

WSGR ALERT

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EUROPEAN COMMISSION ADOPTS NEW VERTICAL AGREEMENTS
BLOCK EXEMPTION REGULATION AND GUIDELINES

INTRODUCTION

On April 20, 2010, following discussion and revisions during an intense public consultation period, the European Commission (EC) adopted its new Vertical Agreements Block Exemption Regulation¹ and the accompanying Guidelines on Vertical Restraints,² which will come into effect after the current regime expires on May 31, 2010, and apply for 12 years.

Generally speaking, the guidelines provide two main functions. First, they specify how the EC applies the block exemption, which provides a safe harbor for supplier and distribution agreements from the prohibition on restrictive agreements contained in Article 101(1) of the Treaty on the Functioning of the European Union, so long as the vertical agreements at issue meet certain criteria (mainly, a market-share threshold and the absence of certain "hardcore" restrictions in the agreement).³ Second, because agreements that do not fall under the safe harbor are not presumptively illegal, the guidelines offer guidance on how to assess when such agreements can run afoul of the competition laws.⁴ Due to the "hundreds of thousands,"⁵ if not more, of supplier and

distribution agreements, the guidelines provide an important instrument and helpful direction for business firms. In addition, the EC believes that the new guidelines will have an important effect on consumers by "ensur[ing] that consumers can buy goods and services at the best available prices wherever they are located in the EU. . . ."⁶

The EC recognized that since the last revision (in 1999), two significant developments were affecting commerce: (1) the increasing occurrence of large buyers with market power in certain industries, which correspondingly increased potential for anticompetitive harm, and (2) the reality that the online marketplace is a "powerful tool to reach more and different customers."⁷ In addition, the new guidelines generally reflect the EC's trend towards an economics-based effects analysis; most notably, the EC arguably has loosened its strict condemnation of resale price maintenance (RPM) restrictions.

SUMMARY

Many considered the old guidelines to have worked well in practice, and in recognition of this, the EC did not significantly alter the old regime. In that light, the changes can be

deemed incremental in nature, not drastic. However, the new guidelines contain certain key changes that will affect business practices in Europe.

- The new guidelines require both distributors and suppliers to fall below the market-share threshold that previously applied only to suppliers, in order to qualify for the block exemption.
- The new guidelines confirmed that online sales are generally considered passive sales, and thus restrictions on online sales are generally considered hardcore restrictions.
- The new guidelines consider the possibility that RPM restrictions can be justified in some situations.
- Certain vertical arrangements not referenced in the old guidelines, such as category management and upfront access fees, generally are allowed.
- The EC may withdraw the availability of the block exemption in some situations if the EC observes it is leading to appreciable anticompetitive effects.

¹ Commission Regulation 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, Official Journal L 142, 23.4.2010, p.1, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:102:0001:0007:EN:PDF>.

² Available at http://ec.europa.eu/competition/antitrust/legislation/guidelines_vertical_en.pdf.

³ The safe harbor reflects the general view that vertical agreements present less competitive concerns than horizontal agreements, and that based on the EC's enforcement experience, the benefits of vertical agreements between parties without market power usually will outweigh any anticompetitive effects. See "Antitrust: Commission adopts revised competition rules for vertical agreements: frequently asked questions," European Commission, April 20, 2010, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/138>.

⁴ Agreements that do not qualify for the block exemption are not automatically illegal under Article 101(1); such agreements are evaluated on a case-by-case basis to assess whether they meet the exceptions under Article 101(3). Note that vertical restraints imposed by dominant firms are still mainly governed by Article 101(2), which regulates abusive conduct by dominant firms.

⁵ Press Release, "Antitrust: Commission adopts revised competition rules for distribution of goods and services," European Commission, April 20, 2010, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/445>.

⁶ *Ibid.*

⁷ Guidelines, ¶ 52.

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Further details are provided below.

ADDITIONAL MARKET-SHARE THRESHOLD

For vertical agreements between non-competitors, the EC historically has concluded that if the parties have individual market shares of 15 percent or less, such agreements fall outside the scope of Article 101(1).

