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EU Vertical Restraints In Focus And Perspective

Law360, New York (May 13, 2010) -- For many years, European Union competition counsel have been advising on distribution systems, based on a wide range of quite complex rules. We used to have specific rules and regulations by category of agreement for exclusive distribution, exclusive purchasing (including beer "tied houses" and petrol stations), selective distribution, franchising and motor vehicle supply.

Much turned on the particular drafting of clauses, rather than market effect. The main concern appeared to be restrictions on parallel imports, which led to a variety of cases with what were then considered significant fines by the European Commission. For example, in 1992, ECU 5 million on Dunlop Slazenger (reduced later on appeal to ECU 3 million). (The ECU was the predecessor to the Euro.)

However, much time was spent on making contractual wording fit the stencils of the specific rules, laid out in so-called block exemption regulations by type of agreement. Resale price maintenance was also a concern, but more likely to be enforced by national competition authorities in Europe.

Then in 1999 and 2003, there were two major modernizing steps in EU competition enforcement:

First, in 1999, after much debate, the European Commission adopted a general vertical restraints block exemption, which gave a form of safe harbor to vertical restraints in general, provided that the supplier had less than 30 percent market share and that the agreement contained no severe restrictions of competition, called "hard-core" restraints. Above that ceiling, and in general, the Commission shifted to a more economic approach, focusing on market power and assessing the perceived pros and cons of restrictions other than the "hard-core" restraints.

All of this was explained at length in detailed EU Vertical Guidelines, running to more than 40 pages in the EU Official Journal. Somewhat long for quick advice, if the parties found themselves outside the block exemption, but still a huge improvement in enforcement approach.

Then in 2003, in a seismic change to EU competition enforcement, the Commission abolished the previous notification system for restrictive agreements (under which "exemption" from the general prohibition could only be granted by the Commission). Enforcement was decentralized so that all EU member state competition authorities and EU national courts could fully apply the EU competition rules, including that part of the basic prohibition requiring a weighing of the pros and cons of a restriction to see if the restriction is overall caught by the prohibition.

Why was that so seismic? Mainly because advice then had to be measured more broadly to the standard of what "a competition authority or judge, following the general rules, can reasonably be expected to say" ... (not just the European Commission). Also because the European Commission and EU national competition authorities started to build the "European Competition Network" ("ECN"), cooperating and working together on common themes of

enforcement on specific topics, a change in approach which we see strongly now. Importantly also, in the process, there appears to have been a shift to looking more at whether restrictions are appreciable in the first place, rather than caught by the basic prohibition and capable of clearance by virtue of compensatory advantages for consumers.

So where are we now and why this long overview? The answer is that this explains much about the broader perspective of EU vertical restraints enforcement in Europe now.

Notably, on April 20 the European Commission adopted revised versions of its 1999 general block exemption and EU Vertical Guidelines, designed to modernize them again and set the framework for more than a decade to come. They come into force in June 2010, with a one-year transitional phase, and apply until May 2022.

However, we are also seeing much focus on vertical issues in ECN competition enforcement recently, which is also important.

To take the new European Commission rules first: Unsurprisingly, given the tremendous depth of the 1999 documents, there are not a lot of changes. The main ones focus on Internet sales, as the EU competition authorities grapple with online selling, trying to find solutions to facilitate such trade (viewed as promoting an integrated EU "internal market"), while preserving manufacturers' rights to determine their sales formats and compensate physical store suppliers for the services they provide. Much is controversial, as the online sellers have struggled with the luxury goods suppliers over what should be allowed or not.

For example, the Commission has elaborated complex rules on what restrictions can be placed on retailers/distributors in regard to online advertising. Notably, where such advertising is specifically designed to reach customers in a certain territory or a certain customer group, that is considered to be a form of active selling to those customers. In line with the current rules, promotion on or use of the Internet may be restricted, where that would lead to active selling into other distributors' exclusive territories or customer groups.

On the other hand, the Commission maintains its view that general advertising, including online, which could reach customers in other territories, but which is a reasonable way of reaching customers inside a territory is not active selling (in EU terms, it is called "passive" selling, because the idea is that the customer seeks the supplier, not the other way around). Suppliers must allow this type of advertising.

Moreover, controversially the Commission suggests that, "on their own" the language options used in a website are considered passive sales. For example, using English on a website in France may not be considered active selling outside France. More generally, "having a we site" is considered a form of passive selling.

In the revised EU Vertical Guidelines, the Commission has developed its views as to what amounts to a "hard-core" restriction in the Internet context. So, requiring distributors to reroute customers from another territory who accesses their sites, or to terminate transactions in the event of credit card details showing foreign addresses are "hard-core" restrictions.

