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REVISITING THE RULES - THE EXTENT TO WHICH MANUFACTURERS AND SUPPLIERS CAN DETERMINE THE PRICES CHARGED BY THEIR DISTRIBUTORS

Introduction

In this article we consider the extent to which suppliers or manufacturers are permitted to determine the prices at which their resellers or distributors on-sell their goods or services. The relationship between these parties is a vertical relationship for purposes of the Competition Act.\(^1\) Parties in a vertical relationship include manufacturers or suppliers of goods or services, on the one hand, and their retailers or distributors, on the other. Agreements or arrangements between parties in a vertical relationship are governed by section 5 of the Competition Act. As franchisors and their franchisees are also regarded as parties in a vertical relationship, section 5 of the Competition Act also applies to franchise agreements.

While not expressly stated in the Competition Act, it is submitted that parties to agency agreements are not regarded as being in a vertical relationship, where the arrangement is a genuine agency agreement. Although distribution agreements are sometimes described as “agency agreements”, the nature of the agreement between the parties determines whether or not it is truly an agency arrangement and a factor of particular importance in this regard is the financial or commercial risk which the agent bears.\(^2\) From a competition law perspective, in a genuine agency agreement, the agent sells the goods or services on behalf of the principal, rather than the agent on-sell ing the principal’s goods or services. The relationship between the principal

\(^1\) Competition Act No. 89 of 1998, as amended. In terms of the Competition Act, a vertical relationship means the relationship between a firm and its suppliers, its customers, or both.

\(^2\) Some of the factors pertaining to commercial and financial risk, and which are helpful in distinguishing an agency agreement from other arrangements between parties in a vertical relationship, are discussed in this article.
and agent in a genuine agency agreement is therefore distinguishable from that of parties in a vertical relationship, and is treated differently as far as agreements on prices are concerned.

This article considers minimum resale price maintenance under the Competition Act and in terms of the approach of the South African competition authorities. It also considers the approach to minimum resale price maintenance in the US, in light of the recent decision of the US Supreme Court in the *Leegin* case.³

**Minimum resale price maintenance in terms of the Competition Act and the competition authorities’ approach**

For parties in a vertical relationship, minimum resale price maintenance is *per se* unlawful under the Competition Act. Put differently, while some provisions of the Competition Act allow for the weighing up of anti-competitive effects against pro-competitive gains to determine the lawfulness of an agreement or practice, no “rule of reason” analysis is permitted where minimum resale price maintenance is concerned – it is outright unlawful.

Where a firm engages in the *per se* unlawful practice of minimum resale price maintenance (or “RPM”), it is exposed to an administrative penalty for a first infringement.⁴ The competition authorities are empowered to impose a penalty of up to 10% of a firm’s turnover in South Africa and its exports from South Africa in the firm’s preceding financial year for such an infringement,⁵ although in practice the authorities have applied penalties to the line of business affected by the agreement or practice concerned, rather than the firm’s total turnover.

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⁴ See section 59(1)(a) of the Competition Act. Other contraventions of the Competition Act which are not *per se* unlawful only expose firms to an administrative penalty for a repeat contravention. Specifically, section 59(1)(b) provides that the Competition Tribunal may only impose an administrative penalty for a prohibited practice in terms of section 4(1)(a), 5(1), 8(c) or 9(1), if the conduct is “substantially a repeat by the same firm of conduct previously found by the Competition Tribunal to be a prohibited practice.”

⁵ Section 59(2) of the Competition Act provides as follows: “An administrative penalty imposed in terms of subsection (1) may not exceed 10 per cent of the firm’s annual turnover in the Republic and its exports from the Republic during the firm’s preceding financial year.”
Minimum resale price maintenance may be easy for competition regulators to detect, as uniformity in the resale price of products is apparent to the public, especially where a reseller is precluded from providing a discount off the resale price. It may also be easy for regulators to prosecute, as a retailer who wishes to on-sell products at a price lower than the supplier’s recommended price is a willing complainant to the Competition Commission (the “Commission”) when the supplier seeks to control the retailer’s prices.

