical Framework for RPM Agreements

In the appellate decision, the High Court set forth a four-part analytical framework for RPM cases that required consideration of: (1) the competitiveness of the relevant market; (2) the defendant's market power; (3) the defendant's purpose in implementing the RPM; and (4) the competitive effect of the RPM.[8] From its description of the test, it appears that the High Court may have put equal weight on all four parts.

We find this framework is potentially problematic from an economist's point of view, because only (4) the competitive

7 In a press conference after the release of the JI, the SPC spokesperson and the chief judge of the Intellectual Property Division of the SPC, which is also the division in charge of reviewing antitrust cases, emphasized the difficulty for plaintiffs to obtain evidence in China and the need to resolve this imbalance. See http://www.legaldaily.com.cn/index_article/content/2012-05/09/content_3557632.htm?node=5955.

8 In its initial decision, the Intermediate Court laid out a three-part analytical framework to evaluate RPM cases that required consideration of: (1) whether the RPM is a monopolization agreement, which depends on whether it eliminates or limits competition; (2) whether there are damages; and (3) whether there is a causal relationship between the monopolization agreement and the damages. The Intermediate Court ruled that Rainbow failed to show that J&J's RPM clause constituted a monopoly agreement, and that the RPM clause led to the damages Rainbow claimed.

effect of the RPM should be used as the ultimate test, while (1) and (2) can at best be used as a screening threshold and (3) is at best a factor for consideration. For (1) and (2), even if a firm has significant market power and the relevant market is not sufficiently competitive, it does not mean that RPM is necessarily anticompetitive. On the contrary, there are findings in the economics literature on RPM that suggest that procompetitive effects of RPM are more likely to occur when implemented by firms that have market power.[9] As for (3), we would argue that judging conduct by its "purpose" leaves too much room for subjective opinions and potential biases; conduct should ultimately be judged by its actual competitive effect, not by the (perhaps misguided) beliefs or intentions of the defendant.

Key Economic Arguments Provided by the Parties and the Court's Rulings

Both Rainbow and J&J hired economic experts to prepare economic analyses that were put forward during the appeal. Rainbow's economic expert testified at two of the three hearings, while J&J's economic expert did not attend the hearings but instead only submitted a written report.[10] In this section, we lay out some of the key economic arguments provided by the parties' experts and the court's corresponding rulings, and provide commentary on some of the issues that may be subject to a different interpretation.[11]

Competitiveness of the Relevant Market and J&J's Market Power

In evaluating the competitiveness of the relevant market, the High Court first defined the relevant market as suture thread for medical use in mainland China. This determination was primarily based on demand substitution and the Court's conclusion that suture thread, with its particular product characteristics, has no close substitutes.

The High Court rejected Rainbow's attempt to delineate a narrower market based on absorbable suture thread, noting that although there is an important difference between absorbable and non-absorbable thread (because non-absorbable thread needs to be removed after a period of time), this difference does not mean that the two products are not reasonably substitutable. The High Court also rejected J&J's suggestion that the relevant geographic market might be broader than mainland China, noting that medical products are highly regulated in China and it is unlikely hospitals can buy suture thread directly from a supplier located outside of China. The High Court also stated that there was no need to perform a hypothetical monopolist test to define the relevant market in this case.

The High Court found that competition in the defined relevant market is insufficient for the following reasons: (1) because suture thread is only a small part of the cost of surgery, and hospitals simply pass on the cost to patients, there is insufficient incentive on the part of buyers to bargain for lower suture thread prices; (2) J&J's marketing has established a strong brand name, which creates switching costs once doctors and nurses have used the J&J product, and there is low cross elasticity between different brands; (3) entry barriers are significant due to government regulation, the strength of brand name effects for incumbent brands, and the strength of the incumbents' supplier-customer relationships built through the incumbents' marketing efforts; and (4) J&J has had pricing power, as indicated by the fact that it had charged the same prices for its products for 15 years.

The High Court further determined that J&J had a "very strong market position" that could affect market competition because competition in the relevant market is insufficient as explained above and that: (1) J&J has a

9 Pauline M. Ippolito and Thomas R. Overstreet Jr., *Resale Price Maintenance: An Economic Assessment of the Federal Trade Commission's Case Against the Corning Glass Works*, 39 J.L. & Econ. 285 (1996).

