

New Rules Applicable to Distribution Agreements: A New Competition/Antitrust Challenge for Suppliers in the EU?

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Executive Summary:

*Earlier this year, the new EU **Vertical Block Exemption Regulation**¹ (“New Block Exemption Regulation”) and the accompanying new **Vertical Restraints Guidelines**² (“New Guidelines”) entered into force.*

Their scope of application covers all agreements between economic operators at different economic levels: these are so-called “vertical” agreements entered into between a supplier and a distributor which have an economic effect within the European Union (suppliers from outside of the EU who export goods to distributors within the EU fall within the scope of the New Block Exemption Regulation).

The new rules have generated considerable discussion with regard to their application. Although the principles of the New Block Exemption Regulation are simple and straightforward (ten articles), the New Guidelines are quite detailed and often involve complex legal and economic reasoning (46 pages, in the version published in the Official Journal of the European Union). The New Guidelines explain how the New Block Exemption Regulation will be applied by the European Commission (Directorate-General for Competition, “DG COMP”) in a myriad of practical situations.

Given the risk of getting it “wrong”, companies on a worldwide scale which distribute products into the EU have a vested interest in reviewing the new rules with considerable attention. In what follows, we endeavor to contribute to that reflection.

*The new rules replace the previous vertical block exemption and guidelines, dating back to 1999. They entered into force on **June 1, 2010**. There is a grace period, extending through June 1, 2011, to allow companies to comply with modified provisions from the previous rules.*

The new rules introduce major changes in the scope of the “safe harbor” of the block exemption due to the introduction of a new market share threshold test. They include clarification on the application of Article 101 of the Treaty of the Functioning of the European Union (“TFEU”) to online sales within the framework of distribution agreements. The new rules also make significant changes regarding so-called “hardcore” restrictions that are no longer automatically prohibited but are henceforth deemed to be subject to the possibility of ad hoc exemption on economic grounds before the courts or competition enforcement authorities of the EU.

Introduction

1. Methodology is extremely important in antitrust analysis by companies. Companies have the onus to carry out self-assessment analysis concerning the compatibility of their agreements with Article 101 of the TFEU. Under EU law, there is no procedure by which companies may notify their agreements to the Commission for clearance *ex ante*. Given this self-assessment responsibility, the methodology of the analysis for companies becomes all the more important.

2. Contrary to a general belief, the competition/antitrust analysis under EU law is technically different from analysis under an American-style “rule of reason” approach. For this reason, appreciation of EU methodological techniques is important. *A summary of EU methodology under Article 101 TFEU is set out in Appendix I.*

3. In a nutshell, here are the features of the new EU rules:

- The new rules came into force on **June 1, 2010** and will expire in **May 2022**. They replace a previous vertical block exemption regulation and guidelines on vertical restraints which had been applicable since 1999.
- Like the previous block exemption rules, the New Block Exemption Regulation exempts certain types of vertical agreements from being considered anti-competitive agreements that violate EU competition/antitrust law. As a general rule, the revision in 2010 has constituted an opportunity for the European Commission to provide clarification on some issues and to take into account the development of case law and market changes that occurred since the issuance of the previous block exemption in 1999.
- In order to allow companies to come into line with EU competition/antitrust law following the adoption of the new rules, a one-year transitional grace period ending on **June 1, 2011** is provided for with regard to vertical agreements, that were in conformity with the previous set of rules but did not comply with the new rules at the time of their entry into force earlier this year.
- Article 101 TFEU applies to vertical agreements that may affect trade between Member States and that prevent, restrict or distort competition (‘vertical restraints’). Article 101 provides a legal framework for the assessment of vertical restraints, which takes into consideration the distinction between anti-competitive and pro-competitive (economic) effects. In this respect, Article 101(1) prohibits those practices and agreements that appreciably restrict or distort competition, while Article 101(3) exempts agreements initially caught by Article 101(1) but which confer sufficient economic benefits to outweigh anti-competitive effects.
- Agreements that are not capable of appreciably affecting trade between Member States or of appreciably restricting competition by object or effect do not fall within the scope of Article 101(1). The New Block Exemption Regulation applies only to agreements falling within the scope of application of Article 101(1). Subject to certain conditions, vertical agreements entered into by non-competing companies whose *individual market shares on the relevant market do not exceed 15% are generally considered to fall outside the scope of Article 101(1) TFEU*. There is no presumption that vertical agreements concluded by companies having more than 15% market share automatically infringe Article 101(1). Agreements between enterprises whose market share exceeds the 15% threshold may still not have an appreciable effect on trade between Member States or may not constitute an appreciable restriction of competition, and must be assessed in their legal and economic context. As regards “hardcore” restrictions (such as Retail Price Maintenance), Article 101(1) may apply below the 15% threshold.

