The Internet: Just Another Distribution Channel?

EU and U.S. Competition Policy Approaches to E-Commerce

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Work in progress

Abstract

Policy makers have recently faced the challenge of integrating the online distribution channel in their competition policy regimes for vertical restraints. This paper applies a Bayesian framework to compare EU and U.S. competition policies on online distribution. Policy enforcement decisions are defined as resulting from prior beliefs and loss functions. The stricter EU policy regime is found to be the result of a bias towards avoiding type-II-errors and the importance of the Internet for market integration. The more lenient U.S. regime is characterized by influences of the Chicago school and a bias towards avoiding type-I-errors. While the Internet takes on more importance in EU reasoning, in U.S. competition policy, it is just another distribution channel.

JEL codes: L44, L81, K21

Keywords: E-Commerce, Competition Policy, Online Distribution, EU-U.S. Comparison, Vertical Restraints

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1 Introduction

As a relatively new distribution channel, the Internet has effects on the economy as a whole, on the interaction between businesses and consumers, and on competition amongst firms. As suppliers and distributors adjust their strategies to the specificities of this important distribution channel, new competition concerns with regard to vertical restraints arise. Vertical restraints can be driven by efficiency motives or result in restrictions of competition. As more and more transactions are shifting to the Internet, competition authorities need to take into account the implications of e-commerce relating to vertical competition problems. Since their advanced antitrust regimes often serve as examples for less experienced jurisdictions, the way in which EU and U.S. competition authorities' take on the online environment is a relevant field of study. Not only will their competition policies crucially influence market players' possible business strategies, but also the prices and choices that consumers face. Given the global nature of the Internet, it becomes all the more important to avoid negative externalities arising from dissimilar regional competition approaches. A detailed comparison of the similarities and differences between the big two competition policy giants is therefore warranted.

Both the effect of the Internet on competition itself[2] and on competition policy approaches towards vertical restraints in the EU and the U.S.[3] are extensively covered by the literature. It is the aim of this paper to link those two strands of analysis in order to explain the forces behind the diverging EU and U.S. competition policy approaches towards online distribution.

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[2] For instance, authors such as Haucap and Heimeshoff (2014), Gebhardt (2010), Bakos et al. (2005), and Kesan and Gallo (2003) all investigate the impact of the Internet and its characteristics on competition in general or in a particular sector.

[3] Among many others, Campbell (2000) and Comanor and Rey (1997) both compare the EU and U.S. competition standards towards vertical restraints.

Applying a Bayesian framework to competition policy enforcement decisions, we depart from the hypothesis that the divergent EU and U.S. competition policy decisions on online distribution are a reflection of their policies towards vertical restraints based on prior beliefs and loss functions. Thereby, we expect their approach to online distribution to be in continuity with their prior attitudes towards vertical restraints and to be imbedded in their overall approach towards competition problems.

This paper is divided into five sections. Following the introduction, section two guides the reader into the subject of online distribution from a competition policy angle, discussing its pro- and anti-competitive effects. Thereafter, section three illustrates the materials and methodology employed to investigate our hypothesis. We apply a Bayesian framework as presented by Cooper, Froeb, O'Brien and Vita (2005) and adopt a comparative approach. Section four presents an investigation into the prior beliefs and the overall legal framework on vertical restraints that feeds into EU and U.S. approaches towards online distribution. Here, the schools of thought that have influenced EU and U.S. ideas on vertical restraints are elaborated on. In section five, we directly compare EU and U.S. approaches towards online distribution, firstly concerning their general attitudes towards this new distribution channel and secondly with regards to their respective legal frameworks and case law. Finally, the conclusion suggests possibilities for future research.

2 Online Distribution

E-commerce describes all activities relating to the buying and selling of goods and services over a virtual marketplace via the Internet (Singh, 2012). The perception that e-commerce has altered the nature of competition and introduced a shift in its parameters has sparked the discussion on competition policy approaches towards online distribution.

As an additional distribution and marketing channel, online distribution has become central to the development of retailing activities. While the relevance of online buying and selling varies significantly from sector to sector (Bundeskartellamt, 2013, p. 16)[4], today, retailers, whether they initially were pure internet players or traditional brick & mortar players, seem to converge towards so-called "multi-channel strategies"[5] (Autorité de la concurrence, 2012, p. 38). The

[4] For instance, online sale of consumer electronics have a much higher proportion in total sales than online sales of gardening tools. (Bundeskartellamt, 2013, p. 16)

[5] Multi-channel, in this context, refers to distribution of products via both online and offline channels. A European e-commerce survey realized by Accenture in 2011 showed, for instance, that nearly one third of all respondent companies generated around 30 per cent of their revenues online (2012, p. 5).

advent of e-commerce itself has produced many pro-competitive and welfare-enhancing effects. However, the coexistence of online and offline distribution channels can also lead to competition problems. As studies on the effect of the Internet on competition parameters are still rare, we will merely provide intuitive implications for the way competition is influenced here below.

2.1 Pro-Competitive Effects of Online Distribution

Firms usually compete based on price, product range, product quality, product image and reputation and associated services (Singh, 2012). Online and offline distribution channels still compete based on the same characteristics, but e-commerce has introduced four substantial changes for both consumers and businesses that altered competition: a price effect, a choice effect related to a dematerialization effect (Lubek, 2011, p. 6) as well as a market-player effect.

E-commerce has increased pressure on prices. On the one hand, this results from the higher degree of price transparency and lower search costs online which enables consumers to observe and compare prices more easily, thereby intensifying intra- and inter-brand price competition compared to classical distribution systems (Bundeskartellamt, 2013; see also Accardo, 2013; Singh, 2012; OECD, 2013).

On the other hand, online distribution also reduces transaction costs for dealers and manufacturers. As opposed to the storage and showroom limitations of physical shops, online face no limit to the amount they can offer on-site (Bundeskartellamt, 2013, pp. 15-16). Moreover, delivery, inventory and staff costs are lower in e-commerce (Singh, 2012)[6]. However, the degree to which prices online undercut prices offline seems to depend on the nature of the product as well as on the distribution model chosen by most of the manufacturers and retailers in the industry concerned[7].

[6] The main reason for cheaper prices online seems to be lower online distribution costs, since the cost structure of pure online players are crucially different from that of hybrid players. Costs for personnel, logistics, rent etc. are on average 15-20 per cent for the former's and 25-30 per cent of the latter's revenue (Autorité de la concurrence, 2012, p. 25).

[7] The French competition authority found that for electrical household products and pharmaceutical products, prices online were on average 5 to 15 per cent inferior to offline prices, with strong variation in the online/offline price difference depending on the specific product. In contrast, concerning luxury perfumes only a weak price difference between online and offline retailing could be found, as online sales are mostly organized by the big national chains leading to price coherence between the in-store and the online price. (Autorité de la concurrence, 2012, pp. 15-20)

Next to lower prices, the online channel expands the range of products that consumers can choose from and that distributors can offer (Singh, 2012) by lifting the restriction of showroom space of physical points of sale[8].

Owing to the dematerialization of the distribution service through the internet consumers no longer face the physical limitations of distance and opening hours (Lubek, 2011; OECD, 2013). While the convenience of Internet shopping for consumers is high, it might lead to information asymmetries that do not exist in the same manner, when consumers physically visit a store and make a purchase after having seen, tested and inspected the product (OECD, 2013, p. 20). For sellers, the dematerialization effect lowers entry barriers: for an offline distributor, start-up costs to also provide and promote his products online are relatively small (Bundeskartellamt, 2013, p. 17). Furthermore, the various techniques through which the Internet allows to collect consumer information enable businesses to retain their consumers' loyalty by better adhering to their wishes. As automated services make buying and paying faster and enable consumers to switch easily, retaining a loyal client base will be a highly valued asset in e-commerce.

A final competition-changing feature of the Internet relates to the emergence of new market players and movements of (dis) intermediation compared to traditional distribution chains (OECD, 2013, p. 18). New players such as price comparison websites, social network platforms and evaluation systems further fuel price competition by increasing transparency and comparison opportunities (Autorité de la concurrence, 2012, pp. 35-37; Accardo, 2013, p. 4). These online intermediaries provide pre- and post-sales information and services or document and structure the flow of information so that it can be easily processed by consumers (OECD, 2013, pp. 9-17). Intermediaries also establish platforms bringing together buyers and sellers, such as Groupon or eBay. Hence, new types of businesses have developed: pure internet players[9], brick & click[10],

[8] The French competition authority found for the case of electronic household products, that both pure players and "click & mortar" players offered a greater number of, often complementary, products online than in physical shops (Autorité de la concurrence, 2012, p. 30).

[9] Pure internet play uses the Internet as the only distribution channel. It is characterized by low fixed costs regarding infrastructure, staff and inventory. The difficulty here lies in the establishment of a strong brand reputation requiring investment in advertising, design and security technologies. (Accardo, 2013, p. 8)

[10] Brick & click is characterized by physical retailers which adopt the internet to be able to supply to a mass audience (Accardo, 2013, p. 9). This is also sometimes referred to as clicks & mortar, surf & turf or hybrid e-commerce (Jen-Yun, 2009, p. I).

and third party platforms[11] are new business models exploiting the different features of the Internet.

Owing to those four effects, the Internet will lead to an intensification of competition on the level of producers as well as distributors. Consumers largely benefit from these evolutions in the form of lower prices and a wider product range (Bundeskartellamt, 2013, p. 16), which is reflected in the fast growth of internet buying in both the U.S. and the EU (Accardo, 2013; Singh, 2012).

2.2 Potential Competition Problems of Online Distribution

Online distribution and e-commerce more generally might also lead to competition problems in the horizontal and vertical relations between firms. Horizontally, an immediate downside of the increased transparency and greater availability of information online is the facilitation of collusive conduct and price discrimination (Bundeskartellamt, 2013; OECD, 2013; Singh, 2012). Moreover, strong network externalities, first mover advantage and switching costs may tip markets towards concerted behaviour and favour the emergence of a dominant position (Singh, 2012).

Vertically, competition problems might arise due to the coexistence of those two distribution channels. Given their different values for consumers, producers and sellers, the online and offline distribution channels are often considered to be complements and studies tend to show that the two channels mutually reinforce each other (Lubek, 2011, p. 6)[12]. This complementary aspect remains unproblematic for competition as long as distribution networks are integrated[13]. Problems for competition arise however, if online and offline distributors are different economic actors. Then the coexistence of offline and online channels can lead to free-riding issues from one type of distribution channel on the service offered by the other.

The competitive effect of online distribution will differ with respect to inter- and intra-brand competition. Inter-brand competition will generally be enhanced as the number of products and services offered to consumers is increased while transaction costs are reduced (Autorité de la

[11] Third party platforms provide an environment for business to provide their products through an umbrella platform (Accardo, 2013, p. 9). This can be via comparison-shopping engines, e-malls and online marketplaces (Singh, 2012).
[12] A recent study by comStore showed, for instance, that online advertising has led to a rise in online sales by 42 per cent, but equally resulted in an increase of offline sales by 10 per cent (comStore, 2008).
[13] Gertner and Stillman (2001) showed that most internet sales websites have been launched by a network of distributors, often reunited by the producer of the respective product.

concurrence, 2009, p. 3). Intra-brand competition, however, may be harmed or at least softened, as manufacturers will attempt to maintain control over the online distribution channel (Autorité de la concurrence, 2009, p. 3) by means of vertical restraints (OECD, 2013, p. 6).

A business strategy particularly affected by the issue of free-riding is that of selective distribution systems[14]. With the advent of online shopping, the importance of the product price as a parameter of competition was heightened, as many consumers favour low-price-low-service offers over high-price-high-service options (Lubek, 2011, p. 7). Certain features of the Internet, such as the ease and convenience of online shopping or lower product prices, are conducive to free-riding by 'pure internet players' on the services offered by brick & mortar stores for products that depend, for instance, on a sensory experience for sales (Lao, n.d., p. 2) or warrant technical assistance. However, free-riding may well occur in the opposite direction. Studies fon the EU and the U.S. provide substantial evidence that so-called 'research shoppers' most commonly browse on the Internet to subsequently purchase the particular product in a physical shop[15]. This free-riding problem has incentivized manufacturers to control their vertical relations not only concerning offline but also regarding online activities[16]. A dampening of intra-brand competition then typically arises, if vertical agreements go beyond what is necessary to remedy free-riding problems.