The Competition Act provides that the practice of minimum resale price maintenance is prohibited, although a supplier or producer may recommend a minimum resale price, provided that two conditions are met. The first is that it must be clear to the reseller that the recommendation is not binding. The second is that if the product has its price stated on it, the words “recommended price” must appear next to the stated price.

The leading South African case on resale price maintenance is The Competition Commission of South Africa v Federal Mogul Aftermarket Southern Africa (Pty) Ltd (“Federal Mogul”) and Others, in which the Competition Tribunal (“Tribunal”) set out its clear approach towards resale price maintenance, confirming that a firm will be regarded as having engaged in the practice of resale price maintenance if (i) the reseller or distributor knows the price at which they are expected to on-sell the goods or services and (ii) there is a “sanction” or penalty for not complying with the expected or desired price. Federal Mogul, the respondent in that case, is a wholesale distributor of a range of motor vehicle components. The components distributed by Federal Mogul include Ferodo, the products of a large multinational manufacturer of braking equipment. The complainant, a distributor of friction products (mainly Ferodo products) alleged

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6 The Toyota case, discussed below, is an example of an investigation initiated after a member of the public submitted a complaint to the Commission, when a Toyota dealer indicated that he was precluded by Toyota from selling a vehicle at the price proposed by the customer. Competition Commission / Toyota South Africa Motors (Pty) Ltd [2005] CPLR 430 (CT).
7 The Federal Mogul case, discussed below, is an example of a retailer objecting to a supplier’s imposed price. The Competition Commission of South Africa v Federal Mogul Aftermarket Southern Africa (Pty) Ltd and Others, Case Number 08/CR/Mar01.
8 Sections 5(2) and 5(3) of the Competition Act.
9 Case Number 08/CR/Mar01.
that Federal Mogul had reduced the rebate which it had granted to the complainant owing to the complainant’s participation in a “price war”, in terms of which the complainant had offered Ferodo products for sale at a price lower than that required by the supplier.

The complainant also submitted that Federal Mogul’s reduction of the complainant’s rebate and, crucially, the complainant’s margins, rendered the complainant’s business non-viable, effectively forcing him out of business.

Federal Mogul argued that as a threshold condition for an adverse finding under section 5 of the Competition Act, there should be an agreement – some element of understanding – between the supplier and its distributor, which, in the event of its breach or violation, will be met by the imposition of a sanction. Federal Mogul submitted that this element of the complainant’s case was lacking.

The Tribunal disagreed with Federal Mogul, finding that section 5(2) states plainly that the practice of minimum resale price maintenance is prohibited, with no reference to an agreement to maintain minimum prices. In any event, the Tribunal found that even on the Federal Mogul’s interpretation of section 5(2), the section had been violated. There was sufficient evidence of an understanding in the industry regarding the price at which distributors were generally obliged to on-sell Ferodo products to their customers. The Tribunal also held that even if there was insufficient evidence of an understanding, a unilateral determination of a minimum resale price, backed up by a sanction for non-compliance, would still fall foul of section 5(2) of the Competition Act. The Tribunal considered that the question in this case was ultimately one of causation; a matter of determining why Federal Mogul had reduced the complainant’s rebate.

It was established that a significant grouping of Federal Mogul’s wholesale customers, including the complainant, received a rebate of 47.5% off the list price of goods sold to them and then on-sold these goods to their retailer customers at the Federal Mogul list price, less 35%. However, during October 1999, the complainant was informed that his rebate of 47.5% was to be reduced to 40%. The complainant alleged that this was done because he had supplied products at a discount of greater than 35% off the Federal Mogul list price. Federal Mogul denied this,
arguing that the reason for the reduction of the complainant’s rebate was not a consequence of the prices charged by the complainant, but because of his poor payment record. On the evidence presented, however, the Tribunal found that the scale of purchases was the pre-eminent, indeed the sole, determinant of the level of the rebate afforded to a Federal Mogul customer, and not creditworthiness. The Tribunal was also satisfied that the convention in the industry was that the price charged by wholesalers to their retailer customers equated to 35% of the Federal Mogul list price. There was no need to monitor this particularly closely. The convention was well-established, pricing practices appeared to have been transparent, and there were only a few distributors to monitor. Nevertheless, ad hoc price meetings were held between the large distributors and members of Federal Mogul management. At one of these meetings, the consequences of “stepping out of line” were communicated to the wholesalers. They were told that wholesalers who “stepped out of line” would have their rebates cut, or would be put on “stop supply”.