- On the merits, for most vertical restraints, competition concerns can only arise if there is insufficient competition at one or more levels of trade, that is, if there is some degree of market power at the level of the supplier or the distributor or at both levels. Provided that they do not contain hardcore restrictions of competition, which are restrictions of competition by object, the New Block Exemption Regulation creates a presumption of legality for vertical agreements depending on the market share of the supplier and the supplier's distributor(s). It is the supplier's market share on the market where it sells the contract goods or services and the distributor's market share on the market where it purchases the contract goods or services which determine the applicability of the New Block Exemption Regulation. **In order for the block exemption to apply, the supplier's and the distributor's market share must each be 30% or less.** Above the market share threshold of 30%, there is no presumption that vertical agreements fall within the scope of Article 101(1) or fail to satisfy the ad hoc exemption conditions of Article 101(3). But there is also no presumption that vertical agreements falling within the scope of Article 101(1) will usually satisfy the ad hoc exemption conditions of Article 101(3). Once again, it is a question of case-by-case analysis, taking into account the significance of both the anti-competitive effects and the countervailing economic benefits, if any.
- In what follows, five of the main changes introduced by the new rules are outlined with particular focus given on the practical implications of each of them for multinational suppliers that distribute their products within the European Union (including by way of export towards the EU).

I. The scope of the "safe harbor" has been reduced: new market share thresholds for both suppliers and distributors

4. The most important modification in the New Block Exemption Regulation concerns the reduction of the scope of its so-called "*safe harbor*". Under the previous block exemption from 1999, only the supplier's market share was relevant and all the agreements concluded by a supplier with 30% or less market share could benefit from the exemption provided that the agreement did not contain any hardcore restrictions. In contrast, the New Block Exemption Regulation adds an additional condition to the supplier's market share threshold *in that the market share of each specific distributor must not exceed 30% in order for the distribution agreement to be exempted in its totality for the entire distribution network.*

5. Therefore, under the New Block Exemption Regulation, the "safe harbor" exemption is only available if the following conditions are met: (i) the agreement does not contain hard-core restrictions and (ii) both the supplier's market share in the market in which it sells and the distributor's market share in its own market do not exceed 30%. *Each distributor must have less than 30% market share in its relevant market for the entire distribution network to benefit from the "safe harbor" of the block exemption.*

6. On the other hand, under *de minimis* considerations set out in the New Guidelines, where both the supplier and *each* distributor have less than **15% market share**, the entire distribution network is presumed to fall *outside* of Article 101 TFEU (except for the case of hardcore restrictions).

7. The new 30 % "safe harbor" threshold regarding the distributor's market share narrows the scope of application of the exemption in quite a substantive manner. Furthermore, the analysis of a supplier's situation in order to determine its legal status is now more complex than in the past: as from now, the supplier must not only determine its own market share, but also have a reliable idea of the market share of **each individual distributor** in its distribution network. The complexity of the

supplier's task is daunting if it endeavors to have an accurate idea of its standing under the New Block Exemption Regulation.

8. Agreements which involve parties exceeding the threshold of 30% market share cannot benefit from the block exemption. This does not automatically qualify those agreements as being incompatible with EU competition/antitrust rules. On the contrary, an in-depth assessment of the pro-competitive and anti-competitive effects of the agreement must be conducted on a case-by-case basis in order to determine whether this agreement is in compliance and in accordance with the ad hoc exemption conditions set out in Article 101(3) TFEU.