The block exception increases this de minimis market-share threshold to 30 percent for supplier and distribution agreements so long as they do not contain any hardcore restrictions. Under the old regime, to qualify for the block exemption, only the supplier had to fall under the 30 percent market-share threshold (except in the case of exclusive supply arrangements, where the relevant market share was the buyer's market).

However, the EC's concern with the power of large buyers is reflected in the new guidelines by the application of the safe-harbor market-share threshold to all parties to a vertical agreement; now, suppliers *and* distributors are subject to the threshold. That is, the supplier must not exceed a 30 percent share of the supply market, and the distributor must not exceed a 30 percent share of the purchasing market (not to be confused with the distributor's downstream markets). In multi-party agreements where one firm is both a supplier and a distributor, that firm must meet this criterion in both the buying and selling markets.

Smaller companies may benefit from this new threshold, since smaller suppliers may be more likely to be harmed by power buyers, and smaller distributors now could have more opportunities to enter into agreements that otherwise may have gone to larger competitors. Although this justification received criticism during the consultation phase, the EC believes that smaller companies, both suppliers and distributors, would ultimately benefit from this revision.

Parties to an agreement now face an additional burden in determining the buyer's

market position and whether an agreement would fall under the block exemption. Thus, transaction and compliance costs may increase. Particularly in industries where reliable external market shares of purchasing markets are not available or where the parties to an agreement mainly operate in different geographies (and therefore are not well suited to assess the market position of one another and determine whether agreements fall within the block exemption), increased legal uncertainty will result.

INCREASED CLARITY REGARDING ONLINE SALES

Suppliers generally are free to decide on the number and type of distributors for their distribution systems. Many firms choose to employ (1) exclusive distribution arrangements, where distributor choices are linked to exclusive territories, customer types, or both (allocated areas), or (2) selective distribution arrangements, where distributor choices are linked to criteria regarding the nature of the product being sold, and restrictions involve sales to non-authorized distributors, not end customers. Some firms choose to employ both systems. The guidelines govern how each of these arrangements is analyzed.

Under the old guidelines, restrictions regarding active sales in certain situations were allowed under the block exemption, while restrictions on passive sales were considered hardcore restrictions that made the safe harbor unavailable. It is important to note that a supplier's choice of distribution systems significantly affects its ability under the guidelines to place restrictions on its distributors. While the guidelines allow suppliers employing exclusive distribution systems to restrict distributors from making active sales outside of their allocated areas (and thus, generally speaking, in this system only restrictions on passive sales are disallowed), the guidelines do not allow suppliers employing selective distribution systems to do so (so, generally speaking, under this system, only restrictions regarding sales to unauthorized distributors are

allowed; all other restrictions, both active and passive, regarding sales to authorized distributors or any end customers are not allowed).

The new guidelines generally carry over the "active" versus "passive" distinction, and offer more clarity regarding online sales, which are for the most part considered passive sales. Thus, certain restrictions on online sales will be considered "hardcore" restrictions, such as any outright ban (explicit or de facto) on Internet sales, limits on the proportion of sales that can be made online (although distributors can be required to have brick-and-mortar locations or sell a minimum volume or value of products offline), restrictions on allowing customers in other territories to view and purchase from a distributor's website (thus, automatic rerouting of Internet traffic to other distributors and cancellation of orders paid for by foreign credit cards are prohibited), and higher prices for products targeted to be sold through online channels (although suppliers may pay a fixed-sum fee to distributors to support offline sales). In principle, the option of online sales must be available to all distributors.

The new guidelines also clarify what online marketing activities will be considered active sales (and therefore, allowable restrictions in certain situations):

"Active" sales mean actively approaching individual customers by for instance direct mail, including the sending of unsolicited e-mails, or visits; or actively approaching a specific customer group or customers in a specific territory through advertisement in media, on the internet or other promotions specifically targeted at that customer group or targeted at customers in that territory. Advertisement or promotion that is only attractive for the buyer if it (also) reaches a specific group of customers or customers in a specific territory, is considered active selling to that customer group or customers in that territory.⁸

⁸Guidelines, ¶ 51.

