Report from Europe

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EUROPEAN COMMISSION REVISES TEN-YEAR OLD FRAMEWORK FOR ASSESSING VERTICAL RESTRAINTS

On 1 June 2010, the revised framework for the assessment of agreements between suppliers and distributors (vertical agreements) under the European Union's (EU) competition rules entered into force. The revised framework brought about some significant changes, as well as a number of important and long-awaited clarifications to the pre-existing rules. In particular, the European Commission (Commission) introduced a new threshold for the application of the *Vertical Block Exemption Regulation* (VBER) to vertical agreements and clarified which restrictions of online selling are capable of infringing EU competition law. Overall, the new framework takes a further step towards a system of effect based assessment of restrictions on competition in vertical agreements.

BACKGROUND

At the core of the EU competition rules is Art 101(1) of the *Treaty on the Functioning of the European Union* (TFEU) (formerly Art 81 of the EC Treaty) which prohibits agreements between undertakings that may affect trade between Member States and have as their object or effect the prevention, restriction or distortion of competition within the common market. Article 101(3) provides for certain exceptions to the general rule.[1]

The Commission has clarified the applicability of Art 101 of the TFEU to vertical agreements, that is, agreements between suppliers and distributors, in the legally binding VBER and in non-binding guidelines (Vertical Guidelines).

The VBER declares Art 101(1) inapplicable to vertical agreements where the parties involved do not exceed certain market share thresholds and the agreement does not contain so-called "hardcore restrictions".

Hardcore restrictions are most importantly (1) restrictions imposed by the seller upon the buyer's ability to determine its resale prices, referred to as "resale price maintenance" (RPM), (2) restrictions imposed by the seller upon the territory or customer group to which the buyer is allowed to resell the goods or services; (3) certain restrictions relating to selective distribution systems; and (4) restrictions imposed on manufacturers of spare parts for incorporation into final products.[2] The presence of hardcore restrictions excludes the whole vertical agreement from the scope of the VBER.

Agreements outside the scope of the VBER are not illegal per se but need to be assessed individually under Art 101. The Vertical Guidelines provide further clarification in applying the VBER and assessing vertical agreements in general (including those outside the scope of the VBER).

The currently applicable versions of the VBER and Vertical Guidelines were adopted on 20 April 2010[3] and entered into effect as of 1 June 2010. The new framework has brought some important changes and clarifications to the pre-existing rules, especially in the area of online selling.[4] On the whole, however, the pre-June 2010 framework that had proved rather successful during its 10-year existence remains largely unchanged.

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[1] Article 101 is set out in Appendix A.

[2] The hardcore restrictions are listed under Art 4 of the VBER – see Appendix B.

[3] Commission Regulation (EU) 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, OJ 2010 L102/1. This Regulation replaces Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, OJ 1990 L336/21. The Guidelines on Vertical Restraints, OJ 2010 C130/1 replace the Guidelines on Vertical Restraints, OJ 2000 C291/1.

[4] See also Pick T and Beck J, "Report from Europe: Online Trade in EU – Recent Developments in the Area of Competition Law" (2010) 18 TPLJ 59.

WHAT HAS CHANGED UNDER THE NEW VBER AND GUIDELINES?

The new framework takes a further step towards a system of effect based assessment of restrictions on competition. In line with existing EU case law, the new Vertical Guidelines now clearly state that – while hardcore restrictions remain under a legal presumption to be illegal under Article 101(1) and non-justifiable under Article 101(3), companies may demonstrate (successfully) pro-competitive effects (efficiencies) under Art 101(3) in individual cases.[5] Most importantly, the Vertical Guidelines explicitly acknowledge such potential efficiency gains in relation to RPM.[6] Where such likely efficiencies are substantiated in an individual case, it is upon the Commission to effectively assess the likely negative impact on competition before making an ultimate assessment of whether or not the cumulative conditions contained in Art 101(3) have been met.