Despite the fact that the Internet has altered the way competition works, most regulatory authorities around the world agree that e-commerce does not require a strong change in the competition policy regime (OECD, 2013, p. 5). The theory on pro-competitive effects of the Internet is widely accepted by competition authorities. In addition, the managing of 'channel conflict' between online and offline distribution is recognized as a reality. Nevertheless, competition authorities evaluate this reality differently with respect to its effect on competition. Hence, the different ways in which competition authorities take account of e-commerce in their competition policy regimes on vertical restraints is a question that warrants closer investigation.

3 Materials and Methodology

[14] Within a selective distribution system, a producer agrees to supply only those distributors who meet certain criteria, thereby maintaining greater control over the resale of its products (Ashurst, n.d., p.1). It is often applied by manufacturers of complex, technical or luxury products.

[15] See for instance Grundlach, Cannon, and Mannung (2010), Jie Zhang, Farris, Irvin, Kushwaha, Steenburgh & Weitz (2009), Verhoef, Neslin and Vroomen (2007), and Baal and Dach (2005).

[16] See Carlton and Chevalier (2001) for an account of the ways in which manufacturers of branded goods manage "channel conflict" between brick & mortar retailers and internet retailers

"Comparison sharpens our power of description, and plays a central role in concept-formation by bringing into focus suggestive similarities and contrasts among cases." (Collier, 1993, p. 105)

The purpose of this paper is to examine an existing policy regime in the EU and U.S. and the way in which it incorporated a change in external circumstance. The aim is to develop an explanatory narrative to illustrate how the differences in legal and economic approaches to vertical restraints of these two jurisdictions fed into their treatment of online distribution.

3.1 Hypothesis and Framework

Our research is based on the hypothesis that both U.S. and EU competition policies towards online distribution result from (i) their general approaches towards vertical restraints, (ii) the economic schools of thoughts informing these general approaches, and (iii) their specific appreciation of the role of the Internet in the economy. In order to test this hypothesis, we apply the Bayesian framework advanced by Cooper et al. (2005) for a comparative study of differences in competition policies towards vertical restraints.

Within the Bayesian framework, competition policy is seen as "a problem of drawing inferences from available evidence and [of] making enforcement decisions based on these inferences" (Cooper et al., 2005, p.303). Using Bayes rule, a policy maker's belief about the relative odds that a given practice is anti-competitive $\frac{P(A|x)}{P(C|x)}$ is a function of the prior beliefs about the practice in question $\frac{P(A)}{P(C)}$ and the relative likelihood that the evidence observed would be produced by anti-competitive conduct $\frac{P(x|A)}{P(x|C)}$ (Cooper et al., 2005, p. 304).

$$\frac{P(A|x)}{P(C|x)} = \frac{P(x|A)}{P(x|C)} * \frac{P(A)}{P(C)}$$

where A is the anti-competitive effect of a practice, C represents the pro-competitive effect of the practice and x describes the available evidence. Likelihoods as well as prior beliefs vary according to the type of vertical restraint in question, as well as the theories about their pro- and anti-competitive effects.

According to a Bayesian classification rule, a policy enforcer will only challenge a given practice based on the available evidence if the expected loss of committing a type-II error, i.e. failing to prosecute an anti-competitive practice, outweighs the expected loss of committing a type-I error, i.e. prosecuting a pro-competitive practice.

$$\frac{P(x|C)}{P(x|A)} < \frac{L_{ii}}{L_i} * \frac{P(A)}{P(C)}$$

The above formula posits that the 'optimal enforcement' rule depends on three elements:

i. Loss functions: A decision to challenge a vertical restraint is more likely if the cost of type-II errors is relatively high compared to the cost of type-I errors.

ii. Prior beliefs: A decision to find a vertical restraint to be anti-competitive is more likely when there are strong prior beliefs that the practice is anti-competitive.

iii. Likelihoods: When theory holds that the evidence at hand is most likely to have been generated by an anti-competitive practice than by a pro-competitive practice, a decision challenging the restraint is more likely.

This framework allows explaining the different enforcement postures of different jurisdictions. For the current competition policy analysis these different enforcement decisions might be either due to different prior beliefs (e.g. schools of thought) about the effects of the practice, or due to different loss functions. Because EU and U.S. decision makers share a common understanding of the theoretical effects of vertical restraints practices, we can discard likelihoods as a point of difference between them. Thus, we will attempt to explain the differences between the EU and the U.S. approach to online distribution by examining both policies as to prior beliefs and loss functions.

3.2 Comparative Research

The research underlying this paper involves a qualitative comparison[17] of two selected sets of competition policies (small N), reuniting legal, policy and economic disciplines. Small N studies are too limited to conduct statistical analysis, but rather aim at an intensive, less variable-oriented study of the cases at hand. The focus on only two policy systems means that we can use less abstract concepts that are more grounded in the specific context under scrutiny (Landmann, 2008, p. 25). Moreover, with small N studies, there is a need of a careful selection of cases.

We chose to compare two jurisdictions that are characterized by very different competition policy approaches to online distribution. Nevertheless, the EU and U.S. jurisdictions are comparable on the basis of the following features: Firstly, both jurisdictions have 'federalist'

[17] Comparative research is defined as the comparison of two or more research objects with the aim of discovering something about one or both of these objects. The comparative technique often reunites multiple disciplines (Heidenheimer, Heclo and Teich Adams, 1983).

characteristics. After the so-called modernization package and the advent of Regulation 1/2003 construing a system of simultaneous application of EU competition law by EU and national authorities and courts, EU competition law "now offers a unique platform for comparative analysis" (Cseres, 2010, p. 10). Similarly, in the U.S. the focus is placed on the federal level. Many state antitrust laws expressly provide that they are to be interpreted consistently with the federal antitrust law as interpreted by the federal courts, or it has been judicially held that they are to be interpreted as such. Secondly, both the U.S. and the EU competition policies have been studied regarding the distinct influence of economic schools of thought on the way in which competition policy is conceived (Hildebrand, 2009). Thirdly, in both the U.S. and the EU, an effects-based approach towards vertical restraints is followed and vertical restraints are treated by means of the same mental categories, i.e. price restraints and non-price restraints. This makes a systematic comparison possible.

The comparative research is undertaken by means of a qualitative analysis of official documents of courts and competition authorities, such as treaties, reports, cases and speeches. Furthermore, an intensive literature study is employed to historicize the genesis and evolution of both U.S. and EU competition policy, placing it in its relevant socioeconomic context.

The economic research mainly consists of a qualitative research on literature, while the legal and policy research can be placed in the discipline of comparative competition law, which follows, among other aims, the purpose of providing a tool for shaping or guiding domestic decision-making and legislation (Gerber, 1998, p. 721). Comparing the two legal regimes, we follow the methodology of 'decisional analysis' advanced by Gerber (2005). It consists of the analysis of legal decisions in relation to the various systemic factors that influence them and separates the analysis into two observational levels or units: decisions and systems. Decisions are the central object of analysis, i.e. decisions by courts or other institutions involved in the shaping of competition policy are the unit of behaviour that is compared across-countries. Decisions are an appropriate measure of objective conduct as they can be observed and quantified. They represent the smallest unit of behaviour that can be investigated across systemic boundaries. Moreover, decisions are influenced by the changing contexts of legal systems, but are at the same time endemic to these legal systems (Gerber, 1998, p. 728-729). The second operational unit observed is that of the "legal system", defined by Gerber as consisting of "the decisions of legal actors acting in legal capacities together with the factors that regularly influence such decisions" (Gerber, 1989, p. 729). These systemic factors are various: For instance texts, such as statutes, regulations and judicial opinions guiding, channelling and justifying legal decisions, are analysed. Across jurisdictions these texts can vary as to their level of abstraction, degrees of systematization, and specificity of language. Other systemic influences are interests, institutions, communities and patterns of thought, which are influenced by discourses and paradigms of their time.

When choosing the above qualitative research design, we have to be aware of its weaknesses as well as the limited nature of the conclusions that can be drawn from it. Given the descriptive nature of the research and the choice of a small N study without quantitative analysis, its sole aim is to analyse why a certain competition policy approach to online distribution has been adopted in the U.S. and the EU, to explicit what these approaches entail in detail and to emphasize their differences and their common elements. The purpose is not to evaluate the suitability of the policies. Furthermore, research on competition policy entails several limitations. Often, the material on cases is treated as confident and the decisions issued by competition authorities are of different depth and length, resulting in varying amounts of information on the case. Moreover, the different agendas of the actors involved in the making of competition policy are not publicly announced and are not directly apparent from the decision finally taken (Gerber, 1998, p. xii).

4 Prior beliefs: EU and U.S. approaches to Vertical Restraints and their Roots

Departing from a similar understanding of the theoretical and empirical effects of online distribution on prices, choices and business strategies, the EU and U.S. arrive at crucially different policy regimes for vertical online restraints. According to our hypothesis, this can, in part, be traced back to prior beliefs about the relative odds that a given practice will be anti-competitive. According to Bayesian epistemology, agents start out with some prior belief that is then updated in the light of new evidence or information. However, one of the most widely recognized shortcomings of Bayesian theory is that it "does not say anything about where those priors come from" (Dietrich & List, 2012, p. 1). Belief formation being a relatively under-researched area, we define prior beliefs, for the purpose of this paper, as originating from two sources: (i) economic schools of thought informing how economic theory is translated into policy, and (ii) prior case practice on vertical restraints.

4.1 Schools of Thought

In both the U.S. and the EU jurisdiction, the dominant economic schools of thought have strongly influenced the development and ideas in competition policy. In a nutshell: when vertical restraints are generally believed to be anti-competitive, a decision to find them so is more likely. Hence, we assume that the EU and U.S. schools of thought are reflected in their vertical restraints and online distribution regimes.

Schools of thought in the U.S.: Chicago and Harvard

Since U.S. law is based on a common law system, courts and antitrust agencies can change their interpretation of antitrust act to match the dominant economic beliefs at the time. This becomes apparent in the overruling of previous cases by the U.S. Supreme Court in so-called landmark judgments. Recent literature[18] seems to compete arguing for the influence of the Chicago school versus the Harvard school on U.S. competition policy. As it is not the subject of this paper to determine which school of thought has exercised the largest influence on current U.S. court decisions, we find it relevant to shortly address both schools.

The Harvard school[19], which dominated U.S. antitrust analysis around the 1950s-1970s, has also made significant contributions to antitrust analysis (Wright, 2007, p. 27). It laid the focus on industry structure as an explanation for firms' performance in the market (Piraino, 2007, p. 348), often applying the structure-conduct-performance paradigm. The Harvard school opposed the existence of market power and concentration in a desire to protect individual competitors. This led to a very strict regime for powerful firms' behaviour, even if the relevant conduct may have benefitted consumers. Within this system, presumptions of illegality of provided legal stability. According to Kovacic the Harvard school's occupied an important role in promoting the administrability of antitrust rules and could even be seen as the predecessor of the error-cost framework (Wright, 2007, 38). In turn, this also implied the neglect of the actual economic effects and particularly of the positive effects of a particular conduct on consumers (Piraino, 2007, pp. 349-354).

For vertical restraints, the Harvard school is often associated with a per se rule of illegality: it was particularly attractive for enhancing the effectiveness of antitrust enforcement, for the legal security it provided to businesses and for the effective deterrence of anti-competitive conduct (Piraino, 2007, p.353). In fact, Harvard school influence on antitrust reached its climax with the application of the per se rule to non-price vertical restrictions in *United States v. Arnold Schwinn & Co.* (1967)[20]. However, the downside of the per se rule was its deterring effect on

[18] Literature as by Hovenkamp (2010), Rubinfeld (2008), Piraino (2007), Elhauge (2007), Wright (2007) argue in favor or against one of these schools, put them against one another or even combine them as to a new antitrust approach.
[19] Some pioneers were Edward Chamberlain, Edward Mason and Joe Bain.
[20] 388 U.S. 365 (1967).

potentially pro-competitive practices, which was the main criticism advanced by the Chicago school. (Piraino, 2007, p.354)

The Chicago school of antitrust analysis developed in the 1950s[21] and was particularly influential in the U.S. in the 1970s and 1980s. It implemented the use of empirical analysis of the actual competitive effects in antitrust rulings on whether or not a conduct is legal (Piraino, 2007, p. 348). The school arose in association with the University of Chicago and has traditionally combined economics and law, using economics to determine what legal rules are economically efficient (Friedman, 1991, p. 371 quoted by Van Overtveldt, 2007, p. 289).