10 It is not clear from the decision why J&J's economic expert did not attend any of the hearings.

11 For a more detailed discussion of the economic analyses used in this case, please see Fei Deng and Litong Chen, *Economic Analyses in Shanghai High Court's Vertical Restraint Case*, available (in Chinese) at http://opinion.caixin.com/2013-08-20/100571720_all.html.

leading market share, though its exact share in the relevant market was not known; (2) J&J has pricing power; (3) J&J has a strong brand name; and (4) J&J has strong control over its distributors given how its distribution system works.[12]

One of the key pieces of evidence that drove the High Court to conclude that competition in the relevant market is insufficient and J&J had a "very strong market position" in the relevant market was that J&J's suture thread prices had not changed much over the previous 15 years. The High Court took this as a sign that J&J has "very strong pricing capabilities."

In our view, there are several issues with such an interpretation. First, as the defendant's expert pointed out, the actual price of J&J's suture thread, after taking account of inflation, had fallen over time. Second, it is likely that J&J's actual gross profit margin had also been falling, given increases in prices of raw materials.[13] Third, even if one assumes that J&J's suture thread price had not changed at all over 15 years, it does not imply that J&J had "very strong pricing capabilities" or that its pricing was not constrained by other competitors at all. One possibility is that other competitors constrained J&J's pricing significantly, but the other competitors themselves had not changed their prices much over time. In that situation, J&J would not have changed its prices either. This possibility can be tested by looking at the historical pricing trends of other competitors.

J&J's Purpose in Implementing RPM Terms

As for the third part of the test, J&J's purpose for using minimum RPM, the High Court noted that although the two sides provided different descriptions of how J&J competed in the market, "no matter through improving service to gain competitive advantage or through raising prices by producing new generations of products, J&J's pricing strategy was always try to prevent prices from falling." The High Court also noted that J&J's distribution contracts contained clauses that discouraged distributors from lowering prices.

In our view, a potential justification that might be plausible in this case is that the main form of competition in the relevant market is not pricing, but rather non-pricing measures such as marketing and sales force activities, and that J&J is simply using RPM as a tool to encourage each distributor to engage in such activities itself rather than attempting to free-ride on the activities of other distributors. Moreover, a principle of a market-based economy is that a firm has the right to determine how it prices its own products. Even if a firm's pricing strategy is to "always try to prevent prices from falling", as long as it determines its prices independently without colluding with other competitors, it should not be punished under the antitrust laws, at least based on precedent in the United States.

Competitive Effect of J&J's RPM

In applying the last and the most important part of the test, the competitive effect of the RPM, the plaintiff's expert referenced "empirical findings" to support his conclusion that RPM generally results in an increase in prices. However, these "empirical findings" were not empirical findings based on evidence in the *Rainbow* case, but rather findings by two works in the economics literature on unrelated products in the U.S. market.[14] The High Court rightly dismissed such evidence as unrelated to the case.

12 The High Court cited evidence such as: (1) the contract between J&J and the distributors stipulating that the distributors cannot sell competing products; (2) J&J assigning exclusive territories to each distributor; (3) J&J monitoring the distributors closely; and (4) the term of contracts between J&J and the distributors being one year, such that the distributors have a strong incentive to adhere to J&J's wishes in order not to lose the opportunity to renew the contract for the next year.

13 The High Court acknowledged this possibility, but did not take this into account as evidence, because the defendant did not provide relevant data and analysis to prove that J&J's actual profit rate had been falling.

14 One work is a report by the American Antitrust Institute (AAI) finding that toy and infant product prices in the U.S. generally rose by 20 to 40 percent after RPM was put in place, and also that listed prices of the same products were identical or nearly so at all major electronic stores. The other cited work is a book entitled *Industrial Organization: Contemporary Theory and Practice* by Lynne Pepall, et al., stating that in the U.S., because different states have different legal standards on RPM, prices of certain products are higher in states where RPM is legal, while lower in states where RPM is illegal.

The plaintiff's expert also claimed that RPM would generally result in a loss in social welfare because, he claimed, RPM generally results in an increase in prices and a decrease in sales volume, and that consumer surplus would decrease by more than producer surplus would increase, leading to an overall decrease in social welfare.