II. Hardcore restrictions and analysis of potential efficiencies: significant changes in the new rules regarding the type of vertical restraints that are presumed to be unlawful under EU competition/antitrust law

9. The new rules do not remove any of the hardcore restrictions set out in the previous block exemption regulation. The novelty, however, is to be found in the recognition in the New Guidelines that those hardcore restrictions could be justified on the basis of "economic efficiencies" under Article 101(3) TFEU.

10. This evolution is a direct consequence of a ruling rendered by the European Court of Justice ("ECJ") in a case where the pharmaceutical company GlaxoSmithKline was opposed to the European Commission. In that case, GlaxoSmithKline argued that companies should be able to rely on efficiencies on the basis of Article 101(3) TFEU in cases where there were hardcore restrictions in their vertical agreements. This argument seems to have been accepted – in principle -- by the ECJ. For the ECJ, efficiencies under Article 101(3) TFEU are "*not identified with all the advantages which the [companies] participating in the agreement derive from it as regards their activities, but with appreciable objective advantages of such a kind as to compensate for the resulting disadvantages for competition*"³. In other words, even hardcore restrictions can be redeemed where economic benefits outweighed negative competition effects. At present, there is no recorded case where a court or competition authority has made such determination on the merits. But it remains possible, at least in a theoretical approach.

11. An illustrative example is to be found in **Resale Price Maintenance** ("RPM")⁴ which can be defined as the establishment of a fixed or minimum price level to be observed by the distributor. As a general rule, RPM remains a hardcore restriction prohibited by Article 101(1) TFEU. In this regard, the New Guidelines determine criteria according to which RPM may restrict competition such as facilitating collusion, reducing pressure on the supplier's margin and eliminating intra-brand price competition. The New Guidelines also provide details on the ways in which RPM may have positive effects. Such could be the case, for instance, where there is the launching of a new product, or avoiding free-riding between distributors or supporting short-term low-price advertisement campaigns⁵. Thus, in theory, there is an RPM defense according to which the practices concerned would fall outside of the prohibition criteria. It remains to be seen whether such defense will be successful in practice.

12. The new rules provide additional details with regard to **exclusive distribution** and **selective distribution**.

13. Historically, the EU has been less favorable than other jurisdictions, especially the United States, to restrictions on a distributor's right to sell to some territories and customers and not to others, given that these restraints are in apparent contradiction with the EU's goal to achieve an EU single integrated market.

14. However, the new rules extend the number of acceptable exceptions as an exemption under Article 101(3) TFEU. The benefit of the New Block Exemption Regulation *"is not lost if it is agreed that the buyer will restrict its distribution outlet(s) and warehouse(s) to a particular address, place or territory"*⁶.

15. As a general rule, suppliers may validly opt to restrict "active" sales by distributors to a specific territory or a customer group. However, absolute restrictions that prohibit passive sales are, as a general rule, not allowed. The New Guidelines provide that a ban on passive sales would be permitted for a period of less than two years in some circumstances, especially in order to facilitate new entry and/or provide appropriate incentives to a distributor to make investments necessary to launch a new product or an existing brand in a new territory⁷.

16. In summary, it will be for the parties to clearly demonstrate that the conditions for an ad hoc exemption under Article 101(3) TFEU are met whether in simple cases of economic benefits analysis such as exclusive distribution agreements or in difficult cases such as RPM.

III. Clarification on online sales

17. Another noteworthy change under the new rules concerns online sales. The previous guidelines from 1999 lacked detailed analysis. Online sales have evolved considerably since 1999. The New Guidelines set out more detailed analysis, taking into account the evolution of online sales over the twelve-year period from 1999 through adoption of the new rules in 2010.

18. The New Guidelines set out a checklist of principles concerning the distinction between **active online sales** (*in the case of direct email specifically addressed to certain customers*) and **passive online sales** (*where the distributor uses a website to sell products or in the case of non-targeted advertising*).

19. In order to ensure that distributors may develop business through a website and sell via the Internet, the New Guidelines outline which types of clauses will be considered as being hardcore restrictions in case of **passive online sales**⁸:

- an agreement that the (exclusive) distributor may prevent customers located in another (exclusive) territory from viewing its website or shall automatically send its customers to the manufacturer's or other (exclusive) distributors' websites;
- an agreement that the distributor may terminate customers' transactions over the Internet once their credit card data reveal an address that is not within the distributor's (exclusive) territory;
- an agreement that a distributor shall limit its proportion of overall sales made via the Internet;
- an agreement that the distributor shall pay a higher price for products intended to be resold by the distributor online than for products intended to be sold offline.

