Lexis®PSL **Competition**

EU competition law and selective distribution

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Most manufacturers do not distribute their products themselves. Establishing a captive retail system is expensive and manufacturers normally outsource such activities to independent distributors, who know the markets, are familiar with retailers and understand how to target customers. Nonetheless, manufacturers are likely to be keenly interested in how their products are distributed and advertised, and the conditions under which they are sold.

One way to achieve both objectives is to establish a selective distribution system (SDS). In an SDS, products can only be sold by the manufacturer itself and by its appointed distributors. Because the manufacturer has an interest in determining who can sell its products, it will usually impose on its appointed distributors the obligation not to sell those products to non-approved distributors (known as cross-selling). An SDS therefore usually constitutes a closed system which is particularly apt to avoid price pressure from low-cost retailers or discounters. At the same time, it allows manufacturers to protect their brands, the creation of which will usually have required considerable investment. SDSs are therefore often used by manufacturers of branded products.

References:

Commission Guidelines on Vertical Restraints, para 178

The European Commission's Vertical Guidelines, which set out principles for the assessment of vertical agreements under Article 101 TFEU, describe an SDS as restricting both the number of authorised distributors and the possibilities or conditions of how products are resold. The restriction of distributors is thereby based on certain selection criteria that should be linked to the nature of the distributed product.

References:

Commission Guidelines on Vertical Restraints, para 174

These criteria typically refer to the training of sales personnel, the service provided at the point of sale, the range of the products which must be sold, a minimum stock of the products or information leaflets being available, or a particular way of presenting the products (as a general rule, the manufacturer can prescribe all conditions that make sense in light of the product and that do not constitute a 'hard-core' restriction). In comparison to an agency relationship, where the agent sells products on the manufacturer's behalf, distributors purchase the goods from the supplier and resell them on their own behalf and for their own account (Article 101 TFEU does not in principle apply to agency agreements, see further Competition law and agency).

References:

Commission Guidelines on Vertical Restraints, para 175

It is recognized that SDSs may lead to a reduction of intra-brand competition. This means that competition among distributors may be diminished simply because the number of distributors is reduced because of the selection criteria. Vertical agreements, such as SDS, may also result in anti-competitive foreclosure of other suppliers or of other buyers; the reduction of competition between the manufacturer and its distributor or among distributors; and the erection of barriers for consumers to freely purchase goods.

References:

Commission Guidelines on Vertical Restraints, para 100

However, at the same time selective distribution may foster inter-brand competition because distributors may add value to the quality or value of the product, thereby making it a more competitive product compared to products not sold through selected distributors. SDS can therefore help minimise distribution costs, ensure efficient and effective

distribution, and enhance the sales of the manufacturer's products more generally. Another advantage is to avoid the free-rider problem which occurs if some distributors are subject to particular promotional or service obligations whilst others are not. Only if the manufacturer makes sure that all distributors are subject to the same selling obligations will each distributor be willing to make investments regarding promotional or service activities.

References:

Commission Guidelines on Vertical Restraints, para 107

Legal qualification/relevant requirements established by case law

In the EU, Article 101(1) TFEU outlaws agreements 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 internal market. This applies to both horizontal and vertical agreements. If either type of agreement falls under Article 101 (1) TFEU, it can still be saved pursuant to Article 101(3) TFEU, which provides that Article 101(1) can be declared inapplicable if the agreement or practice in question brings about sufficient efficiencies which are shared with consumers.

An SDS constitutes a vertical agreement (manufacturer and distributor are active on different levels of the market) that normally restricts competition. It will therefore generally fall within the scope of Article 101(1) TFEU. However, where an SDS fulfils the conditions described below, it falls outside the scope of Article 101(1) TFEU without further ado.

Guidance on when this is the case can be found in the jurisprudence of the EU Courts. In *Metro I*, the Court of Justice ruled that SDSs fall outside the scope of Article 101(1) TFEU provided that:

References:

Case 26/76 Metro I, para 20

- the nature of the product requires an SDS to be established
- the resellers (or distributors) are chosen based on objective criteria of a *qualitative* nature relating to the qualifications of the reseller and the suitability of his sales premises, and
- these criteria are laid down uniformly for all potential resellers and do not go beyond what is necessary for the relevant product.