The Tribunal was satisfied that the conventional 35% discount was well known and that, coupled with evidence of a sanction for the violation of this convention, there was sufficient evidence to secure a finding against the respondent. There was also clear evidence that the rebate was reduced in response to the complainant’s participation in the “price war”. The Tribunal held that it could only conclude that the reduction in the rebate was intended to illustrate to the complainant and other actual or would-be transgressors the consequences of not “playing by the rules”. Having concluded that the respondent had contravened section 5(2) of the Competition Act, the Tribunal imposed a penalty of R3 million on Federal Mogul for engaging in the practice of minimum resale price maintenance.

Since the Federal Mogul decision, other firms have paid penalties for engaging in resale price maintenance. These include Toyota South Africa Motors (Pty) Ltd (“Toyota”), for determining the maximum discounts which Toyota dealers were permitted to grant to customers on certain models of Toyota motor vehicles. The Commission’s investigation of the complaint in this case resulted in Toyota concluding a consent agreement with the Commission which
included the payment of R 12 million.\footnote{Competition Commission / Toyota South Africa Motors (Pty) Ltd [2005] CPLR 430 (CT).} After the \textit{Toyota} case, the Commission conducted an industry-wide investigation into pricing practices in the motor vehicle industry, which resulted in consent agreements being concluded between the Commission and various respondents. Consent agreements (subsequently confirmed as orders of Court by the Tribunal) were concluded between the Commission and DaimlerChrysler,\footnote{Competition Commission / DaimlerChrysler SA (Pty) Ltd [2006] 1 CPLR 73 (CT).} General Motors,\footnote{Competition Commission / General Motors SA (Pty) Ltd [2006] 1 CPLR 82 (CT).} and the manufacturers of Citroen,\footnote{Competition Commission / Boundless Trade 154 (Pty) Ltd trading as Citroen South Africa [2006] 1 CPLR 68 (CT).} Volkswagen\footnote{Competition Commission / Volkswagen SA (Pty) Ltd [2006] 1 CPLR 87 (CT).} and Nissan\footnote{Competition Commission / Nissan South Africa (Pty) Ltd [2006] 1 CPLR 93 (CT).} motor vehicles in South Africa, as well as BMW dealers.\footnote{The Commission’s investigations into pricing practices in the motor vehicle industry resulted in administrative penalties of R 51,65 million being paid for contraventions of the Competition Act and the respondent firms were also required to implement compliance programmes.}

The Commission has also followed the Tribunal’s approach in relation to minimum resale price maintenance in franchise agreements. For example, after investigating a complaint submitted by franchisees against Italtile Franchising (Proprietary) Limited (“Italtile”), the Commission found (i) that the Italtile Group had compelled franchisees to charge prices that were set centrally by the group; (ii) that deviation from the centrally set prices, under certain circumstances, required that franchisees obtain prior approval from Italtile; (iii) that Italtile, through its representatives, threatened to terminate franchises in which products were not sold at the set prices; and (iv) that the prices set centrally in the group were, therefore, mandatory. The Commission concluded that the franchisor’s conduct amounted to minimum resale maintenance in contravention of section 5(2) of the Competition Act. In this case, the Commission and the franchisor entered into a settlement agreement which included the franchisor paying an administrative penalty of R 2 million.\footnote{Competition Commission / Northwest Ceramics (Pty) Ltd, Fazel Rhemthula and Italtile Franchising (Pty) Ltd, Italtile Ceramics Ltd, Italtile Ltd, Case No. 90/CR/Dec02.}