The Chicago school's influence on anti-trust analysis implied the critique of the structure-conduct-performance paradigm set forth by industrial organisation theory and the demonstration that supposedly anti-competitive conduct also revealed pro-competitive aspects (Wright, 2007, p. 28; Baker and Bresnahan, 2006). The emerging new body of antitrust scholarship features two essential characteristics: The first was the insistence that the exclusive goal of antitrust adjudication and the sole consideration of a judge in an antitrust case was the maximization of consumer welfare (Van Overtveldt, 2007, p. 308)[22]. Secondly, economic analysis was applied rigorously to understand the impact of business behaviour and the propositions of law (Van Overtveldt, 2007, p. 308). The now required burdensome proof of the specific economic effects of a conduct on consumers made it more difficult for judges and juries who now have to have experience in both law and economics (Piraino, 2007, p. 350), while reducing legal certainty for firms.

For competition policy this resulted in a minimum legal framework, where government intervention is rejected, where markets automatically correct any imbalances, and which functions by the survival of the fittest as termed by Stigler: a company's dominant position is seen as the result of its own efforts and therefore as a positive development. The threat of potential or actual market entry will avoid any short term abuses of price and quantity by a powerful company. (Piraino, 2007; Overtveldt, 2007; Reder, 1982)

[21] Chicagoan pioneers include people such as George Stigler, Robert Bork, Richard Posner, Ronald Coase and Milton Friedman. One can distinguish between the First (1930-40) and the Second Chicago School (after the second World War), which differed in their views on the minimum role of the government (Bronfenbrenner, 1962). The First Chicago school, embodied by Herbert Simons, advocated laissez-faire government policy in combination with a pro-active antitrust policy (Martin, 2005, p. 12-13), whereas the Second Chicago School, embodied mainly by Director supported the maximum possible retreat of governmental action (Posner, 1978, p. 926).We will concentrate on the latter strand of the school.

[22] In his well-known book "the antitrust paradox: a policy at war with itself", Bork (1978, p. 98) stated that the whole intention of antitrust law and economic efficiency was to pursue consumer welfare.

The concept of measurements of Chicagoans is based on efficiency, which was seen as an expression of consumer welfare. Bork (1978, p. 178) stated that the aim of antitrust is to create allocative efficiency, without impairing productive efficiency so that there is nor a gain, nor a loss in consumer welfare[23].

Wright (2007) lists and defends three methods that he considers as being specific to the Chicagoan approach: The first is the rigorous application of economic theory using neoclassical price theory and models of perfect competition, while also employing elements of institutional economics and transactions costs. The second method is empiricism[24], as pioneered by George Stigler, while the third method relates to the importance of the relationship between antitrust rules on liability, judicial error and the social costs involved. This error-cost approach, developed by judge Easterbrook, stipulates that it is socially superior to adopt that rule which minimizes the expected costs of false clearing, false convictions and administrative costs. It assumes that the cost of a false conviction is larger than the cost of a mistaken clearance. The idea behind this is that the false clearance is said to eventually be undone by competitive forces while a false conviction is believed to have major social costs. (Wright, 2007, pp. 33-39)

These concerns for detailed economic analysis and empiricism, a minimal legal framework, error-cost considerations and the principle of efficiency resulted in a rule of reason approach to the question whether or not certain market behaviour has restrictive effects under the circumstances at hand (Schmidt, 1993, p. 24).

In this line of thought, Chicago scholars consider vertical agreements to be very different from horizontal agreements in that they are primarily "used to make the vertical combination more efficient" (Verouden, 2008, p.1813). The complementary nature of a supplier's and a distributor's output gives them a common goal to maximise output, which enhances consumer welfare (Neubauer & Lever, 2000 quoted by Raychaudhuri, 2011, p. 612). For instance, according to the Chicago school an exclusivity provision to deter entry cannot be profitable. Both Posner (1976) and Bork (1978) claim that a retailer will only accept an exclusive dealing agreement when it is compensated for the loss of profit it could have generated using other suppliers (Rey and Vergé, 2005, p. 34). For this reason, the Chicago schools favours the legality of vertical agreements and stipulates a non-interventionist approach.

[23] Allocative efficiency aims to allocate resources in an optimal way at the macroeconomic level. Productive efficiency aims to use resources as efficient as possible within firms as reflected by economies of scale and transaction cost economies (Hildebrand, 2009, p. 185).

[24] For instance, Chicagoans have used empirical surveys to assess that vertical restraints are not likely to produce anti-competitive effects and favour per se legality.

This approach towards vertical restraints feeds from a host of theorems that Chicagoans developed over time. Reder (1982, p. 11) demonstrates that the Chicago view is rooted in the Pareto optimality and that there is no stable relationship between entry-barriers, concentration and monopoly profits. Even with high concentration ratios, a free market was still expected to function relatively well as long as no legal barriers to entry existed. In addition, competition was seen as dynamic where market imperfections are seen as the causes and effects of the competitive process. An example of a theorem used for vertical restraints is "single monopoly profit theorem"[25] which is widely applied as part of antitrust analysis of vertical restraints. Another example is a case study by Benjamin Klein (1988) that emphasizes the importance of vertical restraints in optimising promotional services when performance is difficult to measure.
Hence, concerning vertical restraints, the Chicago school stepped away from a per se analysis and supported the use of the rule of reason taking into account both economic benefits and disadvantages (Piraino, 2007, p. 354)[26]. Expanded from non-price restraints, to price-fixing arrangements and other agreements, the rule of reason became the dominant way of thinking in analysing vertical competition cases. The rule of reason approach is criticized for not allowing effective decision-making and providing little guidance to businesses causing miscalculations by firms about their behaviour (Piraino, 2007, p. 356). To go a step further, Posner (1977) states that "the rule of reason is little more than a euphemism for non-liability" (p. 14), calling for a per se legality of vertical restraints (Wright, 2007, p. 30).[27]

Other EU-specific influences

The dominant schools of thought influencing EU competition policy are less straightforward. While the Freiburg school and Ordoliberalism have been singled out as distinct influences for the general direction of EU competition policy, the EU system clearly takes on a number of theories from different strands of economic thinking. (Motta, 2004, p. 1-17)

This is because historically EU competition policy has developed in a more reactive manner. Given their advanced development at the time of establishment of EU competition policy,

[25] This theorem states that in a vertical supply chain, a monopolist at one level of distribution prefers competition on all other levels of the supply chain as this will reduce prices for end-consumers and increase sales. (Wright, 2007, p. 29)

[26] A leading case illustrating the importance of economic facts is *Continental T.V., Inc. v. GTE Sylvania Inc.* (1977) in which the superiority of maintaining inter-brand competition was underlined even though intra-brand competition may have been limited (Piraino, 2007, p. 354).

[27] The minimal enforcement of anti-trust rules stipulated by adherents of the Chicago school was challenged from the 1980s onwards by Post-Chicago school economists, which argued in favour of a less simplistic view of firms' incentives and strategic behaviour (Geradin and da Silva Pereira Neto, 2012, p. 8).

German and British regimes coined the basis of EU competition ideas. German competition policy, influenced by the Freiburg school of thought[28], was largely developed as a result from economic shocks occurring due to the war and the following great depression. Similarly, UK competition policy advanced based on their attempt to avoid excessive pricing and foster employment. Also, at the establishment of the European Economic Community, competition rules were created to avoid any discrimination between countries when the free trade area was under development.

The drafters of the EC Treaty were, amongst others, also inspired by the ideas of Ordoliberalism. Their overall view was that state intervention is needed to ensure a free market that adheres to a certain ideology. When imperfect competition exists, the state should intervene using a constitutional market order. With respect to vertical restraints, they believed that businesses have a tendency to restrict competition to obtain higher profits by agreeing on exclusive dealership clauses and other restrictive practices. This tendency had to be avoided by legislation whenever free competition did not have to ability to avoid market failures, external effects etc. Over the years, the role of economic analysis has substantially increased (Röller, 2005).

Since the 1980s there seems to be some consensus among economists that vertical restraints should not be *per se* legal or illegal (Geradin and da Silva Pereira Neto, 2012, p. 7). According to Jean Tirole "the only defensible position on vertical restraints seems to be the rule of reason. Most vertical restraints can increase or decrease welfare, depending on the environment. Legality or illegality per se this seems unwarranted." (Tirole, 1988, p. 186) Both EU and the U.S. policy makers recognize that vertical restraints should be analysed as to their consequences and not as to their form (Kay, 1990, p. 560). However, their competition policy frameworks for the systematic investigation into the effects of these agreements differ as to the degree of guidance given to enforcers.

4.2 The EU and U.S. Approaches to Vertical Restraints

EU Vertical Restraints Regime

EU competition policy is linked to much broader policy objectives, the principal of which is the creation of the single market. Because vertical restraints can either be used to partition the internal market and exclude new entrants, or pro-competitively to further market integration,

[28] This school developed elements such as ordoliberalism and the social market economy.

they are considered an important element of European competition policy (European Commission, 1996, p. i).

A vertical agreement is defined as "an agreement or a concerted practice entered into between two or more undertakings, each of which operates, for the purposes of the agreement or concerted practice, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services" (Article 1 Vertical Block Exemption Regulation, hereafter VBER). A vertical restraint means a restriction of competition within a vertical agreement (Article 2 VBER) [29].

Today's EU regime for vertical restraints is the result of a gradual evolution from a formalistic towards a more effects-based approach. Early case law in the EU largely focused on restrictions of inter-brand competition and condemned many types of contractual clauses per se, regardless of their actual or potential effects in the market. This approach radically changed with the adoption of the first VBER 2790/1999 (Petit and Henry, 2007, p. 2) and rests on the European Commission's recognition that individual agreements or restraints cannot be said to have a per se pro- or anti-competitive effect. Also a combination of different vertical restraints is not necessarily anti-competitive and the effect of the agreement is of primary importance (European Commission, 1996, p. iii).

Hence, under the new approach, economists proceed to a case-by-case analysis and vertical restraints are "no longer regarded as per se suspicious or per se pro-competitive" (European Commission, 1996, p. iii). Moreover, a few fundamental principles guide every economic analysis of vertical restraints: First, if inter-brand competition is fierce, the likelihood that it outweighs any anti-competitive effects of vertical restraints is high. If however, inter-brand competition is weak, anti-competitive effects of vertical restraints are likely (Petit and Henry, 2007, p.2). Second, the "ability of a vertical agreement to produce anti-competitive effects hinges predominantly on the market power of the parties to the agreement" (Petit and Henry, 2007, p.3). Third, the European approach to vertical restraints divides vertical restraints into two categories, i.e. those presumed to be efficiency enhancing and those presumed to be restrictive of competition.

These three considerations underlie the legal framework of vertical restraints in the EU, defined in the Treaty as well as by a regulation and Commission guidelines. Vertical restraints or agreements entered into by non-dominant and dominant undertakings can be challenged under

[29] Vertical restraints and vertical agreements are used interchangeably.

Article 101 and Article 102 Treaty on the Functioning of the European Union (TFEU) respectively. The focus here will lie on Article 101(1) and 101(2) TFEU[30] whereby agreements between undertakings which affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition within the internal market are automatically void. Particularly concerned are agreements that (in-) directly fix purchase or selling prices or any other trading conditions, limit or control production, markets, technical development or investment, share markets or sources of supply, apply dissimilar conditions to equivalent transactions with other trading parties, or make the conclusion of contracts subject to the acceptance by other parties of obligations which have no connection with the contract subject. If however, such an agreement beholds efficiency gains, and these efficiency gains are sufficiently passed on to the consumer, it can be exempted under article 101(3) from the application of article 101(1). This division was first undertaken by the 1999 Vertical Block Exemption Regulation ("VBER")[31] and the accompanying Guidelines on Vertical Restraints, which were subsequently renewed in 2010.[32]

The VBER states the conditions under which vertical agreements are automatically exempted under Article 101(3). The regulation is centred on the concept of market power, whereby the likelihood of an agreement's efficiency-enhancing effects outweighing its anti-competitive effects depends on the degree of market power of the undertakings involved. Hence, agreements between undertakings whose market share on their respective relevant market does not exceed a 30 per cent market share threshold ('safe harbour'), are presumed to lead to an improvement in production or distribution and allow consumers a fair share of the resulting benefits (VBER, § 7,8, Article 3). Above this market share threshold, a so-called 'individual assessment' of the respective agreement is carried out in the light of the principles advanced in the Guidelines on Vertical Restraints.

