REVIEW OF THE VERTICAL BLOCK EXEMPTION REGULATION

COMMENTS OF THE IN-HOUSE COMPETITION LAWYERS' ASSOCIATION ('ICLA')

Introduction

1. The In-House Competition Lawyers' Association ("ICLA") (www.competitionlawyer.co.uk) is an informal association of in-house competition lawyers across Europe and in South East Asia. The Association meets quarterly to discuss matters of common interest to its members, as well as to share competition law knowledge. There are currently almost 350 members in 23 countries. The Association does not represent companies but is made up of individuals as experts in this area of the law. The paper represents the view of the members of the working group that was created to respond to the consultation.

2. Because of their role, in-house competition lawyers have a clear interest in a simple and straightforward competition law regime that prioritises certainty, minimises costs, and does not represent a disproportionate demand on businesses' time and resources.

3. The Commission Regulation (EU) No. 330/2010 of April 2010 on the application of the Treaty on the functioning of the European Union to categories of vertical agreements and concerted practices ('VBER') is due to expire on 31 May 2022. The European Commission is consulting on the Regulation and considering whether it should let it lapse, prolong its duration or revise it on the basis of the evidence gathered. We welcome the opportunity to provide comments to the Commission to assist it in its review.

4. We do not seek to respond to every question posed in the questionnaire; rather, we focus on a small number of points on which ICLA members' views and experience can assist the Commission the most.

Vertical Agreements in general

5. It is widely accepted that vertical agreements create fewer competition concerns than horizontal agreements. They are also a common and efficient way for companies to distribute their goods. Vertical agreements sometimes do contain some restrictions on the freedom of one or both of the parties, but these agreements could lead to efficiencies such as reducing transaction costs, promoting investments into research and development, helping solve economic problems such as double marginalisation, free-riding and inefficient pre-sale services.

6. The VBER, along with the Guidelines on Vertical Restraints ('Vertical Guidelines'), is a very valuable instrument for companies and its advisors. It should therefore be maintained. In general it has worked well. Although not perfect, the legal certainty it provides is crucial for companies and has provided some baseline comfort on the application of competition rules to vertical agreements. Clarity and certainty are of great benefit to business.

7. In our view, there are however some aspects of the VBER which would benefit from some flexibility or where some clarifications to reflect economic and market reality would be welcomed. We highlight those in this paper. But before we do so, we would like to make two general comments, one relating to the need to ensure consistency between National Competition Authorities ('NCAs') and the Commission and a second one on the impact the VBER might have outside the EU.

    a. <u>Consistency</u>

    Since Council Regulation No. 1/2003 was implemented, NCAs have been playing an increasing role in the application of EU competition law, including its application to vertical agreements. Many have observed that, since its entry into force, the majority of cases dealing with vertical agreements, especially in the online world, have been handled by NCAs rather than the Commission. While this development

is nothing more than what was possibly envisaged in Regulation 1/2003, we have concerns about some aspects of the investigations handled by NCAs.
We have noticed that many NCAs have taken a liberal approach in interpreting the VBER, or sometimes arguably even diverging from it. The same is true for the Vertical Guidelines. (although we acknowledge the difference in legal status between the VBER and the Vertical Guidelines). For businesses which have set up an EU wide distribution policy, different application of the rules by the Commission or NCAs can have quite a negative impact while also increasing costs and requiring large (and sometimes burdensome) investments in ensuring compliance with different and sometime diverging rules. In particular, in the online world, if there is divergence in how rules are applied across the EU, companies have no choice but to create different distribution systems to comply with those rules or, most likely, adopt the strictest standard to the whole of the EU. Neither of the two is desirable, as it would go against the spirit of the single market and prevent consumers to reap the benefits of a more efficient distribution system.

We would like the Commission to consider how consistency across the EU could be best realised as this will greatly help in achieving the single market quicker and better. In our view, there are three possible complementary options.

i. The first option is to strengthen the coordination at the ECN level.

ii. The second option is based on the concepts of coordination between Member States and the Commission within the framework of the Merger Regulation. If a company operates a distribution system in more than x number of Member States, and an NCA is conducting an investigation into the legality of some of its elements, there should be a role for the Commission and / or the other Member States in which that model operates to advise on the distribution issues that are subject of the investigation. A more radical option would be for the Commission to be exclusively competent. The purposes of such exercise would be to avoid a repetition of the very disjointed investigations of hotel platforms with different outcomes in different Members States, and to avoid a situation like the one in the recent Stihl case of the French Autorité de la Concurrence. As it is well known, Stihl had actively sought guidance from the German Federal Cartel Office and had also received positive feedback from the Swedish and Swiss NCAs for its clause requiring hand-delivery of tools such as chainsaws but was fined €7 millions for the same clause in France. Stihl now seemingly faces the question of how to proceed: a difference in its distribution policy between France and other Member States in itself is not a positive outcome. A lack of legal certainty in an area of law which carries heavy fines and serious reputational damage is not desirable.