The Commission’s approach in the \textit{Italtile} case follows the Tribunal’s reasoning in \textit{Cancun}
Trading / Seven-Eleven Corporation SA (Pty) Ltd, where the Tribunal granted an application for interim relief by a group of franchisees who complained that Seven-Eleven obliged them to purchase only from its approved suppliers, in contravention of section 5(1) and section 8 of the Competition Act. The complainants also submitted that the obligation on them to sell their products at prices determined by Seven-Eleven contravened section 5(2) of the Competition Act. While the Tribunal considered that the complainants had not placed sufficient evidence before it to allow for the definition of the relevant market in this case, and consequently for the Tribunal to find a contravention of section 5(1) or section 8 of the Competition Act, the Tribunal granted the application for interim relief in relation to section 5(2) of the Competition Act.

Nevertheless, the Tribunal recognized that the application of the prohibition against minimum resale price maintenance in relation to franchise arrangements may create difficulties, insofar as a franchise relationship is a “unique organizational form” which is:

“…neither an employment relationship nor an independent contracting relationship. It rather combines elements of integration and delegation, control and independence and it is this multifaceted vertical structure that paves the way for endless relational and commitment problems”.

Ultimately, however, the Tribunal dismissed Seven-Eleven’s argument that a franchise relationship should be viewed as a single business entity or an association, as it found no authority for treating the franchisor and franchisee as a single firm and, where, on the basis of such authority, vertical price fixing has been condoned, the Tribunal found that, on the contrary, the authorities appear to accept that such prohibitions may be applied to franchise agreements.

The Commission has also set out its approach to franchising in a Franchising Notice, in which it “recognizes the contribution of franchising to job creation and the fact that it is one of the best vehicles and an effective way to opening up markets for small and medium-sized

19 Id. at 174.
20 Id. at 181.
21 The Franchising Notice is available at http://www.compcom.co.za/resources/FranchisingNotice.doc.
enterprises and historically disadvantaged persons to participate in the mainstream economy of the country”. The Franchising Notice confirms, however, that franchise agreements are not subject to special treatment but are subject to the same requirements as other vertical agreements, including section 5(2) of the Competition Act, which prohibits RPM. Accordingly, franchisees must be free to discount and set their own resale prices, even though uniformity may be desirable. The Franchising Notice cautions expressly that “[f]ranchisors should therefore realize that the Act does not allow them to dictate to franchisees/dealers/retailers minimum prices at which to resell goods or to determine the maximum discount that can be given to customers”.

**Prices agreed between principals and agents**

As mentioned above, while agency agreements are not expressly provided for in the Competition Act, it is submitted that parties to genuine agency agreements are not regarded as being in a vertical relationship. In a genuine agency agreement, the agent sells the goods or services on behalf of the principal, rather than the agent on-selling the principal’s goods or services. The relationship between the principal and agent in a genuine agency agreement is therefore distinguishable from that of parties in a vertical relationship, and is treated differently as far as agreements on prices are concerned.

The European Commission Guidelines on Vertical Restraints ("EC Guidelines"), which are not binding on our authorities, but have been influential in South Africa, provide a useful discussion of agency agreements and their treatment in terms of European competition law. The EC Guidelines specify that agency agreements cover the situation in which a legal or physical person (the agent) has the authority to negotiate and/or conclude agreements on behalf of another party (the principal), either in the agent’s own name or in the name of the principal, for the purchase of goods or services by the principal or the sale of goods or services supplied by the principal. As far as the application of Article 81(1) EC Treaty is concerned, which prohibits all agreements which may affect trade between EU member states and which have – as their object

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23 Id. at para 12.
or effect – the prevention, restriction or distortion of competition within the single market, the EC Guidelines remove genuine agency agreements from the application of Article 81(1), by providing that:

“[i]n the case of genuine agency agreements, the obligations imposed on the agent as to the contracts negotiated and/or concluded on behalf of the principal do not fall within the scope of application of Article 81(1). The determining factor in assessing whether Article 81(1) is applicable is the financial or commercial risk borne by the agent in relation to the activities for which he has been appointed by the principal…” 24

In terms of the EC Guidelines, there are two types of financial or commercial risk material to assessing the genuine nature of an agency agreement for purposes of Article 81(1) EC Treaty. The first is the risks directly related to the contracts concluded and/or negotiated by the agent on the principal’s behalf (e.g. the financing of stock). The second is the risks related to market-specific investments required to be made by the agent for the type of activity for which the agent has been appointed. Such investments are usually regarded as sunk if upon leaving that particular field of activity the investment cannot be used for other activities or sold (other than at a significant loss).

