The Internet and EU antitrust rules on distribution practices: New Commission rules on Vertical Restraints attempt to strike a balance

2010-04-26

On 20 April 2010, the European Commission published the revised Block Exemption Regulation (the "BER") and Guidelines on Vertical Restraints ("Guidelines"). They replace the current rules as from 1 June 2010. Distribution agreements in force on 31 May 2010 that do not satisfy the new rules will still be covered by the old rules until they expire on 31 May 2011. The new Block Exemption Regulation will be valid until 2022.

The long awaited revisions have been issued after a large-scale consultation process that generated sizeable lobbying efforts until the last minute, notably in respect of the rules that should apply to online distribution.

Like the old rules, the new BER and the Guidelines aim to reduce the regulatory burden for companies without market power, in particular for small and medium enterprises ("SMEs"). The BER provides a safe harbor, ensuring that restrictions in distribution agreements falling within the BER's coverage will not be found to infringe the EU competition law prohibition on restrictive agreements (now Article 101 of the Treaty on the Functioning of the European Union, "TFEU") and thus be unenforceable. The Guidelines go further, setting out the European Commission's framework for assessing vertical restraints under Article 101 TFEU, even where they do not fall squarely within the safe harbor provided by the BER. Neither the BER nor the Guidelines directly address the compatibility of vertical restraints imposed by dominant firms with Article 102 TFEU, the EU's prohibition on abusive conduct by firms in a dominant market position.

In revising the BER and Guidelines, the Commission wanted to take into account what it saw as the two major developments since entry into force of the existing rules in 1999: First, the recognition that buyer power in the context of vertical agreements can lead to consumer harm in certain circumstances; and second, the now widespread use of the internet as a modern distribution channel. In addition, the Guidelines contain new sections on upfront payments for access to a distribution system and category management.

Most of the other changes to the existing rules are evolutionary. These include the definition of a "vertical agreement" and what a "hardcore" restriction means in terms of enforcement of Article 101 TFEU. They also include more specific issues such as the definition of an agency agreement (generally not caught by Article 101(1) TFEU) and the criteria for assessing restrictions having effects similar to resale price maintenance (a prohibited "hardcore" restriction and currently a prominent issue in competition law enforcement in Europe).

- *Purchasing markets*. The BER is now available only where both the supplier and the buyer have market shares of 30% or less on their respective markets, where previously only the supplier's market share mattered for most restraints. This is likely to make it more difficult for a supplier to assess whether its distribution agreements can benefit from the BER, since the supplier may not have adequate information about the purchasing market of its customer (e.g., where it differs in geographic scope from the sales market) or it may simply be difficult to define such a purchasing market with adequate precision.

- *Internet sales regulation*. The new rules appear to aim at ensuring that suppliers will have to accept some form of internet sales by their distributors. At the same time, they accept that suppliers can regulate internet sales in detail, to address any free rider issues. The traditional distinction between "passive" and "active" sales sets the limits of supplier regulation of internet sales.

  Passive internet sales. "Passive" sales cover all forms of unsolicited supply to customers not actually targeted by the seller. With very limited exceptions (e.g., expansion of a distribution system into a new territory), the BER provides that a supplier cannot prohibit passive sales. Notably, the Guidelines clarify that operation of an online store by an authorized distributor in different language versions, as well as general advertising to attract online customers that is not targeted at specific customer groups or specific territories allocated to others, is considered a form of "passive" sales. Illegal "hardcore" resale restrictions aimed at preventing online sales include:

  (i) a block on website access for customers from another exclusive territory, or automatic redirection of those customers to other websites;

  (ii) termination of transactions with credit cards not issued in the distributor's territory;

  (iii) a limit on the proportion of overall sales made through the internet by a distributor (but suppliers can require a fixed minimum amount of product to be sold in the distributor's physical "brick and mortar" shop); and

  (iv) payment of a higher price by the distributor for products sold online (but a fixed fee can be agreed to support the services offered by brick and mortar shops).

Minimum brick and mortar sales. By requiring a minimum amount of product to be sold in a brick and mortar shop, it appears that suppliers may be able to prevent internet-only distribution, although they cannot limit internet sales by a distributor that operates a physical shop.