Furthermore, the Article 4 of the VBER defines certain 'hard-core restrictions', i.e. restrictions that are held to be severe restrictions of competition, irrespective of the market share of the undertakings concerned (VBER, §10), and that therefore cannot benefit from the block exemption. These include resale price maintenance (RPM), territorial restrictions of active sales,

[30] Note that if a vertical restraint involves firms with dominant position in the market, upstream or downstream, Article 102 TFEU becomes applicable.
[31] Commission Regulation No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty on the Functioning of the European union to categories of vertical agreements and concerted practices; Commission Notice Guidelines on Vertical Restraints (2000/C 291/01)
[32] Commission Regulation No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European union to categories of vertical agreements and concerted practices; Commission Notice Guidelines on Vertical Restraints (2010/C 130/01)

the restriction of active or passive sales by a member of a selective distribution system, the restriction of cross-supplies between members of a selective distribution system as well as the restriction of a component suppliers' ability to sell components or spare parts to end users. The definition of these hard-core restrictions does however not amount to the per se illegality of the vertical restraints in question. Rather, they are not automatically exempted, but have to be subject to the individual assessment under Article 101(1), following which undertakings can still apply for an efficiency-exemption under Article 101(3), even if a hard-core restriction is presumed to not qualify for an efficiency justification.

Whether the parties are held to have restricted competition by object or by effect, they still have the option of claiming their agreement to produce efficiency gains under article 101(3) TFEU. These efficiency gains may include the prevention of a genuine risk of free riding on services offered only in physical shops (§107 Vertical Guidelines). The maintenance of the assessment of efficiency gains of an agreement under article 101(3) introduces a case-by-case analysis that remains open for any competition authority. These ensure that manufacturers can organize their distribution network, and also online selling, to enhance economic efficiency (OECD, 2013, p. 102). An agreement must generally produce sufficient efficiency gains to compensate for a significant reduction in competition between brands. In the case of significantly damaging effects on competition, the benefit of the exemption by category will probably be withdrawn (§176 Vertical Guidelines).

In European vertical restraints cases, the burden of proof is divided: the European Commission or the respective NCA have to prove that an agreement is caught by Article 101(1), whereas any efficiency claims have to be substantiated by the parties to the agreement under 101(3).

U.S. Vertical Restraints Regime

As with the E.U., the vertical restraints regime in place in the U.S. has to be seen in the context of the particularities of its legal system. The common law legal system in place in the U.S. is characterized by a large influence of case law. As such, the basis of U.S. antitrust law has only been altered in a very limited way, while U.S. courts are obliged to investigate each case in light of its characteristics and the applicable market conditions. Therefore, the decisions issued by courts and similar tribunals will determine the framework to assess vertical restraints. Over time, the U.S. courts have interpreted the law in such a way that only vertical restraints that are unreasonably restrictive to competition are prohibited (Accardo, 2012, p.101).

The U.S. definition of a vertical restraint needs to be interpreted in accordance to section 1 of the Sherman Act of 1890. The latter stipulates that "every contract, combination in the form of trust or otherwise, or a conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."[33] (§1 Sherman Act, 15 United States Code).

In the sense of section 1, a vertical restraint is a limitation on the sale of products that is imposed by a manufacturer on a dealer. For such a restraint to be illegal there must be some kind of agreement between firms amounting to an unreasonable restraint of trade or commerce. Evidence must be provided that the latter is not the result of an independent, unilateral action by either the manufacturer or the distributor. If the conduct is unilateral[34], section 1 of the Sherman Act is not applicable. This idea is rooted in the right of freedom to trade (Accardo, 2012, pp. 101- 103). In the U.S., there is a strong belief in the freedom to decide with whom to do business and under which conditions.

In the U.S., a rule-of-reason approach is applied to vertical restraints. The latter has its foundation in the landmark case of *Standard Oil Company v. U.S.* (1911) (Raychaudhuri, 2011, p. 610).

According to the rule of reason there has to be a case-by-case investigation of every restraint and its actual or likely effects on competition (Rosch, 2012, p. 2). Overall, the rule of reason is quite a generous rule resulting in a high tolerance towards vertical restraints. The reasoning behind it is that vertical restrictions, depending on the circumstances surrounding the conduct, can often result in pro-competitive effects.

The rule of reason was developed by Justice Brandeis in its delivered opinion to the U.S. Supreme Court in *Board of trade of city of Chicago v. U.S.* in 1918. The latter states that for an imposed restraint to be illegal, it has to be tested where it promotes competition and when it harms competition. This requires a thorough analysis of the specific business characteristics, the conditions before and after the restraint, its nature and its actual as well as its likely effect (Justia U.S. Supreme Court, n.d.).

[33] The act goes on: "Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court." Certain practices of vertical restraints, which are related to price discrimination and services towards competing buyers may be subject to the Robinson-Patman Act. This is the part of the Clayton Act which deals with price discrimination.

[34] The defense of the unilateral conduct has caused discussion in the case law. For instance, when a supplier exercises coercion on its retail outlets, they may unwillingly comply. This should then be seen as unilateral conduct being difficult to determine. A manufacturer terminating a price-cutting dealer based on the complaint of another dealer represents another example. In these cases, the causal relationship can only be seen as a concerted action excluding that both parties were acting independently. (Rosch, 2012, p. 101-103)

Since the 2007 decision by the United States Supreme Court in *Leegin v. Kat's Korner*, the U.S. approach towards all types of vertical restraints is characterized as a 'rule of reason' approach. Already prior to this seminal judgement, only minimum resale price maintenance was held to be per se illegal. However this special treatment for RPM was removed by the *Leegin* decision (Gosh, 2008, p. 5; Sullivan and Grimes, 2006).

In addition, the rule of reason for vertical restraints puts a large burden on the plaintiffs to show that the agreement in question is anticompetitive (Raychaudhuri, 2011, p. 619). Accardo (2012, p. 105-107) summarizes his interpretation of a rule of reason analysis in four steps. First, the plaintiffs have to be able to show that there was an actual agreement or conspiracy that had a competitive impact down the distribution chain. Second, the plaintiff needs to define a product and geographical market that have been affected by the conduct and show that the supplier had significant power therein. Third, the plaintiffs need to show that the restraint has affected or will affect competition in a significant and negative way. At last, the anti-competitive effects need to be balanced against the pro-competitive justification in order to investigate whether the positive effects could not have been achieved by less anti-competitive means.

Under U.S. antitrust law, there are no `safe harbours´ or `hard-core´ restraints as in EU competition policy. In principle, the rule of reason includes all aspects in its analysis. However, if the characteristics of the case clearly show that the conduct should be declared illegal, a shortened investigation under the rule of reason may apply (Accardo, 2012).

Until today, the U.S. treatment of vertical restraints has been characterized by a certain 'red line' involving three elements: First, we can broadly distinguish price as well as non-price restraints. Both of these restraints are subject to the rule of reason (OECD, 2013, p. 151)[35]. The current standard, established by the U.S. Supreme Court in *Leegin,* is that both these practices should be evaluated under the rule of reason. Second, a proper investigation into the effects on competition will only occur when either at the manufacturing level or downstream at the distributor or dealer level, a manufacturer has economic market power (Collin, 2014). This can be seen as a fundamental threshold in the rule of reason analysis. When no market power exists, the plaintiff is unlikely to be able to prove that a certain restraints has destructive effects on competition and should therefore be declared illegal (Rosch, 2012, pp. 54-55). As a last and related element U.S. antitrust law focuses mostly on the impact of the restraint on inter-brand competition, rather than on intra-brand competition (Accardo, 2012, pp. 97-101).

[35] Although the treatment has evolved over time, we will not provide a historical comparison here.

While the approach to vertical restraints has been rather lenient in the U.S., there have been instances where a vertical restraint was eventually judged upon as a horizontal agreement. This can occur when two or more dealers conspire to eliminate a price-cutting rival or when competing distributors conspire with their rival to impose restrictions, which are mainly to the benefit of the distributors. In these cases, there is no vertical issue, as the supplier imposes the restrictions unilaterally and for his own purposes. Yet, it is possibly that the horizontal part of the agreement will be judged upon and will then be subject to a per se rule. (Rosch, 2012, 31-37)

4.3 How do Prior Beliefs matter?

The differences in prior beliefs through the dominant schools of thought in the EU and the U.S. have led to different policy prescriptions. Five main differences are recognizable divided into the definition of vertical restrains, their analytical approaches, the role of market power, the concepts of welfare and efficiency and the effective distribution of the evidentiary burden. A summary of these main differences is given in the table below.

Table 1: Main Differences in EU and U.S. Vertical Restraints Regimes

Point of difference	EU approach	U.S. approach
Definition of VR	Agreements between two parties	Conspiracies
Analytical approaches	Structured rule of reason	Rule of reason
Market power	Safe harbour thresholds	One criterion among many
Efficiency & Welfare	Explicit emphasis on consumer-welfare	Allocative, productive efficiency as output maximisation
Evidentiary burden	Lighter on competition authorities	Stronger for competition authorities

Definitional differences

While both in the EU and the U.S. vertical agreements take place between two parties, in the U.S. they are treated as 'conspiracies', which is neatly distinguished from legal unilateral conduct. The "survival of the fittest" – reasoning characterising the Chicago school emphasises a firm's deserved market power status. As the principle of freedom to trade is strong in U.S. antitrust policies, this right should also be accessible for companies with market power. Hence, as long as the manufacturer imposes the vertical restraint on the distributors in a unilateral manner, the restraint is considered legal under the manufacturer's freedom to trade, no matter how strongly competition is restricted. On the contrary, in the EU, any signed agreement between two parties unduly restricting competition, falls under article 101(1). This definitional difference explains why EU vertical restraints cases have largely outnumbered U.S. cases.

Rule of reason versus structured rule of reason

Both approaches require and an effects-based analysis and a balancing exercise between pro- and anti-competitive effects. However, while in the U.S. all vertical agreements are analysed under the rule of reason, the European regime relies more heavily on legal presumptions. The function of the use of such (rebuttable) presumptions in the EU is either to facilitate the burden of proof in order to protect the weak party or a better social organisation that still permits for the truth to triumph (Prieto, 2010, p. 20)[36]. This sort of presumption is a political choice that gives the legislator considerable freedom in the way she apprehends, or not, reality: she can base her analysis on a high degree of plausibility of the effects on the case, while leaving the possibility open for a more detailed case-by-case analysis. She can also refuse the latter out of concerns for good administration and administrative costs. In a field such as European competition policy, where economic proof is complicated and costly, it is hence not surprising that legal presumptions are the working base of all analysis. (Prieto, 2010, p. 21) The presumption created by the block exemption and hard-core restrictions organise the analysis of vertical restraints in a sequential process defining successive filters that allow for a detailed analysis, without having to proceed to a full-fledged case by case analysis including all the evidence pertaining to the case. This European approach has been designated by post-Chicago school economists as a "structured rule of reason" (Prieto, 2010, p. 21), reconciling flexibility, simplicity and previsibility (Spector, 2006, p. 272).

The role of market power

In both jurisdictions, market power is an important concept for determining the effects of a practice in the market. The distinction between EU and U.S. is that the EU formalizes this concept through the safe harbour threshold in the VBER. In the U.S., a case will only be properly investigated if some economic power is present on the part of the manufacturer and a suspicion of market power on the authorities' side makes the opening of the investigation more likely. At

[36] See also Perelman & Foriers (1974).

the same time, market power is only one criterion of the U.S. rule of reason assessment and does not constitute a prior 'filter' as it does in the EU.