The EC Guidelines provide that the question of risk is determined on a case-by-case basis with regard to the economic reality of the situation, rather than legal form. However, where the agent bears no risk, or only insignificant risk, in respect of the contracts negotiated or concluded on the principal’s behalf or in respect of the market-specific investments made, the agreement is regarded as being one of genuine agency. Where the agent bears little or no risk, the selling or purchasing function of the agent is regarded as forming part of the principal’s activities and the agent is not regarded as exercising an independent economic activity in relation to the activities for which the principal has appointed the agent, despite the agent being an independent legal entity.

24 Id. at para 13.
The European Commission will generally regard Article 81(1) EC Treaty as not applicable to obligations imposed on the agent as to the contracts negotiated and/or concluded on behalf of the principal, where property in the contact goods bought or sold does not vest in the agent, or the agent himself does not supply the contact services, and where the agent:

- does not contribute to the costs relating to the supply of the contact goods or services, including the costs of transporting the goods. This does not preclude the agent from carrying out the transport services, provided that the costs are covered by the principal;

- is not, directly or indirectly, obliged to invest in sales promotion, such as contributions to the advertising budgets of the principal;

- does not maintain at his or her own cost or risk, stock of the contract goods, including the costs of financing the stock and the costs of loss of stock and can return unsold stock to the principal without charge, unless the agent is liable for fault (e.g. by failing to comply with reasonable security measures to avoid loss of stock);

- does not create and/or operate an after-sales service, repair service or a warranty service unless it is fully reimbursed by the principal;

- does not make market-specific investments in equipment, premises or training of personnel (e.g. petrol storage tanks in the case of petrol retailing or specific software to sell insurance policies in the case of insurance agents);

- does not undertake responsibility towards third parties for damages caused by the products sold (product liability) unless, as agent, he is liable for fault in this respect;

- does not take responsibility for customers’ non-performance of the contract, with the exception of the loss of the agent’s commission, unless the agent is liable for fault (e.g. by failing to comply with reasonable security or anti-theft measures, or
with reasonable measures to report theft to the principal or police, or to communicate to the principal all necessary information available to him on the customer’s financial reliability).  

Pursuant to the EC Guidelines, where an agreement between parties in a vertical relationship is one of genuine agency, the principal is entitled to determine the resale price for the goods or services supplied by the agent on the principal’s behalf. It is submitted that a similar approach should be followed in South Africa and it would be useful to have similar guidelines articulating the position in relation to pricing (and other) agreements between principals and their agents.

**Minimum resale price maintenance by way of indirect sanctions**

In the *Federal Mogul* case, the “sanction” imposed on the distributor for not selling at the recommended price was a reduction of the distributor’s rebate. However, a sanction does not need to be a (direct) financial penalty in order for resale price maintenance to be established. This has been clarified in the EU, where examples of other forms of “sanctions” are set out in the EC Guidelines, which recognize that resale price maintenance can also be achieved through indirect means:

> “Examples of the latter include an agreement fixing the maximum level of discount the distributor can grant from a prescribed price level; making the grant of rebates or reimbursement of promotional costs by the supplier subject to the observance of a given price level; linking the prescribed resale price to the resale prices of competitors; threats, intimidations, warnings, penalties, delay or suspension of deliveries or contract termination in relation to observance of a given price level. Direct or indirect price fixing can be made more effective when combined with measures to identify price-cutting distributors, such as the implementation of a price monitoring system, or the obligation on retailers to report other members of the distribution network who deviate from the standard price level. Similarly, direct or indirect price fixing can be made more effective when combined with

