MEANING OF VERTICAL AGREEMENTS/ RESTRAINTS:

An agreement between the parties with any intention and effect on market is subjected to debate. Agreements between two firms at the same level of production are often anti-competitive for a mere reason (most of the times) that their products are substitutes i.e. satisfaction derived from either of the products is same. Vertical agreements are subject to "rule of reason" unlike the case in horizontal agreements where appreciable adverse effect on competition is presumed. Vertical integration, may include activities such as wholesale functions, the development of private label products, and brand advertising. Firms will generally desire to restrict competition to raise profits while in contrast society may prefer more intense competition. Vertical Agreements dealt under section 3(4) of the Act[1]

Vertical agreements are those between undertakings operating at different levels of the production chain. In case of most goods or services, there is a chain of production before the product reaches the customer - from gathering of the raw material to processing and creating the final product, distributing and selling of the product etc. Therefore, vertical agreements are an essential feature of commercial life, and in one sense a substitute for vertical integration. Vertical restraints exert mixed effects on the competitive process and have to be judged on the basis of the reasonableness of the restraint. The regulation of vertical agreements by competition law has evoked much controversy.

Unlike horizontal agreements, vertical agreements do not involve a combination of market power. On the other hand, vertical agreements affect competition in the market only when the firm imposing a vertical restraint already has market power. In such cases, competition from other firms' products (inter brand competition) is limited, hence it is desirable that there is enough competition between distributors and retailers of the products of the firm which has market power. Conversely, if the firm exercising the vertical restraint does not have sufficient market power, or in other words, if there is sufficient inter-brand competition, then the restriction on competition between the distributors and retailers of the same brand (intra brand competition) may not have any effect on the market.

Under section 3(4) of the Act, it would be anti-competitive only if the agreement providing for this practice causes or is likely to cause an appreciable adverse effect on competition in India. In other words, the restraint is to be evaluated under the rule of reason.

General Exceptions for certain kind of agreements containing Vertical Restraints[2]

Under the Act, there are certain exceptions to the general prohibition against anti-competitive agreements, namely:

a) Exception for the protection of certain IPRs:

The Act does not permit any unreasonable condition forming a part of protection or exploitation of IPR. According to the section 3(5) nothing in the Section 3 shall restrict the right of any person to restrain any infringement of, or to

[1] Article published in NUJS Law Review authored by Assistant Professor, TillottamaRaychaudhari available at "***http://www.nujslawreview.org/pdf/articles/2011_4/tilottama-raychaudhuri.pdf"***

[2] Article published by J. Sagar and Associates on "Vertical Agreements" authored by Amit Kapur, FarhadSorabjee and Amitabh Kumar available at ***"http://www.jsalaw.com/Admin/uplodedfiles/PublicationFiles/VA2012%20India.pdf***"

impose reasonable conditions, as may be necessary for protecting any of his rights which have been or may be conferred upon him by IP laws. In other words, licensing arrangements likely to affect adversely the prices, quantities, quality or varieties of goods and services will fall within the contours of competition law as long as they are not in reasonable juxtaposition with the bundle of rights that go with IPRs. Therefore the reasonability of the conditions in agreements involving IPRs has to be there to avail the exception under Section 3 (5) of Act or otherwise CCI may be called upon to take note of anti-competitive agreement under Section 19 of the Act and it may pass order of divesture of intellectual property or compulsory licensing under the provisions of the Act.

A person has a right to impose reasonable restriction as may be necessary to protect any of his rights conferred by the following statutes:

- The Copyright Act 1957;
- The Patents Act 1970;
- The Trade and Merchandise Marks Act 1958;
- The Geographic Indications of Goods (Registration and -Protection) Act 1999;
- The Designs Act 2000; and
- The Semi-Conductor Integrated Circuits Layout-Design Act 2000.

Reasonable restrictions imposed to safeguard IPRs conferred by six Indian laws are outside the purview of the agreement clauses in the law.

b) Exception to agreements related to export:

Many countries exempt anti-competitive agreements relating to exports from the operation of law; this is presumably on the ground that such anti-competitive agreements harm only overseas consumers and are therefore of no concern to the national authorities Section 3(5)(ii) exempts the right of any person to export goods from India up to the extent to which the agreement relates exclusively to the production, supply, distribution or control of goods or provision of services for such export. It means export agreement relating only to the production, supply, distribution or control of goods or provision of services is exempted. In other words, export cartels are outside the purview of competition law. In most jurisdictions, export cartels are exempted from the application of competition law. A justification for this exemption is that most countries do not desire any shackles on their export effort in the interest of balance of trade and/or balance of payments.

c) Exemption for joint ventures[3]:

Proviso attached to section 3 (4) exempts any agreement entered into by way of joint ventures if such agreement increases efficiency in production, supply, distribution, storage, acquisition or control of goods or provision of services. The term joint venture has not been defined in the Act. In general terms it means the cooperation of two or more individuals or businesses in which each agrees to share profit, loss and control in a specific enterprise. A joint venture can also be defined as an association of firms or individuals formed to undertake a specific business project. It is similar to a partnership, but limited to a specific project (such as producing a specific product or doing research in a specific area).