The concepts of welfare and efficiency

The concept of efficiency is defined in slightly different terms in the EU and the U.S. In the U.S., enhancing efficiency boils down to enhancing allocative and productive efficiency, which will automatically enhance consumer welfare. In the EU, by contrast, the very wording of Article 101(3) links efficiency, as improving production or distribution, to the passing-on of these efficiency gains to the consumer. The increase of consumer welfare is a necessary condition for an individual exemption under European competition law.

In a similar fashion, the unit of measurement for assessing welfare enhancing effects seems to be focused on output, as feeding from the Chicago School of thought. According to this reasoning consumer welfare is enhanced if output is maximised, while output maximisation is the common aim of two vertically related firms. In the *Leegin* decision for instance, the majority opinion held that a restriction of competition would only be recognizable if a decrease of output was observed (U.S. Supreme Court, 2007, p. 6).

Evidentiary burden

Finally, another factor distinguishing the two vertical restraints regimes is the distribution of the evidentiary burden. The latter is higher for anti-trust authorities, who have to undertake a deep economic analysis as soon as a case is opened, but who generally face a lower number of cases. The European regime bears the risk of a higher number of cases to be treated by competition authorities, while the definition of hard-core restrictions as well as the distinction between competition restrictions by object and by effect gives the authorities a certain leeway to decide whether to go into a deeper economic analysis for a given case. Thus, it seems, that the burden of proof on the European Commission does "not require an analysis of competitive effects of the sort undertaken in the U.S." (Cooper et al. 2005, p. 298).

The prior believes about the effects of vertical restraints in the market produced by schools of thought as well as the vertical restraints regime more generally have shaped the mind set with which competition authorities in both the EU and the U.S. apprehended the Internet as a new distribution channel. In the following part, the continuing differences between EU and U.S. competition policy will be shown at the hand of their regimes for online distribution.

5 EU and U.S. approaches to online distribution

With the advent of the Internet as a regular channel of distribution, the question arose in many jurisdictions whether a revision of the relevant policy documents on vertical restraints was warranted or whether the legislation already in place was sufficient to be applied to this new economic and technological setting (OECD, 2013, p. 151). When devising the rules for a competition policy regime, the optimal enforcement rule will aim at minimizing an expected social loss function. Thereby two types of losses may appear when making competition policy decisions: the loss produced by a type-I-error[37] and the loss resulting from a type-II-error[38]. Policy makers will challenge a particular practice if, and only if, ceteris paribus, the expected type-II-loss from allowing the practice is greater than the expected type-I-loss from prosecuting it (Cooper et al. 2005, p. 304).

Cooper et al. claim that the EU's stricter enforcement posture is the result of a loss function, where the expected loss of type-II-errors outweighs that of type-I-errors, while in the U.S. the contrary is the case. Hence, the following part will investigate the loss functions underlying both EU and U.S. competition policy regimes for online distribution. It is summarized in the Graph below.

[37] The type-I-error represents the prohibition of a practice which was overall pro-competitive.
[38] The type-II-error represents a failure to prohibit an anti-competitive practice.

Figure 1: EU and U.S. Approaches towards Online Distribution

	European Union	United States
General principle	No „specific“ rules for online distribution in vertical restraints regimes	
Legal changes	• Special consideration of online distribution	• No • Rule of reason applies
Bias towards...	preventing type-I-errors • Online commerce = instrument for achieving SM • Principle of channel protection	preventing type-II-errors • Specific effects of the internet on competition analysed case-by-case • Error-cost-framework • Equal channel treatment
RPM	Hardcore restriction	Freedom to trade (rule of reason since Leegin)
Non-price-restraints	• VR must not allow a supplier to influence the amount of goods sold offline & online • Definition of allowable restrictions	• Freedom to trade • Weighing of effect on intra-brand, inter-brand and distributors‘/suppliers‘ incentives

5.1 Loss Functions: EU and U.S. Incorporation of E-Commerce in Competition Policy

The EU loss function

In the EU, the debate on how to incorporate online sales into the competition policy regime of vertical restraints started relatively early. Even before the formal review process of regulation 2790/1999, in 2008 a roundtable was launched to discuss the role of online commerce, which gave impetus for the debate about vertical restraints and the distribution via Internet (Petit and Henry, 2007, p. 41). Bigger internet players, such as Amazon or eBay, argued that Regulation 2790/1990 gave manufacturers operating selective distribution systems too big a freedom to restrict or prevent the online distribution of their products (Petit and Henry, 2007, p. 41).

The tenor of the European rules on vertical restraints in the online sphere can be summarized as follows: the Internet is a powerful tool that sellers can apply to reach a wider array of customers. Hence, in principle, sellers must be allowed to use the Internet to distribute their products, but more specific rules apply for the case of selective distribution systems. Two principles guide the European approach to online distribution:

Firstly, no specific rules are devised for online sales in EU competition law so competition policy treats online and offline distribution in the same manner. According to Commissioner Almunia, the “principles of competition-law enforcement do not change when we leave the realm of brick-and-mortar but we have to adjust our methods to the specific features of these new sectors” (Almunia, 2012). Nevertheless, the revised Vertical Guidelines took special account of Internet as a distribution channel.

Secondly, online commerce is seen as instrumental for the achievement of a single internal market for the welfare of consumers as a paramount objective of EU competition law. Alexander Italianer, the Commission Directorate General (2011) recently stated:

> The promotion of online sales is extremely important for the internal market in Europe because it broadens the market, improves the choices for customers, and generally speaking, enhances competition. But that does not mean that we should treat online sales differently from offline sales or ignore possible free-riding problems that may occur between offline and online sales […] We have tried to find a balance between strongly promoting online sales on the one hand, and on the other hand, requirements that are indispensably linked to the branding and the sales of certain products. (p. 7)

It is apparent from this quote that e-commerce is a strong vehicle building on which a single European market can be achieved. It is therefore challenging to refrain from biasing competition policy enforcement in favour of promoting the Internet as a distribution channel. The question whether the Internet is in fact “just another distribution channel” within EU competition law is a valid one.

Furthermore, European competition authorities show their will to preserve a balance between the offline and online distribution channels in the European economy. The Autorité de la concurrence (2009, p. 2), for instance, defines the goal of the European vertical restraints regime as promoting consumer welfare and competition, while at the same time preserving the diversity of distribution strategies and channels. The NCA underlines the necessity of preserving the coexistence of the online and offline channel of distribution, since they respond to different consumer preferences in terms of prices, choice, quality and proximity by means of “subtle/ fine regulation/ adjustment tools”. The aim is suggested as being to achieve an equitable equilibrium between those two sales channels (Autorité de la concurrence, 2009, p. 2). Similarly, the way online sales are treated in the BER and the Vertical Guidelines turns around a certain “balance point” that is recommended by the European Commission and which is supposed to ensure a “mix” between online and offline sales. This has led to the name `bricks & clicks´ or `clicks &

mortar´ (OECD, 2013, p. 102) and signifies a specific European attitude, where competition policy seems to not be solely aimed at protecting competition, but also includes an element of channel protection.

The U.S. loss function

As with the EU, the U.S. antitrust agencies do not see a need to develop specific rules for their analysis of vertical restraints with respect to online sales. The overall state of mind is that the current legislation on vertical restraints can evolve over time and be applied to a changing environment. Each vertical restraint under analysis will be evaluated based on the elements of the case and the prevailing market characteristics at that time. The basic antitrust principles will therefore apply for vertical restraints on both online as well as offline distribution.

The U.S. authority states two reasons on why the current analytical process can still apply in the presence of online sales. First of all, the current analysis takes into account the conditions that make vertical restraint anti-or pro-competitive. These conditions can arise irrespective of the degree of online distribution. Secondly, using the rule of reason stays relevant for U.S. antitrust law, regardless of any relationship between online sales and the conditions that increase or decrease harm from vertical restraints. (OECD, 2013, p. 152)

According to the U.S., economic theory brings forth three predictions with respect to the effect of vertical restraints. Firstly, vertical restraints will internalize any externalities that may arise from vertical relationship and often has intrinsic benefits. For instance, vertical relationships may result in negative externalities such as double marginalization, retailer free riding and under-provision of efforts. Each of these can occur in online vertical relationships as much as they can in offline vertical relationships. Secondly, significant market power needs to be present for any negative effects on competition to occur as a result of a vertical restraint. This will have to be investigated in each case. At last, the actual effects of a vertical restraint will largely be determined by the economic environment. Case-specific empirical analysis will help to define the theories of harm and the theories of benefits. Based on these three predictions, the U.S. antitrust authorities do not find reason to treat online sales any different. (OECD, 2013)

Even though their approach to vertical restraints is the same for online as well as for offline sales, U.S. authorities do recognize that online sales have particular characteristics which will influence the analysis. Market power may enlarge pro-competitive effects of an agreement as well as anti-competitive effects depending on the case at hand. Similarly, price transparency due to online sales may increase the likelihood of concentration but it may also intensify competition. These factors need to be analysed on a case-by-case basis. (OECD 2013, p. 162)

Hence, there seems to be an overall consensus among U.S. antitrust enforcers, practitioners, lawyers and economists that antitrust doctrine and principles should not be altered or adjusted based on the rise of the Internet (Accardo, 2012, 96-114). U.S. law is judged sufficiently flexible and informed by economic theory to cope effectively with the distinctive-seeming antitrust problems that the new economy presents.

EU- U.S. discussion

Both EU and the U.S. loss functions can be defined based on their approach towards type-I-errors and type-II-errors. The U.S. regime is characterized by a bias towards the prevention of type-I-errors. This can be derived from their emphasis on the pro-competitive features of vertical restraints and the equal treatment in the meaning of the offline and online distribution channels. This tendency is furthermore linked to the error-cost framework (Lambert & Wright, 2008, pp. 225-226) related to the Chicago school of thought. This approach states that the social costs of clearing an anti-competitive practice is lower than the costs of a false conviction of a pro-competitive practice since that anti-competitive behaviour will eventually be undone by competitive forces. Therefore, from the U.S. point of view, it is better to mistake a clearance rather than to make a false conviction.

In contrast, given the importance of the Internet for the European market integration objective, it seems as if the European loss function is biased towards the prevention of type-II-errors. This is due to the fact that the EU competition policy goals, such as the promotion of consumer welfare and the achievement of a competitive market, are interlinked with the more fundamental policy aim of achieving a single internal market. Under U.S. antitrust law these goals have little relevance. This is why in the EU the expected loss of type-II errors, i.e. failing to prosecute a restraint put on online sales that may have an anti-competitive effect, would be to hinder the development of the internet commerce as a driving factor for the completion of the internal market. This potential loss outweighs, in the EU perspective, the expected loss of committing a type-I error, i.e. prosecuting an online restraint that might have a pro-competitive effect for the vertical relationship between manufacturer and distributor.

The stakes at play are here not only of legal and economic but also of political nature. Both the ECJ and the Commission aim at promoting the development of online distribution, "because it represents a new method of trading and also because in it they see the perfect means for the construction of the internal market intended by the Treaties" (Vogel, 2012, p. 2). This is in line with a general tendency of European competition authorities to sanction restrictions more harshly, and focused only on objects rather than economic effects, when the opening-up of markets was at stake (Vogel, 2012, p. 2).

In order to investigate how prior beliefs and loss functions translated into the EU and U.S. competition policy regimes on online distribution, a detailed demonstration of those policy regimes and their practical enforcement case law will be given in the following part.

Thereby an important observation when examining EU and U.S. cases on vertical restraints on online distribution is related to the overall number of cases that competition authorities have investigated in the past two decades. Historically, there has been relatively little case law on vertical restraints in the U.S. Based on data collected from the CCH Trade Regulation Reporter, Kovacic (2003, p. 460) reports that for the period 1981-2000, there were only 25 cases on vertical restraints in front of the Department of Justice and Federal Trade Commission together. It naturally follows, that cases involving online commerce and distribution are very rare. This lack of cases could intuitively be explained in two ways. One is that not many conflicts arise in these types of agreement. The other is that due to the, often called, generous application of the rule of reason, plaintiffs rarely decide to bring cases regarding vertical restraints in front of the court (Hovenkamp, 2011 quoted by Accardo, 2012, p. 98). This makes sense since the likelihood for plaintiffs to win a case is so small that they are less likely willing to bear the expenses.