Quality standards. The Guidelines further clarify that suppliers can impose quality standards on a distributor's online shop. This includes rules specifying the appearance of the distributor's website that prevent visits to that site through a branded third party platform. The Commission notes that this is similar to the rules that can be imposed on the appearance of physical shops in a selective distribution system, for example by luxury product suppliers.

Active internet sales. The Guidelines state that targeted online advertising – such as banner ads directed at a specific territory, or paid search or other online ads displayed specifically to users in a particular territory – constitutes "active" selling into that territory.

- In an exclusive distribution system, suppliers can prohibit distributors from actively selling outside their territory or allocated customer group. In the rapidly developing world of online advertising, it will be interesting to see how this evolves. Notably, disputes may be expected about where the line between active and passive sales should be drawn based on how online ads are served.

- In a selective distribution system, suppliers cannot restrict either active or passive sales to end users by distributors operating at a retail level of trade. Thus, online retailers cannot be prohibited from placing targeted search or other online ads.

Quantity restrictions. However, suppliers can restrict sales between levels of trade in a selective distribution system (e.g., requiring authorized wholesalers to sell only to authorized retailers) and restrict sales to unauthorized distributors that are not part of the system. Interestingly, the Guidelines state that this can be done by prohibiting more than a given quantity of sales to an individual end user, a requirement that may be stricter for online sales than for brick and mortar sales if it is easier in practice for unauthorized distributors to buy online.

Other criteria for online sales. More generally, the Guidelines state that the criteria which suppliers may impose for online sales by selected distributors must "pursue the same objectives and achieve comparable results" as the criteria imposed on brick and mortar sales, while taking into account the different nature of online and physical retailing. This is another area where disputes as to what is allowed may be expected.

Upfront access payments. Upfront access payments are fixed fees that distributors require suppliers to pay for access to their distribution networks. The Commission states that they benefit from the automatic BER safe harbor when the market share thresholds are not exceeded. The Guidelines discuss the criteria that will be applied to assess the competitive impact of these practices where the BER does not apply.

The Guidelines state that the use of such upfront access payments may contribute to better allocation of shelf-space for new products, taking into account that suppliers have more information on such products. However, the Commission notes that such payments may result in anticompetitive foreclosure. This is particularly the case where the buyer can require access payments that are so large that they induce the supplier to channel all or most of its products through it (or through only a limited number of large distributors) in order to amortize the cost of the fee.

Up to now such issues have been addressed in EU Member State investigations (e.g. in the UK). With this new section in the Guidelines, the Commission is putting companies on notice that such payments are also an EU issue.

- *Category management*. Like upfront access payments, the new Guidelines also address category management for the first time. These are agreements through which the distributor entrusts a supplier (the so-called "category captain") with advising the distributor on the marketing of a category of products, including in general not only the supplier's products, but also the products of its competitors.

  The Commission states that, in most cases, such agreements will not be problematic. However, the Commission sees the main risk associated with category management as anticompetitive foreclosure of products of other suppliers competing directly with the category captain. Another risk is that category management may facilitate collusion between suppliers by offering increased opportunities to exchange sensitive information through retailers. Risks of collusion are also present where the distributor sells private labels, i.e., its own branded products that compete with those of the category captain.

  At the same time, the Guidelines acknowledge that category management can bring about efficiencies, notably by allowing distributors to better anticipate demand and tailor their promotions accordingly.

  The Commission states that such agreements are covered by the BER where the supplier's and buyer's shares in their respective markets are under 30%. However, since category management is often provided by market leaders, it will often fall outside the BER and require careful individual assessment. Again, with this new section in the Guidelines, the Commission puts companies on notice that these agreements, although often only local or national in scope, may raise EU issues.

In contrast to the attempt to set out detailed rules for assessing restrictions on internet sales, the

Guidelines only list a limited number of considerations for the competitive assessment of upfront access payments and category management.

For all scenarios, however, the Guidelines attempt to strike a balance between the (sometimes conflicting) interests of branded-goods suppliers, online resellers and super- and hypermarket chains. This results in a complex set of assessment criteria that will require careful application and analysis on a case-by-case basis for vertical agreements (the Guidelines are 65 pages long). This may lead to more economically sound decisions, but comes at the price of limited legal certainty and less ability to provide quick advice on many of the issues.

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