The Court of Justice referred to 'high quality and technically advanced consumer durables' as products that may necessitate setting up an SDS.

In later judgments, products such as televisions, watches, gold and silver products as well as dinner services were qualified in a like manner. Hence, if: (1) a good falls into such a group of products; (2) the criteria for appointment can in principal be fulfilled by every interested distributor (ie, if they are non-quantitative); and (3) any restrictions based on these criteria are proportionate, Article 101(1) TFEU does not apply to the SDS—unless it contains 'hard-core' restrictions. If there are hard-core restrictions, the agreement falls under Article 101(1) TFEU.

References:

Case 75/84 Metro SB Grosmarkte GmbH KG v Commission (No 2) (Metro II)

Case 31/85 ETA Fabriques d'Ébauches v DK Investments

Case IV/30.665–Villeroy and Boch

If, however, an SDS does not fulfil the above criteria, and Article 101(1) TFEU applies, an assessment under Article 101(3) TFEU is needed in order to know whether the SDS has sufficient pro-competitive features to outweigh the negative effects of the restriction.

With vertical agreements the starting point for this exercise in practice is the Commission's 2010 Vertical Restraints Block Exemption (Regulation 330/2010) (VRBE). The VRBE stipulates that vertical agreements for the purchase or sale of goods or services can be regarded as normally satisfying the conditions of Article 101(3) TFEU.

References:

Commission Regulation 330/2010 on the application of Article 101(3) TFEU to categories of vertical agreements and concerted practices

Commission Guidelines on Vertical Restraints, para 110

Articles 2 and 3 of the VRBE provide that vertical agreements (including SDSs) are exempted from the scope of Article 101(1) TFEU where neither the manufacturer nor the distributor have market shares exceeding 30% of the relevant markets and provided that the agreement in question does not constitute a restriction by object. Article 4 of the VRBE lists the so-called 'hard-core' restrictions and provides that an agreement which includes a 'hard-core' restriction cannot benefit from the exemption of Article 2 (safe harbour). For more detail on the VRBE, see Vertical Restraints Block Exemption.

References:

Articles 2, 3 and 4 of Commission Regulation 330/2010

Finally, where an SDS does also not qualify for the 'safe harbour', that is, where it does not fulfil the requirements of the VRBE (for example, because either party has a greater than 30% market share or because the parties are in a competitive relationship), the SDS can still be shown to be pro-competitive and benefit from an individual exemption under on Article 101(3) TFEU.

Recent developments

Traditionally, SDSs were organised in a way such that manufacturers would supply their goods to distributors who would in turn sell these goods out of their own shops (brick-and-mortar stores). However, with the advent of e-commerce, resellers now sell increasingly online. They do this either through their own online shops or through third-party platforms, such as Amazon and eBay. In addition, there are pure online retailers who do not have a physical presence but rely on online commerce only.

E-commerce Sector Inquiry

The rapid growth and impact of e-commerce prompted the Commission to carry out the E-commerce Sector Inquiry, the results of which were published in May 2017.

References:

Commission final report on the e-commerce sector inquiry (10/05/2017)

Regarding consumer goods, the Commission reported that the growth of e-commerce has had a major impact on companies' distribution strategies (e-commerce has been growing by way above 10% each year since 2010): a survey conducted as part of the sector inquiry found that e-commerce has increased price transparency—and in turn increased price competition with both online and offline sales—that many retailers use automated price monitoring and automated adjustment of sales prices. It also found that small and medium-sized retailers increasingly use online marketplaces for selling their products. Most importantly, the Commission noted that the above trends have resulted in manufacturers seeking greater control over their distribution networks in order to have greater control over sales prices and quality. Manufacturers acknowledged that they would increasingly use SDSs as their preferred way of distribution because here they could determine who would become their distributors, effectively enabling manufacturers to influence sales conditions.

In response, the Commission cautioned against the increased use of vertical restraints noting that such restraints can take different forms. As regards selective distribution, the Commission noted that more than half of the manufacturers required their distributors to operate at least one brick-and-mortar store, which essentially excludes pure online retailers from the SDS. Other restraints on selling online include pricing recommendations, limitations on cross-border sales (so-called 'geo-blocking' measures that are not based on agreements between undertakings or concerted practices are not caught by Article 101(1) TFEU), and limitations on selling via online marketplaces. The latter are most often found as part of SDS and typically concern branded goods. According to the Commission, about a fifth of retailers reported that their distribution agreements contain marketplace restrictions. The Commission's report suggests that marketplace restrictions do not amount to a de facto restriction on online sales and should therefore *not* be considered as 'hard-core' restrictions under Article 4(b) and 4(c) of the VBER.