In our view, there are several problems with the economic logic of this claim, but it does not appear that the defendant's expert addressed any of them directly, and the High Court did not address these problems in its decision either. First, one cannot assume that RPM would always result in an increase in prices and a decrease in sales volume at the level of a market. The pricing restraint in this case, though binding on Rainbow's bids, might not be binding on market prices, such that market prices would not necessarily be lower in the "but-for" world without RPM. Moreover, RPM could well result in an increase in sales volume, because RPM may provide distributors with greater incentives to compete in dimensions other than price, such as providing better service and greater sales effort. Such activities on the part of distributors would shift the consumer demand curve out, potentially increasing the sales volume and consumer surplus beyond what it would be in the "but-for" world. Indeed, this is exactly the procompetitive motivation for RPM. For this reason, it has been suggested that sales volume, rather than price, is a better measure for evaluating the effect of RPM.[15] Focusing on prices alone can be misleading — an increase in price could be necessary to achieve an increase in quality and services, which in turn could lead to an increase in consumer surplus and social welfare. A change in sales volume can provide a better indication than prices of the net change in these welfare measures. Second, there are empirical findings in the economics literature that provide actual examples where RPM increased social welfare and market competition.[16] Third, the competitive effect of RPM in a given case is ultimately an empirical question. Thus, in order to determine the impact of RPM on social welfare and market competition in a given case, one needs to conduct empirical analyses, studying what the prices and sales volume would have been in the "but-for" world without RPM, based on actual data and evidence specific to that case, rather than relying on general theoretical assumptions. For example, one fact mentioned in the decision is that J&J stopped implementing RPM in 2009. This provides a good opportunity to conduct a "natural experiment" analysis, for example, using regression models to compare prices and sales volume with and without RPM, while controlling for other factors.

The plaintiff's expert next analyzed the harm to competition and social welfare due to RPM from the following perspectives: (1) J&J implemented price monitoring of distributors so that they could not engage in intra-brand price competition; (2) J&J maintained its monopoly power through the use of exclusive territories, which resulted in its demand curve being less elastic and its prices higher; (3) J&J had more than 50 percent share of the relevant market, resulting in more than 50 percent of sales being made under conditions of reduced intra-brand competition; (4) J&J was a market leader that could, by fixing resale prices for its own products, facilitate tacit collusion among manufacturers, which led the overall prices in the market to be fixed; and (5) J&J raised its product prices artificially high through RPM and greatly reduced consumer surplus and social welfare. The defendant's expert attempted to rebut these claims by arguing that: (1) RPM did not facilitate price collusion among manufacturers because there were many manufacturers in suture thread, which makes it hard to reach a stable collusive outcome, and because it can be seen from the competitive bidding situation of distributors at the hospital at issue that there was no collusion; and (2) no empirical

15 *See, e.g.*, Richard A. Posner, *The next step in the antitrust treatment of restricted distribution: Per se legality*, 48 U. Chi. L. Rev. 6 (1981).

16 *See, e.g., supra* note 9.

evidence was provided to show that the prices of suture thread had gone up, so there is no sound basis to conclude that RPM decreased social welfare.

The High Court determined that although there was no evidence of the existence of a horizontal price cartel, the anticompetitive effects were still significant, including: (1) elimination of intra-brand competition and maintenance of a high price; (2) avoidance of inter-brand price competition in the relevant market; and (3) restriction on distributors' pricing freedom and harm to more efficient distributors.

It appears that the High Court, in siding with the plaintiff, relied only on the theory that RPM restricts price competition, instead of relying on empirical evidence of actual harm. Since neither side provided empirical analyses based on actual data and evidence specific to the case, the High Court was left to choose between the two sides' theoretical arguments. Although the defendant's expert highlighted the importance of non-price competition in this market based on qualitative evidence, in our view, his position would have been greatly strengthened had he conducted empirical analysis and quantified the actual effect of RPM on consumer surplus and social welfare. It seems to us that there is substantial evidence suggesting that non-price related sales efforts are more important than low prices in promoting sales in this particular market. For example, it is mentioned in the High Court's decision that:

> …in the medical equipment industry, it has always been that sales are conducted mainly by the direct marketing of dealers to the hospitals. J&J and other brand-name suppliers and dealers have invested a tremendous amount of effort and money in these activities, and have engaged in building strong client relationships with the hospitals. The fact that J&J requires its dealers to invest part of its sales revenue as 'marketing expansion expenses' shows its significant focus on client relationships.