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25 Id. at para 16. The EC Guidelines confirm that this is not an exhaustive list of relevant factors.
measures which may reduce the buyer’s incentive to lower the resale price, such as the supplier printing a recommended resale price on the product, or the supplier obliging the buyer to apply a most-favoured-customer clause. The same indirect means and the same ‘supportive’ measures can be used to make maximum or recommended prices work as RPM. However, the provision of a list of recommended prices or maximum prices by the supplier to the buyer is not considered in itself as leading to RPM.”26

From the above, the position in the EU with regard to minimum resale price maintenance is very similar to the approach followed in South Africa, with both jurisdictions allowing for the provision of recommended resale prices but also recognizing that RPM may be achieved in different ways, without an agreement between parties in a vertical relationship in respect of resale prices being required.

**Should minimum resale price maintenance be per se unlawful?**

The question raised, in particular by manufacturers and franchisors, is whether minimum resale price maintenance should be per se unlawful, when there may be sound commercial reasons for maintaining price uniformity in some cases. Some economists defend resale price maintenance on various grounds, arguing that it should not be per se unlawful as, in some instances, resale price maintenance may be beneficial to consumers or, at worst, have a neutral effect on competition.

One of the arguments advanced is that resale price maintenance has a legitimate aim, insofar as it prevents the “free-rider” problem. An example used to illustrate the “free-rider” problem is the following: a manufacturer of high-end electronic equipment, including DVD players and music systems, may want its distributors to provide an attractive showroom for customers and knowledgeable and well-trained sales personnel, who are familiar with the functions of the products offered for sale and how they compare with similar products in the market, in order to assist customers in making the best selection for their purposes. It may cost

26 Id. at para 47.
the distributor more to recruit and train its sales force and to establish and maintain the
showroom but this is ultimately to the benefit of the consumer, who is educated to make a better
choice and is offered a better service.

Without resale price maintenance, some customers will take advantage of one retailer’s
good service to learn about the special features of the particular DVD players or music systems
they are considering, and then buy the item at a “discount” retailer that does not invest in its
showroom and sales force in order to provide the same service as the first “service-oriented” [sic]
retailer. The discount retailer is able to “free ride” on the service provided by other service-
oriented retailers in the network. In addition, the business of the service-orientated retailer
becomes less viable, as customers, having reaped the benefits of the better services for free, make
their purchases at the discount retailer. An argument in favour of resale price maintenance in this
instance is that it prevents the free-rider problem, thereby ensuring that more retailers are
established in the market and that they provide customer-orientated services.

Another submission made in defence of resale price maintenance is that prohibiting resale
price maintenance does not, in any event, ensure lower priced goods. For example, if the
manufacturer of high-end electronic goods sells its products to its distributors at a particular price
and requires its distributors to on-sell the products at the wholesale price plus a certain margin, to
the extent that the manufacturer has any market power, it can exercise that power through the
wholesale price anyway, rather than through resale price maintenance.

Those in favour of allowing minimum resale price maintenance, at least in certain cases,
would have welcomed the Leegin case, which has allowed for a different approach to be adopted
towards minimum resale price maintenance in the United States.

The Leegin decision

Minimum resale price maintenance has been regarded as per se unlawful in the United
States for almost a century, following the 1911 decision in Dr. Miles Med. Co. v. John D. Park &
Sons Co.\textsuperscript{27} ("Dr Miles"), where the United States Supreme Court held that minimum resale price agreements are \textit{per se} violations of section 1 of the Sherman Act.\textsuperscript{28}

In June this year, in the \textit{Leegin}\textsuperscript{29} case, the United States Supreme Court reversed this century-old precedent, ruling that minimum resale price maintenance should not be regarded as \textit{per se} unlawful. Rather, in the US, vertical restraints will now be assessed under the "rule of reason" test, allowing a defendant to show that conduct complained of has pro-competitive benefits that outweigh its anti-competitive effects.