In addition, the central government has been empowered under section 54 of the Act to exempt from the application of the Act:

- any class of enterprise if such exemption is necessary in the interest of security of the state or public interest;
- any practice or agreement arising out of and in accordance with any obligation assumed by India under any treaty, agreement or convention with any other country or countries; and
- any enterprise which performs a sovereign function on behalf of the central government or a state government; such exemption may be granted only in respect of activity relating to the sovereign function.

The Indian Law on vertical restraints suffers from several drawbacks[4]

a) Firstly, in India, there are no separate rules governing any specific category of vertical agreement and all of them are required to be tested for adverse effects under section 19(3) of the Act. All vertical agreements cannot be evaluated by the same standard. For example, in US, in case of agreements like resale price maintenance proving benefits could be more difficult than proving detriments. So, if we do not lay down standards for evaluating different kinds of vertical agreements and decide to generally follow the *rule of reason* approach of the US, then the CCI would face problems similar to those being faced by the US courts, i.e., a coherent application of the rule of reason to different kinds of vertical agreements.

b) Secondly, the Act also is similar to the European Commission **("EC")** law in the sense that it lays down criteria which are to be taken into account for testing adverse effects. This adverse effects test, however, is an incomplete adaptation of Art. 81(3) of the EC. The EC laws impose certain compulsory conditions for exempting vertical agreements - they require that the agreement allow consumers to share in the benefits, does not impose

[3] Research article published by CCI, submitted by Pratima Singh Parihar on " Anti-competitive Agreements -Underlying concepts & Principles under the Competition Act, 2002" available at: "***http://cci.gov.in/images/media/ResearchReports/Pratima31jan2012.pdf***"
[4] Article published in NUJS Law Review authored by Assistant Professor, TillottamaRaychaudhari available at "***http://www.nujslawreview.org/pdf/articles/2011_4/tilottama-raychaudhuri.pdf"***

restrictions that are unnecessary to attaining the efficiency objective, and does not substantially eliminate competition. All of these conditions are mandatory, whereas those in the Act are merely permissive. This is dangerous and could create considerable complications in future, when cases come up before the CCI.

c) Thirdly, we do not have exemptions given to vertical agreements on the basis of threshold levels (like the *de minimis* exemption, or block exemptions given in the EC) and all vertical agreements are to be tested on the basis of 'adverse effects' on competition. This would create unnecessary burden on the competition authority.

d) Further, any effects based test at the outset, would face the problem of precise market definition. Market definition by itself and subsequent testing for adverse effects is no easy task and requires complicated economic analysis. To add to the irony, the term 'relevant market' finds no place in section 3 of the Act. Thus, the adjudication of vertical agreements by the Commission becomes all the more sticky due to the flawed understanding of concepts like relevant market and analysis of appreciable adverse effects on Competition during investigation.

In the case of ***Neeraj Malhotra vs. Deustche Post Bank Home Finance &Ors*[5].**, CCI has dealt with the issue of prepayment penalties levied by banks and Non-Banking Finance Companies **("NBFCs")** on housing loans and has held that the charging of prepayment penalties by banks, NBFCs and housing finance companies is not in violation of the Act. It was alleged that several leading banks and NBFCs were following a practice and taking decisions in concert to levy a penalty on borrowers, ranging between 1 per cent and 4 per cent of the outstanding principal amount if borrowers wished to prepay or foreclose their home loans. This penalty discouraged borrowers from switching over their loans to other lenders who were offering loans at a cheaper rate of interest and increased the effective rate of interest payable by the borrowers. It was alleged that such a practice caused an appreciable adverse effect on competition in India. It was also alleged that lenders providing home loans were abusing their dominant position within the public domain by imposing unfair and discriminatory conditions while providing loans.

The principal issues before the CCI included the interesting point of whether some discussions between members of the Indian Banking Association **("IBA")** were sufficient to constitute an 'agreement' for the purposes of Competition law.