The decision also cited sales plan documents showing that J&J advised distributors to engage in more sales and promotion efforts including educational presentations to nurses, building stronger relationship with doctors, and paying more visits to hospitals, in order to counterbalance the price disadvantage of J&J's products. Lastly, the High Court already acknowledged when evaluating the overall competitiveness of the market that there was a lack of price sensitivity by hospitals because although hospitals are the decision-makers regarding the choice of suture thread, it is the patient, not the hospital, who bears the ultimate costs. With the lack of price-sensitivity by hospitals, it is no wonder that a supplier like J&J would choose to focus on non-price competition rather than cutting prices. Thus, the correct empirical analysis should focus on the effect of RPM on sales volume and ultimately consumer surplus or social welfare, instead of prices. If RPM increased the sales volume of J&J, consumer surplus and social welfare may well have increased despite any higher prices possibly resulting from RPM. Overall, this would mean that RPM had enhanced competition.

Lastly, the parties' experts disputed whether J&J's RPM had any procompetitive effects. The focus of the dispute was whether the RPM solved a free-riding problem, improved quality of service, encouraged greater promotion by distributors, or provided any other value. Again, the High Court sided with the plaintiff, although neither side provided any empirical analysis of the actual effects of RPM. The High Court decided that there was not enough evidence to prove that RPM had significant procompetitive effects in this case, including insufficient evidence of: (1) RPM improving product quality or safety; (2) the necessity of RPM to solve the free rider problem; (3) RPM being necessary in promoting new brands or new products to enter the relevant market, and (4) other benefits including maintaining brand image, encouraging inventory, expanding distributors' scale, and expanding distributors' sales of J&J's products.[17] However, from an economist's

17 There was exclusive dealing between J&J and its distributors. J&J's distributors were not allowed to carry other manufacturers' brands.

perspective, there is no need to categorize the benefits. Conduct that increases the safety and quality of products does not necessarily increase social welfare more than conduct that purely increases the sales and consumption of certain products. As long as RPM ultimately increases social welfare, whether through an increase in promotional activities or an increase in product quality, it is more procompetitive than anticompetitive.

Other Issues Covered in *Rainbow v. Johnson & Johnson*

Because China has only a short antitrust history, there are very few court decisions. It is therefore worth noting some other issues addressed by the High Court in the *Rainbow* case, even though these issues were not at the core of the case. We briefly discuss some of these issues.

A. Standing of the Distributor to Bring the RPM Challenge

J&J argued that Rainbow did not have standing to bring this case because, as a distributor, Rainbow was neither a competitor nor consumer in the relevant market. J&J further argued that Rainbow could not challenge a distribution agreement that Rainbow itself signed. The High Court ruled that a distributor that is a party to an RPM agreement could be harmed either because it lost the profit opportunities potentially available if it were given the right to lower the price below the stipulated minimum price, or because it was punished by the supplier for lowering the price in violation of the RPM clause. Given the right of the harmed to seek civil remedies in antitrust disputes as provided in Article 50 of the AML and clarified in Article 1 of the JI, a distributor has standing to sue its counterparty to the RPM agreement. Interestingly, the High Court also pointed out that from the perspective of the legislative intent of the AML to protect competition and consumers, participants in monopoly agreements should be allowed to bring civil lawsuits to the court. Because consumers often do not know the details of the monopoly agreements, not allowing the insiders who have the evidence to sue would make it very difficult to prosecute such illegal conduct. The High Court's concerns are quite understandable; because there is no right of private class action and no formal discovery process in China, obtaining credible and sufficient evidence is notoriously difficult for plaintiffs.

B. Admissibility of Evidence

The High Court also discussed in detail the admissibility of the evidence submitted by each side. The High Court's determination of admissibility rested on two criteria: authenticity and relevance. In terms of authenticity, the High Court generally considered evidence collected from government websites, when notarized, as reliable. For example, information contained on notarized web pages of the National Food and Drug Administration that was submitted by Rainbow was considered truthful. The High Court was less receptive to evidence collected from private third parties. For example, on the written statement and the price tables provided by a hospital for Rainbow, the High Court considered them as inadmissible because there was no indication as to when the evidence was prepared, and the hospital did not send staff to the court to testify. Rainbow also provided a third party consulting report, but no source information was provided for the statistics in the report, and the report's disclaimer stated that the consulting firm did not promise the accuracy and completeness of the content. For these reasons, the High Court considered the report inadmissible.[18] The documents Rainbow submitted that came from J&J were considered admissible because even though J&J cast doubt on their authenticity, it did not submit evidence to prove the contrary.

18 Such disclaimers appear to be a serious concern by the Chinese courts in deciding admissibility. For example, in Qihoo 360 v. Tencent, the Guangdong High Court showed concerns over a consulting report partly because the report's legal disclaimer said that "due to the limitation of the survey research method and the sample, as well as the limitation on the scope of the materials collected, some data cannot reflect completely the true situation in the market. The report only serves as a reference to clients who purchase it, and our firm does not bear legal responsibility for the data accuracy in this report."