iii. The Commission might also want to consider moving into the VBER itself some of the guidance currently in the Vertical Guidelines.

b. <u>Impact of VBER outside the EU.</u>

In the last few years, the number of competition authorities across the world has increased. The International Competition Network (ICN) currently has more than 130 members. Online vertical restrictions have been a topic for the ICN for some time. A very comprehensive document is the 'Online Vertical Restraints special project report', prepared and presented by the Australian Competition and Consumer Commission ('ACCC') at the ICN Annual conference in Sydney in 2015. Currently vertical restrictions in the online world are being discussed as part of the ICN Unilateral Conduct Working Group. These discussions show a large amount of convergence between competition authorities when assessing vertical restraints and the Commission has had and has a key role in educating younger competition authorities in the proper assessment of vertical restraints.

While some restrictions are generally recognized as harmful to competition, some of the rules in the VBER are specific to the EU and the objective to achieve a single market. One can only think of the issue of geo-blocking or active and passive sales which are not a competition issue in other jurisdictions. Some clarifications by the Commission in relation to the rationale for these rules in the VBER would be welcome to ensure these are not incorrectly "exported" to countries where there the creation of a single market is not an issue.

Resale Price Maintenance ('RPM')

8. RPM is treated differently in various jurisdictions across the world. While the EU considers RPM as a hardcore restriction, in the USA RPM restrictions are largely assessed on a rule

of reason basis. Economic literature has several examples of where RPM would lead to efficiencies. The Commission at the moment views RPM as a hardcore restriction of competition, with no realistic option for individual exemption. The 2014 Notice on agreements of minor importance[1] excludes its application to agreement containing an RPM clause as the Commission generally considers any restriction on a buyer's ability to determine its minimum sale price as restriction by object, even in cases where the companies involved have no market power whatsoever.

9. In our view, the Commission should consider relaxing the rules on RPM, recognizing more prominently that RPM may, under certain circumstances, bring pro-competitive efficiencies, some of which are mentioned below. This could be achieved by introducing clear de-minimis thresholds for cases where RPM is already exempted within the scope of the VBER (e.g., RPM during a strictly limited time immediately following the introduction into the market of a genuine innovation[2]), or by making RPM subject to a rule of reason analysis where the pro-competitive and anti-competitive effects of the practice are balanced in order to carry out the assessment. In theory one could exempt RPM under Art. 101(3) but this is very unlikely. A more flexible application in practice of this article might overcome some of the issues we mentioned above.

10. When reviewing potential RPM conduct, one should assess the effects on the market by weighing the possibly restrictive effects against the efficiencies RPM may bring. In addition to the advantages mentioned in the Vertical Guidelines, the following should be taken into account when performing such assessment:

    a. <u>Quality and Brand Recognition</u>

    Manufacturers that are concerned with maintaining a strong brand name and a reputation for quality or durability with end customers, might want to use minimum resale price contracts so that its products are not offered at a discount. When prices are discounted by wholesalers and retailers, the end customer may ultimately purchase the product at a price point that undermines the brand image perception that the manufacturer wants to project. This can ultimately create repercussions as consumers might associate lower prices with lesser quality.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.C_.2014.291.01.0001.01.ENG
[2] Paragraph 225 of the VBER

As an example, for certain (luxury or exclusive) products high prices are an essential element of the brand image. The target group for luxury or exclusive products consists precisely of customers who actually appreciate the high price and therefore the image that they portray.

In addition, the supplier may wish to protect the reputation or image of the product and prevent it from being used by retailers as a loss leader to attract customers.

Finally, suppliers may want to ensure that the distribution channel maintains a certain level of investment into the creation of a qualitative and specialized sales environment in order to bring certain products to the market. Distributors that are faced with low-price competition see their margins come under pressure, and might lead them to reduce investments, ultimately to the detriment of the customers who are no longer able to benefit from the professional sales and support environment that some products may require.

