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SELECTIVE DISTRIBUTION NETWORKS: DO'S AND DON'TS AND WHAT MAY BE PROHIBITED

In this issue of Marketplace, we clarify and examine the main rules in respect of selective distribution networks in terms of what is envisaged by the current European legislation governing this type of agreements.

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Selective distribution networks

Selective distribution networks are set up by producers in order to channel in each EU country the sale of prestige, luxury or high-technology products, for which resellers must possess special skills and facilities, i.e. the ability to perform high-end services, including presentation, advice and customer assistance. The appointed exclusive national distributors or the producer's national branches identify, select and appoint a number of exclusive resellers who fulfil the above-mentioned qualitative criteria, establishing therefore a national selective distribution network headed by them and, through them, by the resultantly broader European selective distribution network.

What is the legal framework governing selective distribution networks?

Selective distribution networks, which enjoy some exemptions to the generally tighter European antitrust rules, are currently governed by Commission Regulation (EU) 330/2010, in force from 1 June 2010 to 31 May 2022, also called VABER (Vertical Agreements Block Exemption Regulation).

Like all regulations, the VABER is directly addressed to citizens, individuals and legal persons established in the various EU Member States and has binding status also on national governments and on all the authorities of each Member State, thus including national courts which are required to interpret and apply national laws in accordance with current regulations.

Which agreements fall within the exemption provided for by Regulation (EU) 330/2010?

The VABER concerns, with a few exceptions, only **vertical agreements between non-competing undertakings** (thus, for example, agreements between Philips and its distributors, and not 'horizontal' agreements between Philips and Sony, Samsung and/or other competitors). Exceptionally, also **some vertical agreements between competing undertakings** are included, among which: (1) vertical agreements concluded within a <u>purchasing group or other association formed by a group of resellers</u>, provided that no reseller has a turnover of more than EUR 50 million per annum (excluding transactions with its affiliates); (2) <u>dual distribution agreements</u> in which the supplier also directly distributes the products that it sells to another non-competing distributor.

What are the conditions for the exemption?

The above agreements benefit from the safe harbour provided for by the VABER – despite certain content which would normally be forbidden – if:

- they do not contain fundamental restrictions on competition,
- the share held by the supplier (i.e. producer, importer, national distributor) does not exceed 30% of the relevant market on which it sells the products or services covered by the contract and,
- the share held by the buyer does not exceed 30% of the relevant market on which it purchases the products or services covered by the contract.

In particular: (1) if the selective distribution network is made up of '<u>two rungs</u>' (Supplier and authorized Reseller), the Supplier must not have more than 30% share of the relevant sales market and the authorized Reseller no more than 30% share of the relevant purchase market; (2) if the network is made up of '<u>three rungs</u>' (Supplier, authorized Distributor, authorized Reseller), the share held by the Supplier and the Distributor must not exceed 30% of each 'downstream' market, and the Distributor and the Reseller must not exceed 30% of their respective ‘upstream’ markets.

How exactly are market shares calculated?

Market shares are calculated on the basis of the total value of the entire market during the previous year (respectively, downstream of those who sell and upstream of those who buy, as mentioned above). If such value is not available, the market can be calculated on the basis of other available elements such as the volume.
Own use or buyers integrated into the production or within the sales network:
(1) Products intended for the supplier’s own in house production should not be taken into account for the purpose of determining the size of the market on which shares are calculate (they apply solely for the general purpose of analyzing their competitive structure);
(2) Sales to suppliers of the producer/supplier integrated into the production or to distributors/resellers integrated within the supplier’s sales network are, instead, to be taken into account for determining the market share of the supplier.

What is the relevant market on which shares are calculated?

The Commission, in its official Notice published in the Official Journal C 372 of 09/12/1997 (http://bit.ly/2QfjstS), defines the relevant market on the basis of two elements that must be taken into account:
(1) Relevant products market: it is the market for products/services considered equivalent or substitutable by the average consumer due to their characteristics, prices or intended use;
(2) Relevant geographic market: it is the geographic area in which the undertakings concerned are involved in the supply of the related products/services, in which

the conditions of competition are fairly homogeneous and which can be distinguished from those of neighbouring areas where the conditions of competition are appreciably distinct (e.g. a national market).

What if the exemption regulation does not apply?

In this case, the following situations can occur:
Partial achievement: if the 30% market share is reached by some products but not others, the VABER applies only to products that do not constitute the above-mentioned share, while for others, the exemption does not apply.
Grace period: if the market share exceeds the 30% threshold but not 35% in one year, the VABER continues to apply for two consecutive years and for one year if it exceeds 35%.
If the above 30% thresholds are exceeded, or the other conditions are not fulfilled and the VABER does not apply, the checklist to follow for verifying the lawfulness or otherwise of the agreement is divided into three steps:
(1) **Does the agreement have a significant impact on trade between Member States** (or within the national market)?
There is a Commission’s Notice in relation to agreements of minor importance (De Minimis Notice: http://bit.ly/2MNzZ69) pursuant to which the Commission will not normally institute proceedings in the case of agreements between small or medium-sized enterprises or large companies with market shares in the relevant markets not exceeding, as the case may be, 15% (agreements between non-competitors), 10% (agreements between competitors) or 5% (combination of several parallel vertical agreements).
(2) **Does the agreement contain expressly prohibited restrictions?**
Agreements aimed, for instance, at maintaining prices, or at preventing parallel trade between Member States, are always prohibited, even if of minor importance (see: http://bit.ly/2MNzZ69, paragraph No 2 and 13).
(3) If the answer to points 1 and 2 is yes, **does the agreement benefit from the exemption provided for in Art. 101(3), or (as regards Italian law) Art. 2(3) of Law 287/90?**
(see: http://bit.ly/2scQTUH).