Limiting the proportion of overall sales made by a distributor on the Internet is also a "hard-core" restriction (although a distributor can be required to sell a certain amount of products offline to ensure an efficient operation of its physical "bricks and mortar" shop). Requiring a distributor to pay a higher price for products intended to be resold by the distributor online, than for products intended to be sold offline is also a "hard-core" restriction (although a fixed fee buyer support for offline or online sales efforts would be accepted).

The Commission also states that distributors can be required to have a physical "bricks and mortar" shop as a condition for becoming members of a selective distribution system and they may be restricted in the use of third-party platforms that fail to meet the supplier's standards and conditions.

The Commission also confirms that suppliers can require quality standards for the use of an Internet site to sell their products, which may be different online to offline, but should "pursue the same objectives and achieve comparable results."

No doubt there will be much further discussion (and controversy) as to what this all means in practice. The point to note now is that distribution systems will likely have to be reviewed and perhaps rethought given these rules, both for compliance reasons and to best achieve desired strategies.

There is also a narrowing of the scope of the general block exemption, with the addition of an additional 30 percent ceiling for the buyer's share in the purchasing market where the buyer participates. So, the general block exemption only applies if both the supplier's market share on its sales market and the retailer/distributor's market share on its purchasing market is below 30 percent. (This is also controversial because of the practical difficulties of assessing such market shares.)

There are also new sections on upfront access payments, often called "slotting allowances" in the United States (payments for first listing of products on shelves); and category management (agreements where a supplier advises a retailer on how best to organize a product category on its shelves), reflecting perceived concerns about such issues, thus far mainly at national enforcement level.

Turning to ECN competition enforcement, there are many other important things going on.

For example, a number of national competition authorities have been looking at "hub and spoke" (or "A-B-C") cartel cases, where retailer A is accused of using supplier B to coordinate prices with retailer C. The leading cases involve the supply of toys and replica sports clothing in the U.K., but other cases are understood to be running in several EU member states at the moment.

While strictly not "vertical" cases, clearly there are vertical aspects, as suppliers are implicated in relation to their customers' prices. In other cases, national competition authorities have been focusing on resale price maintenance, with the German Competition Authority taking a controversially broad view of what amounts to unlawful supplier pressure on retailers to follow price recommendations. After two recent decisions, one on contact lenses, the other on hearing aids, the German Competition Authority has now issued a special "guidance letter" on the topic.

The general position on resale price maintenance in Europe continues to be that in most cases it is unlawful ("hard-core"), although usefully the European Commission has acknowledged exceptions in the EU Vertical Guidelines — e.g. when the retail price maintenance is part of a new product launch or in connection with a short-term low price campaign.

This also should be understood against a backcloth of major concern about inflation in recent years, which has resulted in intensive action by the ECN on retail issues whether for food, petrol or other supplies. The European Commission also has a special "Task Force on the Food Supply chain."

These are key issues to watch, because this is important enforcement, as much as the new Internet issues.

Finally, it is important to recall the main concern at EU level, blocking parallel imports. This continues to be a "hard-core" restriction and a restriction "by object," meaning that an anti-competitive effect does not have to be

proven to find the infringement. Such infringements may be found, even if the underlying causes for the price differentials between EU member states are state -riven (e.g. different tax levels, as often in the case of cars; or differences in public health reimbursement schemes, as in the case of pharma pricing, recently confirmed in an EU law case involving GlaxoSmithKline in Greece).

There have not been many cases on parallel imports recently, but where such cases are brought, the penalties are severe (and, on more recent EU Fining Guidelines, potentially much higher than in the Dunlop Slazenger case).

For example, in 2002, Nintendo was fined €149 million (last year reduced to €119 million on appeal), in part because it was held to have a special responsibility to ensure compliance in its distribution system. Several of its distributors were also fined. This included a fine of €4.5 million on Itochu, for its Greek subsidiary's very small activity, because in setting the fine, the Commission takes into account overall group size. In 2005, Peugeot was also fined €49.5 million (reduced later to €44.5 million on appeal) for bonuses and other practices found to have blocked exports of cars from the Netherlands to other EU member states.

The conclusion is that EU vertical restraints remain an important and evolving focus of EU competition enforcement. Company and practitioner focus should take into account recent changes, especially in regard to the Internet. However, in overall perspective, it is as important to watch the basics on EU parallel imports rules and recent ECN activism on resale price maintenance and the hub and spoke cartels at retail level.

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