In line with the effect-based approach, the Commission also introduced a new buyer's market share threshold for the applicability of the new VBER.[7] Under the pre-June 2010 rules, the VBER was applicable to vertical agreements where the supplier's market share on the selling market did not exceed 30%.[8] Above this threshold agreements had to be individually assessed under Art 101(1) and (3). The new rules also require, in all cases, the buyer's market share on the procuring market not to exceed 30% for the VBER to be applicable to a vertical agreement. This shift stems from the Commission's observation that not only suppliers but also distributors may use their market power to put in place vertical restraints to the ultimate detriment of consumers.[9]

Furthermore, the revised Vertical Guidelines contain two new sections on the Commission's enforcement policy with regard to "upfront access payments" and "category management". Upfront access payments are fixed fees that suppliers pay to distributors in the framework of a vertical relationship in order to get access to their distribution network and remunerate services provided to the supplier by the retailer.[10] Category management agreements are distribution agreements whereby a distributor entrusts a supplier with the marketing of a category of products including, in general, not only the supplier's products, but also those of its competitors. Both measures may benefit from the VBER when the supplier's and the buyer's market shares do not exceed the 30% thresholds. The Vertical Guidelines provide further guidance for agreements between parties above these market share thresholds.[11]

Restriction of online sales

Probably the most important new provision is the additional clarifications on the seller's possibilities to restrict the buyer in reselling products and services over the internet. Online sales have significantly increased since the pre-June 2010 vertical framework was adopted in 1999 and have become an important tool of everyday business life.

There has been much debate among business entrepreneurs as to the possibility and under what conditions online sales can be restricted. In particular, producers of luxury and high-value goods regularly impose restrictions on distributors, for example, prohibiting the resale of their goods over online auctioning platforms. In reviewing such restrictions national courts and competition authorities

[5] Vertical Guidelines at [47].

[6] The Vertical Guidelines acknowledge (at [225]) that RPM can be useful to encourage pre-sale efforts, prevent free-riding, and promote market entry of a new product. In franchise (and similar) distribution systems, fixed resale prices may be necessary to organise a co-ordinated short term low price campaign (two to six weeks in most cases) which will also benefit the consumers.

[7] Article 3 of the VBER.

[8] Save for exclusive supply arrangements where this threshold applied to the buyer.

[9] On its face, the additional market share threshold could potentially reduce the scope of the VBER. However, it remains to be seen what the practical implications will be, that is, how many vertical agreements would be deprived of the VBER's safe harbour because the buyer holds a market share of 30% or higher with regard to the procurement of a given product or service.

[10] This practice comes under various forms and labels, such as slotting allowances, pay-to-stay fees, or various payments to have access to a distributor's promotion campaigns.

[11] Vertical Guidelines at [203]-[213].

have come to partially conflicting views.[12] During the public consultations prior to the adoption of the current framework, online sales was therefore one of the most debated topics of the reform. The new Vertical Guidelines, while not binding, attempt to bring further clarification ensuring a uniform application across all EU Member States.

As a general rule, every distributor must be allowed to use the internet to sell products. Some restrictions may, however, be permissible.[13] Key to determining whether a restriction of online sales is permissible or not is the distinction between active[14] and passive[15] sales and the kind of distribution system[16] that the distributor operates.

Under the Vertical Guidelines, active online sales are only those sales activities specifically targeting customers within a territory or customer groups that are (exclusively) allocated to another distributor.[17] Examples of this include sending unsolicited emails or advertising with territory-based banners on third-party websites. Apart from such exceptions, the European Commission treats internet sales generally as passive sales, which constitute a reasonable way to allow customers to reach a distributor. The most obvious example of a passive sale is where a customer's visit to a distributor's website leads to a sale. It also constitutes a passive sale if a customer opts to be kept (automatically) informed by a distributor of its current stock or offers and this consequently leads to a sale. The offering of different language options on a distributor's website does not change the passive character.