The case of start-ups:

in the case of **start-ups that require large initial investments** to build the company and/or develop a new market (e.g., the launch of a new brand or an existing one in a given market, or a new product of a particular brand) in which no previous demand existed for a specific product or for a product from a specific manufacturer, it is considered that restrictions on competition which would normally be prohibited under Art. 101 TFEU (hence in the presence of market shares above 30%) are permitted for an initial period of two years from when the product is first placed on the market.

It should be noted that there are no specific precedents in this regard and the wording of the Commission's *Guidelines on vertical restraints*, which in paragraph 61 explains this exemption, is relatively vague.

What does the exemption consist of?

The adoption of a selective distribution network allows, under certain conditions, to derogate from the prohibition of exclusive arrangements and from a number of other restrictions otherwise provided for in European competition law, as follows:

Clauses normally prohibited but exempted (examples)**:**

• Obligation to supply: Obligation for the supplier to sell the contract products only to authorized distributors or resellers (which, however, can never result into an exclusivity for the distributor/reseller, given that the supplier must be able to sell to third parties products/models other than those agreed and who in any case shall not be responsible for the sale of the agreed products by third parties in the area);

• Obligation to purchase: Obligation for the authorized distributor to purchase the contract products only from the supplier and for the authorized reseller to purchase them only from the distributor.

• **B2B** - Prohibition of active sales: Prohibition on authorized distributors and resellers to actively seek other distributors or retailers to whom to sell the contract products outside their assigned area.

As regards the notion of 'active selling' via the Internet: *"The Commission considers online advertisement specifically addressed to certain customers as a form of active selling to those customers ... Territory-based banners on third party websites are a form of active sales into the territory where these banners are shown ... Paying a search engine or online advertisement provider to have advertisements displayed specifically to users in a particular territory is active selling into that territory*".

Not-exempted clauses (examples)**:**

• **B2B** - Lawfulness of cross-sales between network members: Sales of contract products between authorized distributors or resellers, even if established in different European states, part of the same selective distribution network even if pan-European, are always allowed and cannot be prohibited. Conversely, sales to other distributors and/or resellers that are NOT part of the network can be prohibited.

• **B2B** - Lawfulness of passive sales: It is not possible to forbid authorized distributors or resellers from selling the contract products to other distributors or resellers (also non-network members) who spontaneously request them (typical example of passive sale is the sale via the internet).

• **B2B** - Lawfulness of the prohibition on active sales: Prohibition on authorized distributors and resellers from actively seeking other distributors or resellers to whom to sell the contract products outside their assigned area.

• **B2C** - Lawfulness of active and passive sales to end customers: Authorized resellers (but not authorized distributors which, as such, operate exclusively as 'wholesalers') must always be free to sell, both actively and passively, to end consumers.

Some cornerstones established by the EU Commission and the European Court of Justice:

To complete the picture, I report, even though in a concise way, some important core points relating to the interpretation of the legislation on selective distribution networks:

(1) "***In principle, every distributor must be allowed to use the internet to sell products. In general, where a distributor uses a website to sell products that is considered a form of passive selling****…"* (Guidelines on Vertical Restraints No 52).

(2) The Commission highlights a critical issue in relation to **the requirement for resellers part of a selective distribution network to own at least one brick and mortar shop.** In fact, according to the Commission, where such requirement is not aimed at ensuring the quality of the distribution and/or brand image, it could be prohibited since not justified by the exemption regulation. This has resulted in a particular attention of the supervisory authorities on this point.

(3) Under certain conditions (i.e. an actual need to protect the prestige or luxury image of a product ordinarily sold through a selective distribution network) **it is possible to prohibit an authorized reseller from selling on the marketplace products ordinarily marketed through a selective distribution network** (ECJ Case C-230/16 - Coty Germany GmbH v Parfümerie Akzente GmbH).

(4) **Possibility of prohibiting a third party, not part of a selective distribution network, from selling online luxury or prestige products intended by the manufacturer for its own selective distribution network** (ECJ Case C-59/08 - Copad SA v Christian Dior SA et. al.).

(5) **Possibility for a trademark proprietor to oppose (on the basis of the mark itself) the parallel imports of its own brand product from another EU or EEA country**, based on three conditions: (a) existence of a selective distribution network; (b) the product must be a luxury or prestige product; (c) existence of an actual or potential prejudice to the luxury or prestige image as a result of its marketing through parallel imports.

If these three conditions are present, the supplier X, trademark proprietor (pursuant to Art. 7(2) of Directive 2008/95/EC, implemented in Italy by Art. 5 of the Intellectual Property Code), can argue that the product has never been lawfully placed on the market and, consequently, that its trademark rights were never exhausted; he can therefore act not only (contractually) against the authorized distributor who supposedly violated the contract, but, on the basis of trademark protection, directly against the third party who purchased the products from the latter to import them into another Member State.