References:

Commission final report on the e-commerce sector inquiry (10/05/2017), para 40

See further, Competition law and the online sector—The E-commerce Sector Inquiry.

EU case law

As seen above, merchants have increasingly embraced the possibilities of selling online. In contrast, manufacturers will often be more concerned about losing control over how their products are sold. It is no surprise that manufacturers' attempts to limit online sales have been the subject of dispute.

Pierre Fabre Dermo-Cosmétiques SAS

In the *Pierre Fabre* case, the Court of Justice ruled that SDSs would generally amount to by-object restrictions but that they could be justified based on the *Metro I* criteria.

It assessed whether a contractual clause included in a selective distribution agreement, requiring sales of cosmetic products to be made: (1) in a physical space, and (2) in the presence of a trained pharmacist, breached Article 101(1) TFEU by rendering online sales impossible.

References:

Case C-439/09 Pierre Fabre Dermo-Cosmetique SAS

In analysing whether Article 101(1) TFEU applied, it held that whilst distributors were selected on the basis of objective criteria of a qualitative nature (see *Metro I*), the requirement to have a pharmacists present amounted to a *de facto* ban of all forms of internet selling. The aim to 'maintain the prestigious image'—which Pierre Fabre argued was its goal—was not, the Court of Justice held, a legitimate restriction of competition. It found, to the contrary, that Pierre Fabre's ban was a restriction by object according to Article 4(c) of the VRBE and that therefore it could not benefit from an exemption under Article 2 of the VRBE.

The finding that an aim 'maintain the prestigious image' does not amount to a legitimate restriction of competition was confirmed by the General Court in Case T-712/14 CEAHR v Commission.

References:

Case T-712/14 CEAHR v Commission

Coty Germany GmbH

The notion that banning online sales was not a legitimate aim in the context of an SDS was subsequently examined in the Case C-230/16 Coty Germany case. In Coty, the Court of Justice considered whether an SDS that had as its goal the protection of a luxury brand fell within the scope of Article 101(1) TFEU. The case concerned attempts by Coty, a luxury perfume producer, to prohibit its selected distributors from selling Coty's products on third-party platforms (Coty did not forbid that distributors sell online via their own webpages).

References:

Case C-230/16 Coty Germany GmbH v Parfümerie Akzente GmbH

The Court of Justice reiterated that a vertical distribution agreement fulfilling the *Metro I* criteria would not infringe Article 101(1) TFEU. It noted that in order to assess the quality of luxury goods one had to look at 'the allure and prestigious image which bestow on them an aura of luxury'—it held that maintaining this aura was essential because it allowed consumers to differentiate them from ordinary goods. An impairment of that aura could then also affect the actual quality of those goods in the eyes of the consumer. Establishing a distribution system that ensured that the products were presented in a way that is reflective of their value was therefore seen as to contribute to their special aura (for a somewhat similar reasoning, see the judgment in Case T-712/14 CEAHR v Commission, where the General Court argued that while protecting the brand image of prestige watch producers did not constitute a legitimate aim to escape Article 101(1) TFEU (*Pierre Fabre*), the objective of preserving the quality of products and their proper use could in itself justify a restriction).

References:

Case C-230/16 Coty Germany GmbH v Parfümerie Akzente GmbH, paras 24 to 27

The Court of Justice therefore ruled that a selective distribution system might be necessary to preserve the product's luxury image, and was hence compatible with Article 101(1) TFEU.

References:

Case C-230/16 Coty Germany GmbH v Parfümerie Akzente GmbH, para 29

It dismissed the argument that *Pierre Fabre* indicated a different outcome, on the grounds that in the earlier case the Court of Justice had taken the view that a *specific* clause entirely banning online sales infringed Article 101(1) TFEU. Coty was different, as it concerned the

overall legality of SDSs regarding luxury products. *Pierre Fabre*, it held, was about non-luxury cosmetic products. Protecting them was hence no legitimate requirement to justify a total prohibition on online sales.