The High Court also considered whether the evidence, even when authentic and reliable, was relevant to the case. For example, J&J submitted notarized copies of web pages of the National Food and Drug Administration that showed different brands of suture thread. The evidence was considered truthful by the High Court. However, because this evidence contained information that was redundant or irrelevant to suture thread, or for brands whose registration was no longer effective, or the data were inconsistent with actual production and sales information, the High Court considered it inadmissible.

It is also interesting to note how the High Court determined admissibility of emails. Emails are commonly included in discovery in the United States, and are often used as evidence in court in antitrust cases. In this Chinese case, Rainbow submitted four notarized emails, in which Rainbow questioned J&J's punishment of Rainbow by adjusting Rainbow's sales territories and by refusing to supply more products. J&J responded by saying that it could not locate such emails in its system and thus could not confirm their authenticity. The High Court pointed out that J&J submitted similar emails in the contract dispute case with Rainbow from about the same period, and reasoned that the loss of these emails, which were addressed to multiple recipients, was not plausible.

C. The AML and the Contract Law

At the same time that this antitrust suit was being litigated, a contract lawsuit between the same two parties was also being litigated. In April 2010, J&J sued Rainbow for not paying for goods J&J supplied and sought damages of close to 3 million RMB (about US$490,000). The RPM case discussed here was filed by Rainbow shortly afterwards as a response to the breach of contract case. The contract case was determined by a lower court in November in favor of J&J, and Rainbow's appeal was not successful when the appellate decision was given in April 2011 by the Shanghai Intermediate People's Court, where the antitrust case was still pending.

The relationship between the contract case and the antitrust case was reflected in how the antitrust damages were calculated. In general, the High Court's position was that damages which could be explained by the contract dispute and were not necessarily a result of the antitrust dispute would not be included as part of the antitrust damages.[19] The High Court decided:

(1) Damages for 2008 were calculated based on projected 2008 sales that could not be completed due to the supply disruptions. However, profit margins should not be the high level achieved based on the original RPM contract, but should be adjusted based on the "normal profits" that might be achieved by other manufacturers' brands.[20]

(2) Prospective Rainbow sales and profits on suture thread beyond 2008 were not included in the calculation of the damages because a contract termination as permitted under Contract Law (independent of the antitrust dispute) could explain them.

(3) Similarly, the sunk cost Rainbow devoted to marketing J&J products in the past 15 years when they had maintained the distribution relationship with J&J was not included in the calculation of damages.

19 The High Court's opinion seems to be quite strict in its approach. It seems that, even if there was a probability that the termination of contract was caused by the antitrust dispute, as long as this probability was not a clear and dominant reason, the High Court would not consider it as part of the damages calculation.

20 The High Court's decision does not discuss whether RPM was also practiced by other manufacturers, in which case the prices of such other manufacturers might not be an appropriate benchmark for the but-for world.

Conclusion

In *Rainbow v. Johnson & Johnson*, the Shanghai High Court set an important precedent of applying the rule of reason approach to RPM cases. Though China has a civil law system, this decision is still likely to have considerable influence on future private antitrust cases as well as on China's antitrust agency decisions. [21] In particular, the High Court established that the rule of reason applies to RPM, that the application of the rule of reason requires consideration of four factors, and that the plaintiff bears the burden of proof in an RPM case. In addition, the High Court's decision demonstrates the importance of economic analysis in applying the rule of reason. *Rainbow v. Johnson & Johnson* is further notable for its holding that a distributor has standing to challenge an RPM agreement even when the distributor signed the agreement, and for the decision's holdings on admissibility of evidence and on the role played by contract law in assessing antitrust damages. The decision on all of these issues provides not only important guidelines for future litigation concerning RPM disputes, but also an indication as to the general direction of antitrust litigation in China. Though some of the High Court's reasoning may be subject to debate, the lengthy and carefully drafted decision reflects that the Chinese judiciary is becoming increasingly sophisticated in adjudicating complex antitrust cases. As such, both plaintiffs and defendants engaged in antitrust litigation in China need to formulate legal theories and strategies carefully, and have them supported by strong factual evidence and solid economic analysis.

21 For a brief explanation of China's judicial system, see *China's Judicial System: People's Courts, Procuratorates, and Public Security, available at* http://www.olemiss.edu/courses/pol324/chnjudic.htm.