In contrast, the EU competition authorities have been more active, both concerning vertical restraints cases in general and regarding cases involving online distribution. Here, special attention has to be paid to the differences in the stringency with which NCAs apply certain provisions.

The downward presentation confronts price and non-price restraints cases on online distribution in the EU and the U.S..

5.2 Price Restraints on Online Distribution in the EU and the U.S.

European competition authorities have so far considered cases of manufacturers resorting to online resale price maintenance (RPM[39]) as a direct response to the price pressure introduced by the Internet (Bundeskartellamt 2013, p. 19). Because RPM directly restricts a distributor's freedom to set prices, it is considered to be a hard-core restriction and has been treated as a restriction "by object" in past case law[40]. This EU approach is based on the conviction that the practice of online RPM across EU member states "would result in more harm than benefit for the European consumers as a whole" (OECD, 2013, p. 18). While individual exemptions are still possible, companies "usually do not even claim that the prerequisites for an individual exemption are fulfilled" (Bundeskartellamt, 2013, p. 19).

RPM and Online Distribution in the US

As already stated above, in the U.S., all price restraints, consisting of maximum and minimum RPM and restrictions on price advertising, are judged upon by use of the rule of reason. For maximum RPM, this has been so since the ruling of the U.S. Supreme Court in *State Oil v. Khan* (1997) (Rosch, 2012, p. 1). For, the more criticised, minimum RPM, in *Leegin Creative Leather Products, Inc. v. PSKC, Inc.* (2007), the U.S. Supreme Court established that minimum RPM was from that point forward also to be dealt with by the rule of reason[41]. It thereby replaced the long-established *Dr. Miles Medical Co. v. John D. Park & Sons Co.* (1911) doctrine which stipulated vertical price restraints to be per se illegal under Section 1 of the Sherman Act.

In Leegin, the Supreme Court identified four circumstances under which the use of RPM might be anti-competitive: when used to identify cheating in price cartels, when used to creating price cartels by forcing manufacturers to eliminate any price-cutting dealers, when used by a dominant retailer to protect itself from other dealers with better distribution systems and lower cost structures and when a manufacturer has market power and wants to prevent retailers from selling products from smaller rivals or new entrants (Accardo, 2013, pp. 109-110).

Concerning maximum RPM, vertical restraints may be used to interfere with the freedom of a dealer, set prices so low that the dealer cannot offer desired services, favour distribution by

[39] RPM are agreements or concerted practices on a , recommended, minimum, fixed or maximum resale price. RPM is considered as <u>hard-core restrictions under EU competition law</u> regarding minimum price and fixed price RPM, whereas recommended prices as well as maximum resale prices as such do not constitute restrictions of competition.

[40] For instance, in case *243/83 SA Binon & Cie v. SA Agence et messagerie de la presse* (1985), the Court of Justice of the European Union ruled on an individual exemption of restriction by object.

[41] It has to be noted that the rule of reason treatment has not been embraced by all the states and is subject to criticism.

certain advantages or disguise an arrangement to fix minimum pricing. These anti-competitive effects always have to be balanced against the pro-competitive effects. (Rosch, 2012, p. 12-17)

While the Leegin judgement did not directly address online distribution, it nevertheless fuelled the debate about the legal regime for online RPM. The U.S. Supreme court was at many instances criticized for not taking into account the characteristics of online commerce within the rule of reason approach[42].

The most prominent argument holds that a likely increase of RPM, as a result of this legal leniency, may undermine online discounters' strategy of competing for consumers and market shares based on prices and price-cutting (Fabricius, 2007, p. 87; Accardo, 2012, 112). On the other hand, the judgment will also provide more legal acceptance and security for manufacturers to defend themselves against price-fixing charges.

Related to this discussion over a too lenient treatment of RPM, two cases following the *Leegin Creative Leather Products, Inc. v. PSKS, Inc. (2007)* demonstrated that RPM would not be acceptable in all circumstances (Davis, 2011).

In *Babyage.com, Inc. v. Toys "R" Us, Inc.* (2008), a small e-retailer accused Toys "R" Us of pressuring its suppliers to not sell to online retailers that undercut the prices of large store retailers. Subsequently, the manufacturers involved began to require the retailers to sell their goods at or above a certain price (Casetext, 2013). Among other accusation such an attempt to monopolize by Toys "R" Us, this scheme was claimed to violate federal antitrust law under § 1 of the Sherman Act. Interestingly this judgment does not make any reference[43] to online distribution as a key aspect of this price-cutting or the motivation of manufacturers and store retailers to prevent it. In fact, in this case, Babyage.com is treated as any regular retailer. The FTC did hold that Toys "R" Us implemented vertical restraints to hinder competition from certain large warehouses as well as e-retailers. Yet in this specific claim of an e-retailer, the fact that the distribution was online did not play a role and was not specifically addressed.

Related to this case and eventually consolidated with it was the class action *McDonough v. Toys "R" Us, Inc.* (2009), showing that manufacturers and retailers must not conspire into setting prices (Davis, 2011). The class certification claimed that Toys "R" Us had coerced the manufacturers into adopting the vertical price restraint, thereby raising prices for the customers.

[42] Examples are Fabricius (2007), Vanderbilt Journal of entertainment and technology law (2009) and Harvard Law Review (2008).
[43] Words related to online distribution such as e-retailer, e-commerce, internet, and online were never mentioned throughout the entire judgment.

In the class action complaint, reference was made to the rising competition from e-commerce as a new way of distributing products. Babies “R” Us, owned by Toys “R” Us, was claimed to have responded to this pressure by coercing manufacturers of baby products into preventing internet retailers from offering discounts. In the granting of class action, specific reference was made to online retailers even though this specific characteristic did not seem to be taken into account in the granting of the certification.

The above U.S. cases underline two aspects with respect to the treatment of online vertical restraints: firstly, U.S. antitrust case law clearly treats offline and online retailing in the same manner, and, secondly, the fear of an over-generosity of the rule of reason has been lessened by the clear prohibition in *Babyage.com*.

RPM and Online Distribution in the EU

A similar case in the EU showed a comparable outcome but a different underlying reasoning: In 2009, the Bundeskartellamt fined Phonak[44], a producer of hearing aids, for having influenced resale prices of its products and for having prohibited the publication of prices on the Internet (OECD, 2013, p. 115). Reacting to complaints about a price-cutting e-retailer by other hearing aid retailers, Phonak had refused to supply this retailer who had resold its hearing aids at considerably lower prices and had published this visibly on the Internet. The Bundeskartellamt (2009) found that Phonak’s behaviour had “a competitive relevance beyond this individual case. Eliminating the only price-active Internet provider of hearing aids was a suitable and intended means to maintain or re-establish the predominant price stability on the German market for the trade in hearing aids.” In a market, where price competition was already weak, the prevention of further competition advances by an internet retailer was judged to be “all the more severe.” It is visible, that, in contrast to the FTC judgement, the Bundeskartellamt emphasized the severity of the competitive restriction, given that it involved an internet retailer and eliminated the transparency and price-lowering effect that the use of the internet would have introduced on the German market for hearing aids.

In the same year, the Bundeskartellamt imposed a € 11.5 million fine on CIBA Vision, a market leader in contact lens production, for having influenced resale prices of internet traders in an anti-competitive manner. The Bundeskartellamt (2013) also fined a producer of high-end cosmetics for systematically pressuring retailers to apply its recommended prices and introducing in the contracts for its selective distribution system clauses restricting internet sales,

[44] The fine imposed on the company as a result of their conduct amounted to € 4.2 million.

which further supported the enforcement of the vertical price fixing practices. In a similar manner, the UK Office of Fair Trading (OFT, 2013) issued a decision finding online RPM by a manufacturer of mobility scooters in breach of competition law. The manufacturer had entered into arrangements with seven UK-wide online retailers and prevented them from selling Roma-branded mobility scooters online and from advertising their prices online. Here again the restriction of competition was held to be severe as the practices "limited consumers' choice and obstructed their ability to compare prices and get value for money." Moreover, it was judged "vitally important that consumers can use all the advantages of the internet to get a good price on this essential product and that innovative and efficient companies should not be prevented from winning new customers".

It is visible from these decisions by European NCAs that online RPM is judged in line with the stricter stance adopted towards RPM more generally. The severity of the prevention of lower prices online is thereby explicitly underscored in most decisions, hinting to the crucial role of the Internet for lower prices, wider consumer choice and the achievement of the EU internal market. These judgements do not only correspond to the EU's loss function, but also to the prior belief putting a stronger emphasis on direct consumer welfare. In contrast, the specific nature of the Internet does not play any role in the U.S. appreciation of vertical restraints cases. Here, the Internet is in fact, just another distribution channel. In line with the preference for error-II-loss, the U.S. is hesitant to prohibit an agreement if there is no prove of a conspiracy or strong coercion. This practice is related to the freedom of manufacturers to choose how and under which conditions their products are distributed. It is also in line with the schools of thought that find vertical restraints to be usually pro-competitive. However, the discussion around *Leegin* shows that some forces in the U.S. would like the Internet to be accounted for in more explicit ways within judgements.

5.3 Non- Price Restraints in the EU and U.S. Online Space

EU Non-Price Restraints and Online Distribution

As for vertical restraints more generally, for online distribution, the EU's Vertical Guidelines undertake a balancing act between protecting a manufacturers´ freedom of choice of its distribution model and maintaining the distributors´ freedom of choice of its distribution channel. While online sales should be able to compete fully with offline sales, competition should not challenge the offline channel (OECD, 2013, p. 105).

Hardcore restrictions of passive online sales

The general EU approach to vertical restraints also feeds into the treatment of online sales: any agreement that allows a manufacturer to directly or indirectly influence the amount of goods sold over the offline/online distribution channel amounts to a restriction of competition.

Thereby the distinction between active and passive selling in the VBER is key to defining hard-core restrictions within exclusive and selective distribution arrangements[45] (Accardo 2012, pp.116-118). When e-commerce emerged as a competition policy issue, the European Commission decided to "fit" online sales into the active/passive dichotomy (Accardo, 2012, p. 609). Accordingly, passive online selling includes instances where the customer's visit on a website leads to a sale or to a request of information to the retailer. Even the offering of different language options does not change the passive character of the selling (§ 52 Vertical Guidelines). As with offline sales, any restriction of passive online sales is considered a hard-core restriction. These include Internet provisions which restrict the territory in which the seller can passively distribute his products[46] and provisions which limit the amount of products sold via the Internet[47].

While the Vertical Guidelines offer some guidance on which parts of online selling constitute active and passive selling, they have been criticized for falling short "of setting clear and sound criteria to distinguish active and passive online selling in a way that properly reflects the characteristics of the online channel and the continuing development of internet technologies" (Accardo, 2012, p. 59-60). This exercise is left to the individual decisions by NCAs.

Allowable restrictions

[45] Regarding exclusive distribution, an exclusive distributor can be protected from active sales by other distributors in a specified territory or consumer group. The Guidelines underline that the BER covers such agreements, even when the supplier is acting as a distributor in an otherwise exclusive area or group. Restrictions on passive sales are, however, considered as a hard-core restriction.
Regarding selective distribution, the BER allows distributors to be selected according to some specified criteria. In the new BER, particular attention is paid to online sales, since the resale restriction rules apply to both online and offline sales. Once distributors, they should be free to sell both on websites as well as in traditional shops. For selective distributors, this implies that quantities sold via the Internet cannot be limited or higher prices cannot be charged for products sold online.

[46] These can be agreements which oblige the exclusive distributor to terminate a transaction with a customer when data reveals they come from outside the territory or when the distributor has to reroute the customers to another website.

[47] This can be done by obligating the distributor to limit their overall amount of online sales or by using a dual online/offline pricing system where a higher wholesale price is paid for the products sold online.

Beyond defining those provisions, which may amount to hard-core restrictions, the Commission also gives guidance on those provisions for online selling which do *not* constitute a restriction of competition.