References:

Case C-230/16 Coty Germany GmbH v Parfümerie Akzente GmbH, paras 32 and 34

When applying the *Metro I* criteria to the specifics of the case, the Court of Justice also concluded that Coty's specific platform ban did not infringe Article 101(1) TFEU. It stated that an obligation to sell only through the retailers' own online shops helped the supplier to preserve the luxury image of its goods, and for that reason the restriction was appropriate. Only the direct contractual relationship with distributors enabled the supplier to enforce quality conditions; if goods were to be distributed over third-party platforms, there would be no such relationship. Because distributors were generally still allowed to sell online through their own webpages, the Court of Justice also considered the prohibition to be proportionate.

References:

Case C-230/16 Coty Germany GmbH v Parfümerie Akzente GmbH, paras 43–68

The Court of Justice also held that the ban did not constitute a 'hard-core' restriction within the meaning of Article 4(b) or 4(c) of the VRBE, which is why it could benefit from the VRBE. Distributors were still able to sell online and, subject to certain requirements, the distributors could also still advertise on third-party platforms and use search engines, which is why customers could still locate a distributor's online offer.

Future implications

With its Coty judgment, the Court of Justice has further refined existing case law. It confirmed that SDSs directed at the preservation of the luxury image of luxury goods do not fall within the scope of Article 101(1) TFEU if they fulfil the *Metro I* criteria. The Court of Justice re-stated its historical view that it would tolerate vertical restraints in light of manufacturers' endeavour to build a premium brand and in light of consumers' expectations to obtain a luxury good in return for a premium price. It concluded that platforms such as Amazon or eBay were different, less quality outlets than distributors' own websites.

Remarkably though, the Court of Justice held back in giving guidance as to what constitutes a luxury product. This is surprising given, firstly, that before the Court of Justice's ruling there had been some debate on how to differentiate high-quality or luxury goods from mere quality, non-luxury products; and, secondly, that the Court of Justice itself pointed to this as a difference between *Pierre Fabre* and Coty—it is obvious from the ruling that the Court of Justice considered Coty's perfumes as luxury goods.

That the Court of Justice took no clear position is also surprising given that Advocate-General Wahl in his Opinion of 26 July 2017 had included non-luxury products. When stating that an SDS aimed at preserving the luxury image of prestige goods was compatible with Article 101(1) TFEU, he stressed that this conclusion applied to both luxury and quality products. He stressed that what mattered was 'the need for the network head to preserve the prestige image'.

References:

Case C-230/16 Coty Germany GmbH v Parfümerie Akzente GmbH, opinion of Advocate General Wahl

Developments at Member-State level

Such guidance would also have been helpful in light of current developments at Member State level, where courts have also ruled on the legality of restrictions regarding online distribution. As it currently is unclear what distinct qualities products must have in order to benefit from an exemption under Article 101(1) TFEU, Member State courts have approached this question differently. One case that has addressed this is the German case against running shoe producer *ASICS*.

The Bundeskartellamt (BKartA) ruled that restrictions imposed on distributors not to use the ASICS trademark in online advertising and not to engage with price comparison websites constituted a by-object restriction violating Article 101(1) TFEU and Section 1 of the German Act Against Restraints of Competition (the national equivalent). The BKartA held that the ASICS brand did not convey a signalling function justifying a vertical restraint.

Because the restriction was 'hard-core', it could not benefit from the VBER. Besides price comparison sites, the case also concerned a prohibition on selling running shoes on online marketplaces. Although explicit only on the first two issues (prohibitions not to use trademark or price comparison sites), the BKartA indicated that it took the same view with regard to platform bans, concluding that they would most probably constitute a 'hard-core' restriction under Article 4(c) of the VBER.

References:

Decision B2-98/11 Bundeskartellamt v ASICS Deutschland GmbH, Neuss et al. of 26 August 2015 at para. 252

The decision was confirmed by the German Appeal Court (Case VI-Kart 13/15 (V) of 5 April 2017), which denied leave to appeal. ASICS challenged the denial of leave to appeal before the Federal Court of Justice, Germany's highest court. The latter rejected the appeal, arguing that there was no need for further clarification because it was clear that by its contractual clauses ASICS had restricted at least passive sales, which amounted to a 'hard-core' restriction under Article 4(c) of the VRBE (Case KVZ 41/17 of 12 December 2017). It held that the ASICS case was indeed different from *Pierre Fabre* as it did not contain a de facto prohibition of sales but entailed a severe limitation of retailers' freedom to sell online. Most importantly though, the Court did comment on the Coty case—which had been delivered just a few days earlier. It confirmed the Appeal Court's view that ASICS' running shoes were neither luxury nor high-end and that, therefore, Coty did not suggest a different outcome.