The Vertical Guidelines go on to list certain examples of prohibited and permitted restrictions on online sales.[18] Hardcore restrictions are prohibited and include, in particular:

- an agreement that a distributor shall prevent customers located in another territory from viewing its website or shall automatically re-route its customers to the supplier's or other distributors' websites;[19]
- an agreement that a distributor terminate consumers' transactions over the internet once their credit card data reveal an address that is not within the distributor's (exclusive) territory;
- an agreement that the distributor shall limit its proportion of overall sales made over the internet; and

[12] See also Pick and Beck, n 4 at 59.

[13] Vertical Guidelines at [52].

[14] According to the Vertical Guidelines, "active selling" means actively approaching individual customers inside another distributor's exclusive territory or exclusive customer group by, for instance, direct mail or visits; or actively approaching a specific customer group or customers in a specific territory allocated exclusively to another distributor through advertisement in media or other promotions specifically targeted at that customer group or targeted at customers in that territory; or establishing a warehouse or distribution outlet in another distributor's exclusive territory.

[15] "Passive selling" means responding to unsolicited requests from individual customers, including delivery of goods or services to such customers. General advertising or promotion in the media or on the internet that reaches customers in other distributors' exclusive territories or customer groups but which is a reasonable way to reach customers outside those territories or customer groups (for instance to reach customers in non-exclusive territories or in one's own territory), are considered passive sales.

[16] The VBER and the Vertical guidelines give specific consideration to two types of distribution systems. In an *exclusive* distribution system, the supplier agrees to only sell its goods to one distributor for distribution in a particular territory or to a particular customer group. Neither the supplier nor other distributors of the supplier inside the EU may then actively sell into the exclusive territory or to the customer group. Passive sales, including online sales, into an exclusive territory or customer group are, however, permitted and must not be restricted. *Selective* distribution systems are characterised by a supplier undertaking to sell the contract goods, either directly or indirectly, only to distributors selected on the basis of specific criteria and where these distributors undertake not to sell such goods to unauthorised distributors. All distributors that fulfil the selection criteria are (automatically) admitted to the distribution system. Selective distribution systems can be divided into qualitative and quantitative selective distribution systems. In qualitative selective distribution systems, the supplier selects distributors based on objective criteria according to the requirements of the specific product. If the supplier imposes additional conditions on distributors, the selective distribution system is classified as quantitative. Purely qualitative selective distribution systems fall outside the scope of Art 101(1) of the TFEU.

[17] Vertical Guidelines at [53].

[18] Vertical Guidelines at [52]-[57].

[19] Vertical Guidelines at [52(a)]. An agreement that the distributor's website shall also offer links to websites of other distributors and/or the supplier is, however, permissible.

- an agreement to impose higher prices for products which are intended to be resold online, compared to products which are intended to be resold offline.

There are also certain restrictions upon online sales that the Commission sees as compliant with Art 101 of the TFEU. A supplier can require its distributor to have one or more “bricks and mortar” shops or showrooms as a condition for becoming a member of its distribution system.[20] Suppliers can also oblige distributors to sell a certain absolute amount (in value or volume) of the products offline to ensure an efficient operation of the bricks and mortar shop, or pay a distributor a fixed fee to support the latter’s offline (or online) sales efforts.[21] Suppliers may also limit the use of third-party platforms by distributors with regard to contract products by making such use subject to the standards and conditions agreed between the supplier and the distributor for the latter’s use of the internet.[22]

A supplier can impose certain quality standards for online (and offline) sales and request a distributor’s activities to be consistent with its distribution model.[23] For instance, suppliers can request that distributors’ websites have a certain layout, offer a certain range of products and provide specific information and advice. The criteria imposed for online sales must not be identical to those imposed for offline sales, but should pursue the same objectives and achieve comparable results. Differences between the criteria must be justified by the different nature of these two distribution modes.[24]