As it is well accepted, absent market power, if a company puts its prices up, it will hurt itself with lower sales.

b. <u>Prevention of free riding</u>

RPM may also be used to prevent free riding by retailers on the efforts of other competing retailers which spend time, money and efforts promoting and explaining the technical complexities or attributes of the product to create a sales environment to attract new customers, or to convey the image of the brand to consumers. For example, a retailer may choose to price its products at a higher price, but in return invest in a highly trained and skilled sales personnel that can properly explain and demonstrate to customers the use of a complex product such as computers or other high-tech equipment. The customer may after acquiring this information choose to buy the computer from a retailer that sells it at a lower price and does not explain or demonstrate its uses. This will cause the initial retailer to rethink its business strategy, ultimately lowering its prices and reducing the skill-level of its trained sales force – to the detriment of the customer. Similarly, one retailer may invest heavily into creating experiences for its consumers rather than purely focusing on sales. With the world at a consumer's finger tips on their smart phones, such retailers deserve protection against free riding.

11. One should not forget that manufacturers which would like to have more control about their final price could choose not to distribute products through independent distributors but rather to organize the distribution themselves, which ultimately means that no intra-brand competition whatsoever remains. One may argue that this outcome would be less beneficial to consumers than a rule of reason approach to RPM.

12. One of the members suggested that some clarification on maximum prices might be helpful in situations they encounter such in the so called 'fulfillment model'[3]:

    a. A manufacturer negotiates the conditions of a business transaction directly with an end-customer. In many cases the negotiation is initiated by the end-customer by way of a formalized private tender procedure or a request for quotation to several manufacturers;

    b. Due to objective economic reasons, an independent third party (distributor) becomes involved;

    c. The distributor buys the products from the manufacturer as an independent contractor and resells them to the end-customer in its own name and for its own account and therefore takes the full financial and commercial risk on the transaction. From a competition perspective, the distributor is an independent third party.

13. Currently these business transactions are arranged using maximum price agreements, that is the manufacturer agrees on a certain price for a product in direct negotiations with the end-customer. Afterwards the manufacturer enters into a maximum price agreement with a distributor containing an individual maximum price that the distributor may charge from the specific end-customer.

14. It would be helpful to clarify in the Vertical Guidelines that in such situations, the use of a maximum price agreement will not infringe competition law. The mere fact that a maximum price is set low (as it was negotiated in a tender scenario) and that the distributor will be

[3] This model describes the distribution of goods from a manufacturer to an end-0customer via an independent third party, a distributor.

unlikely to undercut it, should not lead to the result that it is not a valid maximum price agreement.

Hardcore restrictions

15. In our view, the list of hardcore restriction should not be expanded although, to the extent that the notion of blacklisted and hardcore restrictions has become confused, there is an opportunity to improve clarity in the distinction.

Online sale restrictions

16. In today's world, more and more consumers are shopping online. Online sales are also a perfect way for consumer to have access and buy products in other Member States.

17. While online sales arguably have a special role to play in the context of the European single market, and European competition law may be used as a tool to promote the single market, there are instances in which the current rules go beyond what is necessary.

18. If inter-brand competition is strong, any restriction of intra-brand competition is unlikely to harm competition and other suppliers are able to fill the "gap" that the supplier who chooses not to sell online leaves. This applies to restrictions of online sales even more than to resale price restrictions. Even against the background of the need to protect cross-border trade and promote the European single market, there should be no need for every product to be available online and able to be found on price comparison websites.

19. Para. 52 of the Vertical Guidelines ("*in principle, every distributor must be allowed to use the internet to sell products*") has been misinterpreted as a general rule that any restriction of online sales is prohibited. It is important to remember the context of para. 52: It provides additional guidance on Art. 4 b) (i), i.e., on cases where the supplier has allocated exclusive territories or customers to buyers and wants to protect these buyers from active sales into their allocated territory or to their allocated customer groups.

20. The restrictions which are imposed on European players and which are not imposed on players operating in other countries are having a negative impact on European businesses. It is not a coincidence that most of the online players in the world are not European but have been successful and expanded first in other jurisdictions. Given that

any violations are likely to result in considerable fines, compliance with the detailed EU rules on online sales restrictions is paramount for suppliers active in the EU. Substantial effort and resources are required to achieve a reasonable degree of legal certainty.

21. For example, the quality requirements for online sales on the retailer's own website, on platforms and perhaps also for promotions via price comparison websites in the context of selective distribution agreements must be closely scrutinized by companies and regularly updated to ensure compliance. When certain conditions (such as performance related bonuses or other incentives) are imposed to brick-and-mortar, hybrid and online retailers, expert legal advice must be obtained in order to avoid falling into "dual pricing" scenario. For example, what if a manufacturer wants to reward retailers for services that can by nature only be provided in a meaningful way in the brick-and-mortar shop and where no reasonably "equivalent" online service exists? This assessment has to be done for several EU countries because of divergent enforcement practices. Business people find it difficult sometime to understand the reason for these rules as well as the different application by NCAs. For example, one of our members mentioned the difficulties he encountered in explaining to his business colleagues why it usually is possible to refuse selling a particular product to a pure online player, but not allowed to prohibit a hybrid player from selling the same product online.