A supplier may require a distributor to only combine sales via the Internet with a sales point from a physical shop (§54 Vertical Guidelines), so that the prohibition of online-only sales as part of a selective distribution system[48] is not seen as a restriction of competition. The idea behind it is that the physical sales channel beholds certain benefits for the consumer and supports a certain selective distribution model.
In addition to that, a manufacturer may require a retailer to make a certain absolute amount of sales from the physical shop. However, fixing a mandatory amount of offline sales *relative* to the sales made online, or vice versa, is a way of restricting the distributor's freedom and is therefore a restriction of competition[49]. Moreover, a manufacturer may agree with the distributors on the payment of a fixed fee to support their shop-based or online sales (§52 Vertical Guidelines), whereas any support related to the amounts of products sold online or offline is deemed a restriction of competition.
Finally, as is the case with distribution from physical stores, manufacturers can ask distributors to abide by certain quality standards in the use of the Internet for the product sale (§54 Vertical Guidelines). However, in accordance with the equivalence principle (§56 Vertical Guidelines), any criteria imposed on online sales that are not equivalent to the criteria put forward for offline sales are seen as a hard-core restriction. While the criteria do not need to be identical, they should be equivalent in the aims they pursue and the results they achieve. Any difference in the criteria must be justified by a difference in nature of these two distribution channels. The existence of such an equivalence principle demonstrates that, while the Commission aimed at integrating online distribution neatly into the prior existing vertical restraints framework, it is still treated as different from the offline channel.

U.S. Non-Price Restraints and Online Distribution

[48] As mentioned before, the BER exempts most selective distribution systems since they behold a benefit for the consumer in terms of product and service quality as long as the nature of the product and selection criteria are justified by efficiency benefits.
[49] See decisions no. 06-D-28 and no. 07-D-07.

As is the case with the EU, non-price restraints are generally seen as more pro-competitive than price restraints in U.S. competition law. Since the U.S. Supreme Court judgment in *Continental Television v. GTE Sylvania* (1997) the rule of reason is applied in all cases of non-price vertical restrictions. Overall, a manufacturer is completely free to decide on any non-price restrictions when it comes to distribution (Collin, 2014). Even if restrictions on online distribution or territorial protection limit intra-brand competition, they may be allowed under the rule of reason provided that inter-brand competition is enhanced (Accardo, 2012, p. 115). If however, intra-brand competition is limited without any countervailing benefit to inter-brand competition, the agreement is in violation of Section 1of the Sherman Act under the rule of reason.

As opposed to the European approach, where any seller should in principle be allowed to sell via the internet, exclusive appointments conferring Internet privileges to selected distributors are often seen as pro-competitive under U.S. competition law, even though they reduce intra-brand competition (Collin, 2014). This is because the restraint may limit the right of the manufacturer, but enlarges the commitment to invest by the dealer (Accardo, 2012, pp. 125-127). Similarly, geographical restrictions such as exclusive territories, location clauses and areas of primary responsibility are rarely challenged under the rule of reason and investigations will mainly evolve around the effects of vertical restraints on distributors' incentives and on inter-brand competition (Accardo, 2012).

Furthermore, the legality of customer and channel restrictions online depends, as in the offline case, on the justifications are used to impose them (Collin, 2014). Given the manufacturer's freedom to decide at what conditions it will do business, with whom and to cease business with anyone not adhering to these principles, any ban to sell through that channel needs to result from independent conduct and must be evenly enforced (Accardo, 2012, p. 121).

Moreover, dual distribution arrangements, where a manufacturer is itself also a distributor and imposes restraints on other dealers with which it is competing, are treated as vertical restraints and subject to the rule of reason (Accardo, 2012). The practice of manufacturers making Internet sales directly to retailers and end users is seen as not so different from the manufacturer's ability to reserve certain national accounts or foreign sales for itself (Rosch, 2012). The vertical restraint guidelines do mention that such restrictions could be treated as horizontal when the intent or main effect of the restraint is to prevent competition for the firm in its dealer activities.

In the overall rule of reason analysis, factors such as the degree of market power, the possibility of market foreclosure, agreement duration and possibilities to terminate agreements, entry barriers and pro-competitive effects feed into the assessment of the overall competitive effects of an agreement (Collin, 2014).

EU vs. U.S. Treatment of Non-Price Restraints in Online Distribution

Territorial and customer restrictions of online sales are probably the first and most evident area that distinguishes U.S. and EU loss functions. Not only does U.S. competition policy provide for no equivalent to the complex EU distinction between active and passive online sales. On top of that, in the U.S. even absolute territorial protection might be considered unproblematic, if it is accompanied by a sufficient strengthening of inter-brand competition. Therefore the different treatment of crude bans on online sales, imposed by manufacturers on distributors, is probably the most distinguishing feature between EU and U.S. policies when it comes to online non-price restraints. This difference is also duly reflected in case law and the discussions around it[50].

Outright prohibitions on online sales

On the EU level, the ECJ's preliminary ruling in *Pierre Fabre v. Président de l' Autorité de la concurrence* (2010)[51] set the corner stone for the evaluation of bans on online sales. In this ruling, the ECJ touched upon (i) the definition of the Internet as a distribution channel and not as a sales point[52], (ii) the ban on Internet sales as a hard-core restriction and (iii) the possibility of an individual exemption under article 101(3).

According to the ECJ the contractual clause in question resulted "in a ban on the use of the Internet for those sales" and thereby amounted "to a restriction by object within the meaning of that provision if, following an individual and specific examination of the content and objective of that contractual clause and the legal and economic context of which it forms a part, it is apparent that, having regard to the properties of the products at issue, that clause is not objectively justified". (Pierre Fabre v Président de l'Autorité de la concurrence and Ministre de l'Économie, de l'Industrie et de l'Emploi, § 47).

[50] In the EU, the various cases in front of European and national competition authorities, where manufacturers prohibited the internet sales of their products, are not all identical. Some prohibitions of internet sales were applied to sellers which were part of a selective distribution system. Others concerned pure internet players, which did not receive the right to distribute the specific products in the first place.

[51] Pierre Fabre had organized the sales of its cosmetic and personal care products via a selective distribution system. Within that system, the company had de facto prohibited the appointed sellers from selling their cosmetics products online, by inserting a contractual clause requiring the sales of cosmetics and personal care products to be made in a physical space where a qualified pharmacist must be present. The referring French court asked the question whether this general ban on online sales had to be considered a hard-core restriction, which would not benefit from a block exemption under the VBER and which could be eligible for an individual exemption under Article 101(3) TFEU.

[52] In its preliminary ruling, the ECJ firstly rejected Pierre Fabre's definition of the Internet as an "unauthorized place of establishment", holding that the Internet was merely a "method of marketing the contractual products" (§55-59). Thus, the Internet was clearly recognized to be a distribution channel and not a sales point.

Pierre Fabre sought to argument an ‘efficiency defence’ by pointing to the specific nature of the personal care products, their medicinal image, the prevention of counterfeiting, and the improvement of consumer welfare. While specifically recognizing selective distribution systems as favouring competition on factors other than price (§40), the ECJ held that the aim of protecting a prestigious brand image cannot serve as an efficiency justification under 101(3) (§46). This was in line with the Advocate General´s Opinion. He held that product image, the risk of counterfeiting or the risk of free-riding as put forward by Pierre Fabre were not sufficient reasons[53].

The denial of any efficiency justification for Pierre Fabre’s ban on online sales led to heated discussions in the legal community about its definition as a restriction by object. According to Vogel (2012, p. 3), the practice of defining a certain restraint as an object-restriction follows from the experience, that economic analysis of this particular restraint in prior cases has always proven its anti-competitive effects. Therefore, for this certain type of restriction, anti-competitive effects are then presumed to exist. It is therefore questionable, whether such a presumption can also be applicable to the new area of Internet sales.

In this context, the assessment by the ECJ of the economic and legal context of this vertical restraint is remarkable: Pierre Fabre had a market share of merely 20 per cent, all of its competitors allowed online sales of their products, and there was a strong level of intra-brand competition between 23,000 Pierre Fabre outlets in France.

The fact that a ban on online sales in a selective distribution agreement was considered a restriction ‘by object’, which can only benefit from an individual exemption under exceptional circumstances, shows, according to Vogel, that the ECJ seems “to favour a traditional, legal, and formal approach based on the characterization of the restriction which poses a per se prohibition regardless of the effects of the practices” (Vogel, 2012, p. 1).

In the U.S. two relatively recent cases deal with the reservation of online sales by a manufacturer. Such a reservation practice would amount to a restriction of passive sales via the Internet and would therefore be deemed a hardcore restriction under EU competition law. U.S. courts dealt differently with those cases. In *Gerlinger v. Amazon.com, Inc.* (2008), a customer filed an antitrust action against a mirror hosting agreement between Amazon.com Inc and a brick-and-mortar bookseller Borders Group Inc. The claim by Gerlinger was rejected. Another

[53] Opinion of the Avocat Général for Pierre Fabre, points 35,36,39

case was the *Jacobs v. Tempur-Pedic Int´l Inc.* (2010). Jacobs accused Tempur-Pedic, a mattress manufacturer, that its dual distribution[54] system constituted a horizontal price fixing agreement. The district court, and subsequently also the court of appeals, stated that courts generally judge manufacturer-distribution chain as vertical, which is consequently subject to the rule of reason. In both cases, the complaint was dismissed in favour of the manufacturer. (Accardo, 2012, p. 128)

Another interesting US case illustrating the difference with the EU's active/passive sales distinction is *Emporium Drug Mart, Inc. of Shreveport v. Drug Emporium, inc. (2000).* In this case, a virtual store of Drug Emporium was considered an intrusion on the exclusive territory of a brick & mortar franchise. An American Arbitration panel ordered the franchisor to not sell to any customers located in the franchisees territories and, to go even further, to place a notice on its website that products cannot be shipped to customers located within those territories. In addition, Drug Emporium was ordered to direct the online shoppers to the nearest franchised outlet in the appointed territory. (Jones, Day, Reavis & Pogne, 2000, p. 1) Such an agreement would have been judged as a restriction of passive sales of Drug Emporium's virtual store under European competition law.

Towards the practice of straight-out bans of online sales for distributors, EU and U.S. competition law directly oppose a more formal EU approach to such a ban as a hardcore restriction or restriction 'by object' and an equally formal U.S. approach as a result of the freedom to trade. In both cases, the actual effects of a ban of online sales on the economy were not considered: in *Pierre Fabre*, despite a strong competitive environment particularly for inter-brand, competition, the restraint was presumed as restrictive to competition. Inversely, in *Gerlinger* and *Jacobs*, the negative effects of prohibiting Internet sales for by other distributors on intra-brand competition were not even considered. This is in line with the prior beliefs in the U.S. and the EU, respectively putting the producer and the consumer at the centre of their reasoning.

Other restrictions on online sales

While these outright prohibitions of Internet sales are forbidden in the EU, the possibility for imposing restrictions on online sales within distribution networks still exists. In the U.S. the criteria that can be justifiably imposed on Internet sales allow the discrimination between

[54] The manufacturer sold mattresses through both is authorized distributors and its own website.

different kinds of selected retailers. This discussion has also been present in European case law relating to the sale over third party platforms.

In the U.S. case *MD Products, Inc. v. Callaway Golf Sales Co.* (2006), the U.S. Courts considered the practice legal where a manufacturer conferred internet privileges to certain distributors (Accardo, 2012, p. 126). Callaway had instituted an internet policy determined to use only full-price retailers, not discounters such as MD Products. Callaway would only sell to retailers who would sell directly to golfers, who refrained from discounting the products, who would not engage in bait-and-switch selling and would not disparage the Callaway product. Hence, internet distribution was still allowed, but made subject to certain conditions. The plaintiff´s motion was dismissed as the act was not seen as a concerted action in restraint of trade under § 1 of the Sherman Act. In the view of the court, the policy simply described the attributes of the retail account that Callaway wanted to work with, even though led a retailer that had long been able to sell Callaway products to suddenly being excluded from its distribution. (Casetext, 2006) This case strongly illustrates that manufacturers have the freedom to decide under which conditions their products will be sold. If manufacturers believe that Online distribution produces certain behaviours or attaches certain connotations to their products that they judge undesirable, they have the right to impose conditions that prevent distributors with certain characteristics from distributing their product. As long as the manufacturer decides on these conditions unilaterally and can lay down pro-competitive reasons for taking such action, it can confer Internet privileges to whatever distributors that meet the requirements that it imposes (Accardo, 2012, 127).