20. The New Guidelines allow suppliers to regulate **active online sales** to prevent free-riding and to protect exclusive distribution networks by restricting active sales. In this regard, the New Guidelines provide that suppliers may:

- prevent distributors from selling only through the Internet (suppliers are allowed to refuse to supply pure online players);

- impose quality and service conditions, provided that these are equivalent to the conditions applicable to offline sales;
- require that a certain amount of the products be sold offline and agree on a fee with the distributor to support the latter's online or offline effort.

21. It should be noted, however, that online sales are clarified in the New Guidelines, and not in the New Block Exemption Regulation itself. The New Guidelines are legally binding upon the European Commission only: they constitute Commission guidance. However, national competition authorities and the national courts of the 27 Member States of the European Union tend to scrupulously follow guidance issued by the European Commission.

IV. New guidance regarding upfront access payments and category management

22. Two new types of business practices are dealt with in the New Guidelines: (i) upfront access payments (*fixed upfront fees paid to distributors by suppliers*) and (ii) category management (*when a distributor entrusts a particular supplier with the marketing of a broader category of products*).⁹

23. Both types of agreements are exempted under the New Regulation provided that (i) both the supplier and the buyer's market shares do not exceed the 30% threshold and that (ii) the agreement does not include hardcore restrictions. For agreements that go beyond the 30% market share threshold, the New Guidelines provide guidance as to how to assess the pro-competitive and anti-competitive effects of the agreement. (See the general description of the analytical method set out in **Appendix I**.)

24. **Up-front access payments** may sometimes result in anticompetitive foreclosure of *other distributors* if such payments induce the supplier to channel its products through only one or a limited number of distributors. Up-front access payment may also lead to anticompetitive foreclosure of other suppliers if the broad use of such payments increases barriers to entry. However, the New Guidelines provide additional remarks on potential pro-competitive effects of upfront access payments, i.e. efficient allocation on shelf space for new products and reductions in asymmetry of information between suppliers and distributors.

25. **Category management agreements** may sometimes result in anti-competitive foreclosure of other *suppliers* if the category captain is able to limit or disadvantage the distribution of products of competing suppliers. However, the New Guidelines provide that the use of category management agreements may also lead to efficiencies. Indeed, it may allow distributors to have access to the supplier's marketing expertise for a certain group of products and to achieve economies of scale.

V. Agency: a more restrictive approach

26. In order to distinguish between independent reseller relationships and genuine agency, the New Guidelines set out a test of whether the agent/buyer takes on significant risks, in which case the relationship cannot be regarded as one of genuine agency. This distinction is extremely important in practical terms. Under EU competition/antitrust law, a supplier is allowed to set the resale prices and impose absolute export bans on a genuine agent. This is because the supplier and the agent are deemed to constitute one and the same market presence (as though they were a single market entity). For purposes of EU competition/antitrust law, a "genuine" agent is deemed to have no commercial autonomy and no entrepreneurial risk. Restrictions are thus valid when imposed upon a "genuine" agent but invalid when imposed upon an independent distributor. Indeed, it takes two "independent" enterprises for an anti-competitive agreement or practice to be caught by Article 101 TFEU.

27. In this regard, under the New Guidelines, there are now three types of financial or commercial risks to consider in determining whether the relationship can be regarded as genuine agency for purposes of analysis under the New Block Exemption Regulation, in accordance with the principles of the New Guidelines. There were only two under the previous rules.

28. The three types of risks are the following¹⁰: (i) contract-specific risks such as the financing of stocks; (ii) risks related to market-specific investments, i.e. investments required to enable the agent to sell the products; and (iii) risks related to other activities undertaken on the same product market, to the extent that the supplier requires the agent to undertake such activities, but at the agent's own risk. Analysis of an agency agreement to determine whether it is caught by Article 101 TFEU or excluded therefrom can only be made on a case-by-case basis. As with other provisions of the new rules, such analysis often involves complex economic reasoning.