22. We welcome the statements by the Commission that platform bans are not a hardcore restriction and need to be assessed on a case-by-case basis. In our view, it would be important for the Commission to update the VBER to bring it in line with most recent case law in this regard.

Dual distribution systems

23. Nowadays suppliers increasingly sell directly to consumers either online or in brick and mortar shops and thus at retail level compete with their distributors. Being considered competitors has an impact on what suppliers can do or share with their distributors and on the application of the VBER. The VBER should continue to exempt dual distribution and the Vertical Guidelines should clarify that dual distribution is purely a vertical relationship and that collection of information that is relevant in the vertical relationship (e.g. retail sales data for better planning and logistics that ensures better availability of products to meet consumer demand and limits over production) should not give rise to horizontal concerns between the supplier and its distributors at retail level. It should be recognized that

competition between a supplier and a distributor is by definition of a different nature than competition between independent distributors as the suppliers owns the brand, designs the products and drives the brand image. This is possibly an area where further thoughts should be given to avoid creating unnecessary obstacles and compliance costs.

Selective distribution

24. The general principle is that each seller should be free to set up its distribution system in the way that suits it, as long as there are no harmful restrictions. Selective distribution is a perfectly legitimate way to distribute goods. The way rules on selective distribution have been applied in Europe, especially online, have been inconsistent and hampering legitimate business activities.

25. One of our members, an in-house competition lawyer at a supplier of consumer goods, notes that his company has a selective distribution network across the EU, based on largely identical agreements. When, in 2014 Adidas was investigated by the German Federal Cartel Office and agreed to remove the "platform ban" from its selective distribution agreements, that company decided that they should do the same – at least in Germany. Hundreds of agreements had to be changed. Since a uniform selective distribution system across different countries is highly desirable to create a level playing field for all partner retailers, the company then had to "export" these adaptations to other countries. Hundreds of agreements were subsequently adapted in countries other than Germany (even if it was not legally required), and external legal advice had to be sought to assess the risk if individual countries wanted to keep the "platform ban".

26. Today, our members take comfort in the Coty case and we believe that the "Coty" arguments apply to high-quality branded goods as well, and not only to luxury goods. As AG Wahl wrote in his opinion[4]: "*Selective distribution systems are, especially for goods with distinctive qualities, a vector for market penetration. Brands, and in particular luxury brands, derive their added value from a stable consumer perception of their high quality and their exclusivity in their presentation and their marketing. However, that stability cannot be guaranteed when it is not the same undertaking that distributes the goods.*" It would be helpful if the Commission can confirm this point in the revised VBER.

[4] Para 43: http://curia.europa.eu/juris/document/document.jsf?text=&docid=193231&doclang=EN

How a seller can reserve a customer group and benefit from VBER

27. Each seller should be free to set up its distribution system in the way that suits it – provided there are no harmful restrictions. Furthermore, any restriction on intra brand competition cannot be harmful to competition on the market if inter-brand competition is strong.

28. Under the current VBER, the exemption for the restriction of active sales only applies in very limited circumstances. The current VBER lets a manufacturer appoint an exclusive distributor, only by restricting the active supply to a territory that the manufacturer has reserved to itself or has exclusively granted to another distributor. Especially with the rising importance of online sales and thus the difficulty of distinguishing sometimes between active and passive sales, this does not allow a manufacturer to actively appoint only one distributor to sell in a particular territory.

29. In certain circumstances it may make sense for a manufacturer to decide per territory / customer group on the best strategy to distribute a product. In some areas, it may make sense to distribute the product via an exclusive distributor, e.g. in an area which has not yet been well developed and where a distributor would invest a significant amount of money in setting up a distribution network. In this case, it could make sense to reserve a territory or a customer group solely to this distributor (excluding passive sales by others, in order to incentivize the distributor to invest in that field, to provide a compensation for its efforts and to limit the risk of free-riding. However, in other areas / for other customer groups, this may not make sense and the producer would like to appoint more than just one distributor to serve exclusively a territory with a limited number of others.