In this case, Leegin, a manufacturer of accessories, instituted a policy whereby the firm would do business only with retailers that followed its “suggested” resale prices. Leegin stopped supplying PSKS, Inc. ("PSKS") with merchandise when PSKS offered Leegin’s products for sale below the “suggested” minimum resale price. PSKS sued Leegin and a jury found that Leegin’s pricing policy constituted a \textit{per se} violation of section 1 of the Sherman Act.

At the district court, Leegin tried to introduce expert testimony to establish the pro-competitive effects of its vertical price restraints. However, the trial court excluded the expert testimony on the grounds that pro-competitive effects are irrelevant where a \textit{per se} violation is concerned.

The question which came before the US Supreme Court was whether minimum resale price maintenance agreements between parties in a vertical relationship should continue to be deemed \textit{per se} unlawful under section 1 of the Sherman Act, or whether such conduct should be evaluated under a “rule of reason”. Leegin argued that minimum resale price maintenance can have a number of pro-competitive results that can enhance consumer welfare, such as guaranteeing a product’s brand image, increasing inter-brand competition and mitigating the adverse effects of

\textsuperscript{27} Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).
\textsuperscript{28} 15 U.S.C. § 1 (1997). Only eight years after \textit{Dr. Miles}, however, the Court in \textit{United States v. Colgate & Co.}, 250 U.S. 300, 307 (1919) generally allowed a supplier unilaterally to adopt and enforce a policy of refusing to deal with discounters because such a unilateral decision did not involve the agreement necessary for a violation of section 1 of the Sherman Act.
\textsuperscript{29} Leegin Creative Leather Products, Inc. v. PSKS, Inc. supra (n 3).
“free-riding”.

After reviewing recent economics literature, the Supreme Court found that although resale price maintenance agreements may harm competition in some circumstances (e.g. they may facilitate cartels), they often enhance competition by giving retailers incentives to promote the manufacturers’ products; by facilitating entry by new competitors; and by otherwise stimulating competition among rival suppliers of branded products.\(^{30}\) The \textit{per se} rule, the Court considered, is an outdated approach to the complex economic issues raised by minimum resale price maintenance. The Court held that minimum resale price maintenance arrangements should be assessed under the “rule of reason” test. The Court also rejected the argument that resale price maintenance agreements should remain \textit{per se} unlawful because the “rule of reason” would be too difficult to administer.\(^{31}\)

The Court also provided some guidance to lower courts about three factors that may be particularly relevant when assessing resale price maintenance agreements under the “rule of reason”.\(^{32}\) These include:

\begin{itemize}
  \item The number of competitors in the market that have adopted resale price maintenance agreements. The possibility that RPM agreements are facilitating cartels is less likely when few competitors employ such agreements, but “\textit{resale price maintenance should be subject to more careful scrutiny . . . if many competing manufacturers adopt the practice}”.
  
  \item Whether the RPM originated with the manufacturer or the retailer. The Court observed that because a manufacturer generally has incentives to promote efficient distribution that are aligned with the interests of consumers, harm to competition is more likely if RPM agreements are brought about as a result of retailer pressure rather than on the manufacturer’s own initiative.
\end{itemize}

\(^{30}\) Id. at 9-12.

\(^{31}\) Id. at 15.

\(^{32}\) Id. at 17-18.
• Whether the manufacturer or retailer party to the RPM agreement has market power:

“If a retailer lacks market power, manufacturers likely can sell their goods through rival retailers . . . and if a manufacturer lacks market power, there is less likelihood it can use the practice to keep competitors away from distribution outlets.”

The Court considered these factors as a starting point for the lower courts to develop substantive standards and procedural rules for evaluating resale price maintenance agreements under the rule of reason. In particular, the Court stated that lower courts should “establish the litigation structure to ensure the rule operates to eliminate anti-competitive restraints from the market and to provide more guidance to businesses” by, for example “devis[ing] rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote pro-competitive ones”.