In a selective distribution system, a supplier can restrict its distributors from selling to unauthorised dealers.[25] If the selective distribution system is operated at wholesale level, a supplier can also prohibit distributors from selling directly to end-customers.[26] Both restrictions apply equally to offline and online sales. Additionally, a supplier can restrict distributors to sell more than a given quantity of contract products to an individual end-user so as to prevent circumventive re-sales to unauthorised dealers. Such a requirement can be stricter for online sales if it is easier for an unauthorised dealer to obtain those products by using the internet.[27]

In order to ensure timely delivery of contract products, a supplier may impose a condition that the products are delivered instantly in the case of offline sales, whereas an identical requirement cannot be imposed for online sales; the supplier may specify certain practicable delivery times for such sales.[28]

OUTLOOK

The pre-June 2010 framework operated rather well throughout its 10-year existence. It is therefore not surprising that the new framework brings only limited changes. The Commission seems to have introduced changes, such as the buyer’s market share threshold and the clarifications of online sales restrictions, mainly in response to the economic developments over the last decade. One may be optimistic that the new framework will continue to provide useful guidance to business entrepreneurs when entering into vertical agreements. As far as restrictions of online sales are concerned, it would, however, be desirable that the courts and authorities of the Member States come to a more uniform application of the rules.

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[20] Vertical Guidelines at [54].

[21] Vertical Guidelines at [52(c)]-[52(d)].

[22] Vertical Guidelines at [54]. For example, where the distributor’s website is hosted by a third-party platform, the supplier may require that customers do not visit the distributor’s website through a site carrying the name or logo of the third-party platform.

[23] Vertical Guidelines at [54].

[24] Vertical Guidelines at [56].

[25] Article 4(b)(iii) of the VBER.

[26] This follows from the wording of Art 4(c) of the VBER, which explicitly refers to distributors at retail level only.

[27] Vertical Guidelines at [56].

[28] Vertical Guidelines at [56].

Appendix A: Article 101 of the TFEU

1. The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:
   (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
   (b) limit or control production, markets, technical development, or investment;
   (c) share markets or sources of supply;
   (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
   (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.
2. Any agreements or decisions prohibited pursuant to this article shall be automatically void.
3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:
   – any agreement or category of agreements between undertakings,
   – any decision or category of decisions by associations of undertakings,
   – any concerted practice or category of concerted practices,

   which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
   (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
   (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

Appendix B: Article 4 of the VBER – hardcore restrictions

The exemption provided for in Article 2 shall not apply to vertical agreements which, directly or indirectly, in isolation or in combination with other factors under the control of the parties, have as their object:

(a) the restriction of the buyer's ability to determine its sale price, without prejudice to the possibility of the supplier to impose a maximum sale price or recommend a sale price, provided that they do not amount to a fixed or minimum sale price as a result of pressure from, or incentives offered by, any of the parties;
(b) the restriction of the territory into which, or of the customers to whom, a buyer party to the agreement, without prejudice to a restriction on its place of establishment, may sell the contract goods or services, except:
   (i) the restriction of active sales into the exclusive territory or to an exclusive customer group reserved to the supplier or allocated by the supplier to another buyer, where such a restriction does not limit sales by the customers of the buyer,
   (ii) the restriction of sales to end users by a buyer operating at the wholesale level of trade,
   (iii) the restriction of sales by the members of a selective distribution system to unauthorised distributors within the territory reserved by the supplier to operate that system, and
   (iv) the restriction of the buyer's ability to sell components, supplied for the purposes of incorporation, to customers who would use them to manufacture the same type of goods as those produced by the supplier;
(c) the restriction of active or passive sales to end users by members of a selective distribution system operating at the retail level of trade, without prejudice to the possibility of prohibiting a member of the system from operating out of an unauthorised place of establishment;
(d) the restriction of cross-supplies between distributors within a selective distribution system, including between distributors operating at different level of trade;
(e) the restriction, agreed between a supplier of components and a buyer who incorporates those components, of the supplier's ability to sell the components as spare parts to end-users or to repairers or other service providers not entrusted by the buyer with the repair or servicing of its goods.