30. A supplier and a distributor should be free to define a reserved customer group. The parties should have freedom to decide which customers are covered by the reservation (from a very generic "all current and future customers of the manufacturer" to a more granular "all customers above a certain threshold/ all customers in a specific distribution channel", etc.), when such reservation is made (at the start of the agreement or at a later stage) and how (explicitly in the agreement or orally) as long as both parties understand who targets which customer.

Commercial agency

31. For an agent to be considered a genuine agent, it must not undertake other activities within the same product market required by the principal unless these activities are fully reimbursed by the principal.

32. The relevant section of the Vertical Guidelines, para. 16 point g), is often interpreted as precluding such a “dual role” of trade partner, that is the distributor selling other products of the same manufacturer cannot be an agent for other brands of the manufacturer at the same time.

33. One of our members, an in-house lawyer advising a company that manufactures and sells products under different brands based on a traditional two-tier distribution model and that wishes to position these brands along the spectrum of “basic”, “added value”, to “luxury”, highlighted that they would like to use commercial agency for their luxury brand. However, they think the risk is too high if they use as commercial agents their existing partners , who sell and would continue selling that company’s basic brands as distributors. Commercial agency would allow companies to ensure the appropriate positioning of their brand and their products in a way that selective distribution cannot, and companies want to work with partners that are already active in the relevant market because only they have the necessary skills. Commercial agency as such is a perfectly legitimate alternative to other distribution models. We would therefore welcome a clarification in the Vertical Guidelines (or deletion of para. 16 point g) that such a dual role does not prevent an undertaking from acting as a genuine agent.

Market share thresholds

34. Vertical restrictions are mainly intra-brand restrictions which are not likely to harm competition if there is sufficient inter-brand competition. The Commission should either at least maintain the 30% and consider introducing a buffer between 30% and 40% or more to a 40% threshold, considering the difficulties in defining market shares precisely.

35. If the market share of a supplier does not exceed 40% there is still at least 60% inter-brand competition which is sufficient, especially because hardcore-restrictions are not exempted in any case.

36. Separately we would welcome if the Commission were to consider whether the market shares to take into account need to be in all instances, the market shares of the buyer and the seller. In our view, the market share test should relate to the party (whether seller or buyer) which is imposing the restrictions.

Non-compete obligation – 5 years

37. The VBER states in Art 5(1)a that any non-compete obligation, "*which is indefinite or exceeds five years*" does not fall within the block exemption. It then states that any such obligation which "*is tacitly renewable beyond a period of five years shall be deemed to have been concluded for an indefinite duration*."

38. Para 66 of the Vertical Guidelines states that "*non-compete obligations are exempted… where their duration is limited to five years or less and no obstacles exist that hinder the buyer from effectively terminating the non-compete obligation at the end of the five year period*."

39. Art 5(1)a should be more flexible, e.g. by including a provision that also a longer duration of a non-compete obligation/exclusivity falls under the VBER, if a five year duration does not make sense considering the market situation / product in question. This is in particular the case where the product has long service intervals, extending beyond the five years where customers look to total life cycle cost.

40. In addition, one of our members requests clarity on whether contracts agreed for a term of five years or less, in which the buyer can terminate at any time after the term has elapsed, require an explicit "active renewal" clause, whereby the contract stipulates that the buyer should actively renew its commitment to the contract after the initial term has elapsed.

41. The member notes that para 58 of 2000 Verticals Guideline contained the following additional wording (which was removed from the 2010 Guideline: "*non-compete obligations are covered [by the VBER] when their duration is limited to five years or less, or when renewal beyond five years requires explicit consent of both parties and no obstacles exist that hinder the buyer from effectively terminating the non-compete obligation at the end of the five year period.*"

42. It seems that that the removal of the underlined wording indicates that active renewal is no longer required in order for agreements with terms of less than five years to benefit from the VBER. However, there is some confusion among commentators over whether this is the case [5].

43. In any event, the current position that any non-compete containing an "evergreen clause" is deemed to be of an unlimited duration appears to be overly restrictive. In practice, a non-compete for two years with an evergreen clause which can be terminated by either party or at least the purchaser at certain (typically yearly) intervals thereafter without cause is much less restrictive than a non-compete with a fixed duration of five years.

Geo-blocking

44. The relationship between the VBER and the geo-blocking regulation should be clarified. For example, the prohibition of passive sales of audiovisual content should not be considered a hardcore restriction where the Geo-blocking Regulation expressly provides that it may be subject to geographical restrictions.

Conclusion

45. We appreciate the opportunity to provide these comments and we would be happy to develop them further, if helpful.

[5] Vertical Agreements in EU Competition Law **by** Filip Tuytschaever **and** Frank Wijckmans (2nd edition)