Reviewing the economic effects, stimulation of inter-brand competition, reduction of free-riding, and the facilitation of market entry on the one hand, and the facilitation of cartel behaviour and abuse by powerful manufacturers or retailers on the other hand, the Court found that it could not be stated with any degree of confidence that minimum resale price maintenance “always tend(s) to restrict competition and decrease output”.

The Court considered that a “rule of reason” analysis, which requires all the circumstances of the arrangement to be considered on a case-by-case basis with reference to the relevant market, and to balance any anti-competitive effects against legitimate business justifications and pro-competitive effects which result from the arrangement, is more appropriate. Following this approach, only restraints that have a net negative effect on competition are regarded as unlawful.

The US Supreme Court’s decision in the Leegin case has opened the door for the potential beneficial effects of minimum resale price maintenance to be assessed on the basis of the rule of reason in the United States. It does not mean that manufacturers have carte blanche to impose

33 Id. at 19.
minimum prices but it does allow manufacturers to create efficiencies in the marketing and distribution of their products, using such vertical price restraints on resellers or distributors. The application of the “rule of reason” – as opposed to the per se rule – has significant implications. As a practical reality, unlike the per se analysis, under the “rule of reason” analysis, plaintiffs typically have to prove a relevant product market and show that the defendant has market power before any anti-competitive and pro-competitive effects can be analysed. Future challenges against minimum resale price maintenance arrangements are likely to focus on defendant firms that have market power. Defendants facing such challenges will be able to present evidence of the pro-competitive justifications of their conduct.

The approach adopted in Leegin provides flexibility to suppliers and manufacturers in their vertical pricing policies, as long as they can establish that the restraints are necessary to achieve efficiencies in the marketing and distribution of their products.

However, those who opposed the decision in Leegin include the US Federal Trade Commissioner, Pamela Jones Harbour, who sent an open letter to the US Supreme Court before the decision was announced, cautioning that the assumptions supporting the Leegin decision do not match the reality of the American marketplace. The Federal Trade Commissioner’s view is that without the per se prohibition against minimum resale price maintenance, intra-brand and inter-brand competition may continue to exist but only to the extent that this benefits manufacturers, not consumers.

The Leegin decision is a recent one and it remains to be seen what the real effects of the case will be in the US: whether the prices of products will be raised; whether the quality of products will be enhanced; whether there will be greater innovation. One of the possible challenges in the US that remains to be seen is the possible consequence of individual states taking a hard line against resale price maintenance, such that firms distributing products nationally may face a different approach to minimum resale prices being followed in different jurisdictions.

It will also be interesting to see what effect, if any, the decision will have in other jurisdictions and whether legislators and authorities will follow a similar approach over time, when they have an opportunity to review their legislation and/or the application thereof.

**Maximum resale price maintenance under the Competition Act**

Maximum resale price maintenance is not expressly prohibited, nor are such arrangements *per se* unlawful under the Competition Act. There are no decisions by the Tribunal dealing specifically with maximum resale price maintenance between parties in a vertical relationship.

Agreements between a supplier or manufacturer and a reseller or distributor in terms of which a maximum resale price is established, falls to be considered under section 5(1) of the Competition Act in the ordinary course, so that maximum resale price maintenance arrangements are subject to a “rule of reason” analysis. Section 5(1) of the Competition Act provides:

> “An agreement between parties in a vertical relationship is prohibited if it has the effect of substantially preventing or lessening competition in a market, unless a party to the agreement can prove that any technological, efficiency or other pro-competitive, gain resulting from that agreement outweighs that effect.”

Agreements in terms of which maximum resale prices are established may have the effect of lessening competition in certain situations. For instance, the EC Guidelines recognize that a maximum resale price may become a focal point for distributors or resellers, so that they gravitate towards the maximum resale price rather than responding to market conditions when determining resale prices. With a network of suppliers or distributors, the maximum resale price might be followed by all distributors, resulting in uniformity of prices across the distribution network, especially when a maximum price is coupled with a recommended resale price. The effect of a fixed maximum price on competition in a market, however, will depend on the product

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35 Ibid.

concerned and the dynamics of the market in which the product is offered.

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