> *"For an agreement to exist there has to be an act in the nature of an arrangement, understanding or action in concert including existence of an identifiable practice or decision taken by an association of enterprises or persons. In this case, the allegation by the Informant is that the act of charging prepayment interest/penalty is such an act. Furthermore, for an agreement, it is essential to have more than one party… An agreement is a conscious and congruous act that has to be associated to a point in time. It is apparent from a plain reading of the contents reproduced above that the meeting of the IBA was actually to discuss the growing practices of corporate borrowers who would avail of committed lines of credit by banks for working capital but would first look at other market options such as CPs, bonds etc. for funding and use line of credit only as a fallback. This put adverse pressure on asset-liability management by banks. It was only in the context of those discussions that some banks raised the issue of prepayment on housing loans also. The discussion on the subject was consequential and not initial. Even then, it*

[5] CCI Case No. 5 of 2009 decided on 2nd December 2010

> *merely resulted in a clear decision that it "should be left to the banks to decide. The lack of imperative voice and intent is evident from the language and content of the said circular of IBA. It would be patently unjust to use it as an evidence of either action in concert or process of combined decision making by banks. This rules out any element of contravention of sub section (1) of section 3."*

CCI did not find any 'agreement' among such lenders to charge prepayment penalties. Furthermore, in light of economic evidence produced by the home loan providers showing that in fact the home loan market had registered growth during the period when collusion was alleged, such prepayment penalties could not be held to cause an appreciable adverse effect on competition in India.

Two members of CCI i.e. Mr. P.N. Parashar and Mr. R. Prasad did not agree with this majority decision, and in two separate dissenting orders held that there were various violations of the Act by home loan lenders.

In case of ***Consumer Online Foundation v Tata Sky Limited &ors[6],*** the information had been filed by Consumer Online Foundation ('**the Informant'**) against Tata Sky Limited, Dish TV India Limited, Reliance Big TV Limited and Sun Direct TV Pvt. Limited ('**the Opposite Parties' or the "DTH service providers"**) under section 19 (1) (a) of the Act alleging, inter alia, contravention of the provisions of sections 3 and 4 of the Act. It was alleged that the Opposite Parties were restraining competition in the market by preventing interoperability between hardware and Direct to Home **("DTH")** signals provided by different manufacturers and DTH service providers. DTH service providers are not providing DTH services to consumers, unless they also purchase the hardware from them, which includes the Dish Antennae and the Set Top Box **('STB'**). Section 3(4) of the Act was not made applicable as it envisages *an agreement between enterprises or persons at different stages or levels of the production chain in different markets…* Internationally, these agreements reflect dynamics between manufacturers-retailers; manufacturers-distributers or distributers-retailers existing at different levels in the production and supply chain. It was held by CCI that:

> "*manufacturer / service provider and the consumer cannot ever be said to be part of any 'production chain' or even operating in 'different markets' because a consumer does not participate in production and at the same time, the market for any good or service must include the producer and the consumer. There cannot be any market that only has the producer or the consumer. Therefore, both are, by definition, part of the same relevant market. Any 'agreement' between the producer / service provider and consumer occurs after inter-brand or intra-brand competition has already played out and therefore such agreements with the end consumers do not have any competition aspect. Economic theory supports the view that if any such restraint is imposed by a manufacturer / service provider on the end consumer, it would be resolved over time since the consumers would start shifting to competitors who do not impose such restricting conditions".*

Therefore, after going through the material placed before it and also the facts and circumstances of the case, CCI dismissed the information as no violation of section 3 of the Act was made out.

[6] CCI Case No. 2 of 2009 decided on March 2011

Thus, every party in production chain specialises in its assignment in the chain. One player cannot perform the role of input supplier, producer and distributor and even if it does and can, then there is a probability that it will exploit returns to scale and factor in all areas. Co-ordination between producers and distributors formalized through vertical agreements can help firms to increase their profits and under certain circumstances, those efficiency gains may or may not be passed on to consumers. This exercise might require a commitment in terms of say time, quality of service, exclusivity etc. to minimise for example transportation cost, administration cost or to establish goodwill.

Given such a background there is scope for vertical agreements to help obtain more efficient outcomes not only for producers and distributors but also for consumers and efficiency. Vertical integration, may include activities such as wholesale functions, the development of private label products, and brand advertising. Firms will generally desire to restrict competition to raise profits while in contrast society may prefer more intense competition. The problem for the policy-maker lies in determining the net effect of prohibiting a restraint, given that (at the very least, due to fixed costs) imperfect competition may still remain.