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Appendix I

Background on Article 101 TFEU Analysis (Prohibition of Collusion and Anticompetitive Covenants)

The conceptual structure of the analysis is set out in the three paragraphs of Article 101 TFEU, each of which constitutes a separate step of the analysis:

- *Article 101 (1) TFEU prohibits anticompetitive agreements having an effect on trade between the Member States.*
- *Article 101 (2) TFEU provides that agreements which infringe Article 101 (1) without being exempted under Article 101 (3) are automatically null and void. Such automatic nullity only applies to those parts of the agreements that are incompatible with Article 101, provided that such parts are severable from the agreement as a whole and to the extent such severance is permitted by applicable national contract law.*
- *Article 101 (3) TFEU sets out an exception rule, which provides a defense to undertakings against a finding of an infringement of Article 101 (1) TFEU, and this where four cumulative conditions are met with regard to countervailing economic benefits. Agreements which satisfy the four conditions of Article 101 (3) TFEU are fully valid and enforceable, and no prior decision to that effect is required.*

For this reason, before conducting a “safe harbor” analysis under an applicable block exemption or a “legal exception” analysis in cases where a block exemption could not apply, it is necessary to place the concerned agreement in its correct place in the EU antitrust way of looking at the world of potentially restrictive agreements. That “world” is essentially divided into three types of potential restrictions: (i) vertical restrictions, (ii) horizontal restrictions, and (iii) restrictions deriving from licenses for the transfer of technology (patent, know-how and software license agreements).

Where an agreement includes restrictive covenants caught by Article 101 (1), the Article 101 (3) issues become controlling. For certain types of agreements, the Commission has issued block exemptions. Block exemptions define the scope and set out the conditions by which, where met, the Commission accepts that agreements caught under Article 101 (1) are exempted under Article 101 (3). This is the “safe harbor” approach. Where a given agreement does not meet the conditions of any block exemption, i.e. does not benefit from the “safe harbor”, it may nevertheless meet the four cumulative conditions of Article 101 (3). That is the “legal exception” approach. In this respect, the four “legal exception” criteria essentially revolve around the concept of efficiency: an anti-competitive agreement will be covered by Article 101 (3) where, despite being restrictive of competition, it also directly generates positive economic effects, that is to say, in the words of the Commission, “pro-competitive effects by way of efficiency gains”. As a general rule, to meet Article 101 (3), criteria, the efficiency gains must benefit “consumers” (that is to say, all direct or indirect users of the concerned products or services; this generally means lower prices) and the restrictions must be “indispensable” to the attainment of those efficiencies.

Many practitioners believe that it may be difficult to prove, in most cases, that the positive effects of efficiencies outweigh the negative effects of restrictive covenants. The “efficiencies” based approach to the exemption conditions under Article 101 (3) means that Article 101 cases may involve the same type of complex economic analysis found in merger control cases. It should also be remembered that in cases where a “safe harbor” block exemption would not apply, the first line of defense may be that the concerned agreement is not caught by Article 101 (1) at all. Indeed, in the “self-assessment” context of EU competition/antitrust law, the notion that a given agreement is not actually caught by Article 101 (1) may prove in appropriate cases to be a more promising defense that a defense based on the Article 101 (3) exemption rule.

¹ Commission Regulation (EU) No. 330/2010 of April 20, 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, 2010, OJEU L 102/1.

² Commission Guidelines on Vertical Restraints, 2010, OJEU C 130/1.

³ ECJ, October 6, 2009, C-501/06P, *GlaxoSmithKline v. European Commission*, at point 92.

⁴ See points 223-229 of the New Guidelines.

⁵ The US Supreme Court and its decision of June 28, 2007, *Leegin Creative Leather Prods* can be considered as the reason for this change.

⁶ See point 50 of the New Guidelines.

⁷ See point 61 of the New Guidelines.

⁸ Article 4(b) of the New Block Exemption Regulation and points 51 and 52 of the New Guidelines.

⁹ See points 203-213 of the New Guidelines.

¹⁰ See points 12-21 of the New Guidelines.