A similar attitude of the courts was advanced in *Worldhomecenter.com, Inc. v. KWC America, Inc.* (2011), where the e-retailer worldhomecenter.com selling home improvement products from several suppliers brought an action against one of its suppliers KWC America for its Internet Advertising Policy. Due to shared overhead costs, it worldhomecenter.com could offer KWC´s products at lower prices compared to traditional display rooms. KWC unilaterally decided to implement an Internet Advertising Policy under which it would not sell to internet retailers that advertised an online price lower than a certain percentage of the list price set forth by their price books. It did allow for actual prices charged to be communicated to consumers by phone, e-mail response and product purchase confirmation on the website. In addition, KWC also posted a disclaimer on its website stating that they were unable to assist with problems resulting from purchases from unauthorized distribution channels including online purchases. In this case, KWC particularly aimed for the application of the rule of reason, which was a righteous claim but deemed irrelevant as this unilateral policy applied only to advertised prices and not to the actual resale price. Moreover, it was not sufficient for the policy to be mutually beneficial to KWC and non-internet distributors to be seen as a conspiracy agreement. (Leagle, 2011) This case is interesting in the sense that even if it is quite clear from an outsider´s point of view that there seems to be some discrimination against the online retail channel, it does not matter for the judgment. As the way the policy was implemented was unilateral and not limiting actual resale price, it was allowed.

The above cases show the leniency with which restrictions on online sales are assessed in the U.S., as long as they result from the unilateral decision of the manufacturer. As opposed to that in *Bang & Olufsen* (2012)[55], the Autorité de la concurrence fined a producer of hi-fi electronic products of having unilaterally constrained the commercial freedom of its distributors. According to the authority, *Bang & Olufsen* had de facto prohibited the marketing of its products over the Internet by issuing certain provisions for the use of the Internet, which in accumulation rendered online sales "materially impossible" (§ 32, § 63). These included the prohibition of mail-order selling, the enumeration of "allowed contents" for a distributor's personal website which did not mention internet sales and the prohibition to use the manufacturer's logos and trademarks (§60-63). Here, once again, the NCA reminded that the Internet was a pertinent distribution channel for the market of hi-fi products. By de facto prohibiting internet sales, Bang & Olufsen had weakened competition between distributors, thereby deprived consumers of lower prices and restricted the width of choice for those consumers who did not have a physical store distributor nearby (§128 – 130).

Furthermore, the above U.S. case showed that the manufacturer enjoys great freedom as to the kind of criteria it can set for online sales. In contrast, in EU case law, the assessment of those criteria is much more detailed and complicated, pertaining to requirements of equivalence, non-discrimination and proportionality for any criterion imposed on the online resale of goods. The 2007 decision of the French NCA regarding several producers of cosmetic products gives a very detailed account of what it apprehends to be admissible and non-admissible restrictions imposed on distributors for online sales[56].

Therein the French NCA reconfirmed the equivalence criterion. It held that the restrictions imposed on online sales should be proportional to the aim they pursued as well as comparable to

[55] 12-D-23
[56] 07-D-07

the requirements for sales in a physical store. Hence, their excessive character should not boil down to internet sales being de facto "empty of content" (§ 97). Above a certain limit, such norms and standards destined at preserving the brand image, could thus constitute severe restrictions to competition (§ 99). For instance, some cosmetics producers had only approved the online sale of their products on the condition that they would be sold via a separate website dedicated for 'products sold on pharmaceutical consulting'. This was judged by the NCA as effectively prohibiting the sales of products over the Internet, as it multiplied the cost of website creation for a multi-product distributor. Similarly, the requirement for the products to be sold via a specific sales point on the website was considered excessive, as it would force consumers to pay twice if they wanted to order several types of products (§ 100 – 102). Other anti-competitive restrictions on online distribution were limitations on the amount of articles able to be bought at once on the Internet (when there is no such limit for the sales via physical shops) or the prohibition for the distributor to emphasize the price difference between the online price and the average shop price (§1 12 – 119).

For bans on the sales over third party platforms, the NCA only recognized them to be justifiable, if they resulted from concerns regarding the selling by non-authorized dealers or the risk of counterfeiting. In fact, as long as these platforms could not guarantee the quality of their seller's identity, the risk of the development of parallel trade networks and counterfeiting could be damaging for selective distribution networks. Interestingly however, the French NCA found that third party platforms were indeed able to satisfy the quality requirements for product presentation, particularly when reserving virtual shops for authorized sellers (§104 – 105).

Whereas here a NCA evaluated single provisions of agreements as to their proportionality, in the US, these criteria would have been entirely left to the appreciation of the manufacturer, again under the principle of the freedom to trade.

Efficiency defence for non-price restraints on online distribution

A final big difference recognized in case law hinges on the appreciation of efficiency effects by U.S. and EU competition authorities. As resulting from the Chicago school of thought, vertical restraints are a priori presumed efficiency-enhancing in the U.S. and the prevention of free riding is the efficiency reason for which vertical restrains are considered a legitimate restriction. For the EU, we have seen that efficiency plays a role, first via the VBER, then via the individual assessment. European competition policy enforcement tries to strike a balance between prohibiting a total ban on internet sales by manufacturers and allowing them to mitigate the risk of online/offline free riding. However, the article 101(3) justification for a total ban of Internet sales has, in coherence with the presumption of hardcore restrictions not to be eligible for this individual exemption, rarely been applied by the ECJ.

In recent case law, factors that were considered for the purposes of efficiency defence involved product characteristics (importance of brand image, accompanied by pre-/post sales services and advice, need for consumer protection due to product complexity or health concerns) as well as the possible 'directions' in which free riding could take place (online to offline or offline to online). In a 2006 decision, the French NCA noted that certain types of products, such as perfumes or luxury hi-fi material, which cannot be easily described or reproduced, are less suited for internet sales, as consumers would prefer to test them in a physical store before buying them. These product categories are particularly prone for service free-riding issues, when heavy investment has been made by owners of physical shops (*Festina France*, § 68-70)[57].

Decisions by national competition authorities have been varying in strictness with respect to 101(3) assessments of pro-competitive effects. In CIBA, the German NCA stated, for instance, that consumer health protection and free-riding were no appropriate reasons to impose restrictions on online sales and proceed to RPM[58]. It found the argument on health and safety reasons invalid, as contact lenses were prescription free in Germany and the measurement and control services offered by optical stores (non-medical) were at the discretion of the individual customer. Similarly, the free riding argument was countered by the assertion that supermarkets and drugstores also sold soft contact lenses (OECD, 2013, p. 116). In contrast, a Dutch court ruling found the block exemption applicable in case of a manufacturer that had issued different supply conditions for online retailers compared to traditional retailers, as there was a difference in added value between the two distribution channels. A difference had been for example, that traditional retailers offered advice and installation service, which was not the case for online retailers[59].

[57] Often the European Commission has, in the light of the freedoms of movement, not accepted arguments relating to the need to provide individual advice to the customer and to ensure his protection against the incorrect use of products. This was, for instance the case in the context of non-prescription medicines: none of the arguments advanced was recognized as a valid reason for prohibiting online sales. The European Commission held that adequate advice and information could be provided via the internet, while the introduction of certain online interactive pre-sale features could mitigate the risk of incorrect use by the consumer (Deutscher Apothekerverband, § 106, 107, 112-116). Equally, the prohibition of the sale of contact lenses online by national Hungarian law was deemed to impede intra-community trade and not proportionate to the aim of protecting public health (Case C-108/09 Ker-Optika [2010] ECR I-0000, § 76).

[58] German Federal Cartel Office (Bundeskartellamt), 25 September 2009, Case n B 3 - 123/08, CIBA

[59] District Court of Zutphen (Rechtbank Zutphen), 30 December 2005, Case 74100, KG ZA 05-309, Groen Trend B.V.and Schouten Keukens B.V. / Atag Etna Pelgrim Home Products B.V.

As opposed to the EU's complex discussions, the U.S. situation of efficiency considerations has been clear-cut. In *O.S.C. Corp. v. Apple Computer, Inc.* (1985), Apple imposed a ban against mail order sale of its products by authorized Apple dealers due to free-riding concerns. The complaint arose from retail dealers which distributed using mail order sales. At that time, Apple applied a strategy requiring in-depth pre- and post-sale support to protect the brand. Those dealers providing support incur a lot higher costs than a dealer who does not. As support would decrease in case the increased costs were not compensated, Apple was only willing to authorize dealers who refrained from engaging in the mail order sale of Apple products as to prevent free-riding by them. Apple also published a written price list with suggested prices. Again, this behaviour was judged illegal in absence of any proof of concerted action or price fixing, even if the mail-order prohibition eliminated a form of intra-brand competition. (Leagle, 1985)

6 Conclusion

We have seen that the policy response to the advent of the Internet as a new distribution channel in the EU and the U.S. has been in line with their overall policy approaches towards vertical restraints. Policy makers' beliefs about the relative odds that a given practice is anticompetitive have been defined as a function of their prior beliefs about the practice in question and the relative likelihood that the observed evidence is the result of an anticompetitive conduct.

For the U.S. we have defined the prior belief as a combination of general focus on the pro-competitive effects of vertical restraints and a stringent application of the rule of reason approach. The variables examined for assessments of competition effects seem to be freedom of trade, inter-brand competition, market power, producers' efficiency and output. We have found that this prior belief is rooted in the Chicago school of thought. The *Leegin* landmark judgement is thereby exemplary for a change of this prior belief towards the overall endorsement of the rule of reason for all types of vertical restraints. The perceived successful application of the rule of reason to vertical restraints and its adaptability to a changing market environment has led U.S. competition authorities to believe that the same principles could apply to both offline and online distribution and that a revision of their vertical restraints policy was not needed. Hence, none of the U.S. rule of reason cases dealing with online retailers takes special account of the Internet as a distribution channel. Many commentators have remarked that the rule of reason has in numerous instances operated as a de facto legality rule[60]. We therefore believe that, given these prior beliefs, U.S. competition law leans towards strong leniency for vertical restraints on online distribution.

The loss function underlying competition policy making in the U.S. supports this lenient attitude: given the error-cost framework and the general perception as both distribution channels being of equal importance, the expected loss from type-I-errors clearly outweighs the loss expected from committing type-II-errors. Therefore both prior beliefs and loss functions have led to an enforcement practice that treats online and offline retailing in the same manner, while generally finding vertical restraints to be either pro-competitive or legal owing to the principle of freedom of trade.

For the EU, the prior belief has been defined as a combination of a focus on both pro- and anti-competitive effects of vertical restraints and the need to perform a balancing act between these two effects within a structured rule of reason. The variables examined for assessments of competition effects seem to be: the applying legal presumption, inter- and intra-brand competition, market power, consumer welfare and prices.

We have found that this prior belief is in fact a combination of traditional schools of thought complemented by insights from Ordoliberalism and the Freiburg school. This mainly results from the specific features of the Internal Market and the willingness to foster its completion. According to this line of reasoning the question whether pro- or anti-competitive effects dominate, depends on the case at hand, which led policy makers to specifically take the features of the Internet into account.

The specific status of the Internet has become apparent when defining the EU's loss function. The latter gives more weight to the loss resulting from type-II-errors, because the Internet is a crucial vehicle for the achievement of a true internal market. The focus on consumer welfare, in terms of lower prices and wider choice brought about by online retailing, is clearly present in most of the discussed cases. At the same time, an efficiency defence of online restrictions has is most cases not been accepted. Overall, we conclude that the European approach towards online restrictions is based on strong presumptions of their restrictive effect on competition and biased towards a general supporting attitude towards online distribution.

With this paper we hope to lay the foundation for deeper research into the optimal competition policy regime for a global world, where online and offline distribution channels coexist. We have underlined the strong differences between the EU and U.S. regime, while

[60] See for example Posner (1977), Ginsburg (1991, p. 71), and Calkins (1999, p. 512).

refraining from any evaluation of what would be the optimal competition policy approach. Further research avenues could therefore include empirical research about the effects of the two competition policy regimes on online distribution in different industries. Furthermore an empirical analysis on whether Internet retailing would strengthen or weaken the free-rider justification for restrictions could support competition policy makers in their assessments.

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