In a similar vein, in November 2015, the French Autorité de la Concurrence closed an investigation into Adidas, which had prevented its distributors from selling on third-party platforms, such as Amazon and eBay. In return Adidas gave commitments to change its distribution contracts to allow distributors to sell on online marketplaces. It was implicit in the decision to open proceedings and from the fact that Adidas was willing to give undertakings that the authority took the view that restricting retailers from selling on online platforms could infringe Article 101(1) TFEU. It therefore appears unlikely that the authority would have treated Adidas' products as luxury products.

References:

Press release of the French Competition Authority of 18 November 2015

In contrast to the above two cases, in October 2017, the Amsterdam District Court rejected a distributor's claim that Nike's distribution policies violated competition law because Nike had imposed a ban to sell on online platforms (Case C/13/615474/HA ZA 16-959 Nike v Action Sport of 4 October 2017). In rejecting the distributor's claim, the District Court explicitly referred to Advocate-General Wahl's Opinion in Coty—which had included both luxury and quality products in the range of products that could benefit from an exemption under Article 101(1) TFEU. It ruled that Nike products should be considered luxury goods and that the manufacturer's prohibition served the legitimate aim to protect the brand image.

Luxury vs quality products

While the Coty case on the one side and the German and French cases on the other side can arguably be reconciled by pointing to the different nature of the products concerned, there is a degree of uncertainty as to which products fall outside the scope of Article 101(1) TFEU—provided the *Metro I* criteria are fulfilled—and which do not. Until the Court of Justice rules as to which features should be taken into account in assessing whether a product is a luxury product, there is no guarantee that Member State courts will not continue to take apparently conflicting views as to the scope of Article 101(1) TFEU. If one takes the Coty case as one side of the coin and the ASICS case, which has travelled the hierarchy of German courts, as the other side of that coin, it appears that national courts and competition authorities will have to look at each product's distinct features and make its own assessment whether in their view the product actually qualifies as a luxury good. Only if it does, will the exception from Article 101(1) TFEU apply.

While there is a divergence between the German and French cases on the one side and the Dutch case on the other, it should be noted that at the time of the Dutch ruling the Court of Justice had not ruled yet in the Coty case. It is possible that the Dutch Court was expecting the Court of Justice to follow Advocate-General Wahl's Opinion and therefore decided to take a more inclusive approach.

Conclusion

Manufacturers rely on SDSs to exercise control on how their products are sold. Selected distributers need to meet particular conditions in order to join the network. An SDS constitutes a vertical agreement that falls within the scope of Article 101(1) TFEU—unless it fulfils the *Metro I* criteria. If the nature of the product requires an SDS, if resellers are chosen objectively, and if the criteria laid down are applied uniformly and are proportionate, Article 101(1) TFEU does not apply. In addition, SDSs can benefit from the VBER, which exempts vertical agreements irrespective of the nature of the product and the criteria chosen, and an individual exemption according to Article 101(3) TFEU.

The Commission's E-commerce Sector Inquiry shows that manufacturers increasingly turn to SDSs in order to maintain control of the way their goods are distributed. This goes hand in hand with an increased use of vertical restraints. In *Pierre Fabre* the Court of Justice ruled that the aim to protect a prestigious brand was not a legitimate aim and did therefore not as such prevent an agreement from falling under Article 101(1) TFEU. In Coty, the Court of Justice clarified that SDSs directed at the protection of a luxury brand did not restrict competition. A ban of third-party platforms did not violate Article 101(1) TFEU. It also did not constitute a 'hard-core' restriction under Article 4 of the VRBE.

It is regrettable that in Coty the Court of Justice did not give guidance as to what constitutes a luxury product, particularly given the diverging case law at the Member State level. Member State courts and competition authorities will need to continue to assess on a case-by-case basis whether goods distributed by an SDS qualify as luxury products and, as a result, whether the SDS falls within the scope of Article 101(1) TFEU.