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Additionally:

The Commission considers online advertisement specifically addressed to certain customers a form of active selling to these customers. For instance, territory based banners on third party websites are a form of active sales into the territory where these banners are shown. In general, efforts to be found specifically in a certain territory or by a certain customer group is active selling into that territory or to that customer group. For instance, paying a search engine or online advertisement provider to have advertisement displayed specifically to users in a particular territory is active selling into that territory.⁹

Again, the supplier's choice of distribution systems is controlling. Generally, a supplier in an exclusive distribution system can restrict a distributor from actively marketing to customers outside of the allocated area, but a supplier cannot prevent a distributor from making sales to customers who make their way, unsolicited, to the distributor online. Translating a distributor's website into the language of another territory, and general online advertising, are not considered active selling, even though they may assist the distributor in making a passive sale to a customer outside its allocated area.

Suppliers are still free to decide to employ a selective distribution system that requires distributors to have one or more brick-and-mortar locations (and thus they can continue to refuse to employ Internet-only distributors), but once the supplier chooses a distributor, the supplier cannot prevent that distributor from establishing an online presence and making sales online. However, certain restrictions that are analogous to allowed restrictions in the offline world are generally allowed in the online context. For example, the new guidelines provide that a supplier may require a distributor to maintain certain quality standards for the distributor's website

(this is likened to allowable restrictions placed by luxury-brand suppliers on the appearance of a physical shop), as long as the supplier ensures that prescribed website standards are "overall equivalent to" those that apply to brick-and-mortar establishments. In general, any criteria imposed for online sales need not be identical to those imposed for offline sales, but the new guidelines state that they "should pursue the same objectives and achieve comparable results," and any differences in the applicable criteria must "be justified by the different nature of these two distribution modes."¹⁰

The EC recognizes that certain goods, such as luxury products, legitimately require or benefit from a restrictive distribution network. At the same time, the EC recognizes the benefits of online sales, including lower prices, more transparency, and wider access (indeed, much of the debate during the consultation period was comprised of the interests of luxury brands on one hand and the proponents of online commerce on the other), and the availability of a selective distribution system is not limited according to any specified nature of the relevant product. Thus, the new guidelines note that the EC will keep a careful watch on selective distribution networks. If the EC determines that such networks are being employed for products that do not justify a need for selective criteria, which results in appreciable anticompetitive effects, the block exemption may be withdrawn.

The new guidelines also note that online sales restrictions that make the block exemption unavailable are not necessarily in breach of Article 101(1). For example, an outright prohibition on Internet sales, while most likely a violation, may be allowed if competition is not restricted (e.g., the product is not allowed to be sold online for other regulatory reasons) or if it is necessary to achieve significant benefits to customers. Restrictions on passive sales, while normally a violation, may be allowed if limited in duration and necessary for a new product

launch that requires significant investments. Suppliers will need to carefully assess the online restrictions placed upon their distributors.

Given that the online marketplace is a relatively recent phenomenon, and that innovations and changes in the online world can happen very quickly (especially with regard to sophisticated online advertising), it remains to be seen how the EC will apply the as yet untested new guidelines concerning online sales.

POSSIBILITY OF JUSTIFICATIONS FOR RPM RESTRICTIONS

Under the new guidelines, RPM is still considered a hardcore restriction, and thus presumptively in breach of Article 101(1). While the EC maintains that there are no per se illegal categories in the EU, and that even hardcore restrictions could meet the exemption requirements of Article 101(3), in practice RPM has been considered to be per se illegal conduct.

The new guidelines provide limited examples of when RPM could lead to efficiencies that meet the criteria of Article 101(3) (although they do not go as far as the wholesale rule of reason treatment of RPM as articulated by the U.S. Supreme Court in its recent decision in *Leegin*). For example, the new guidelines recognize that RPM restrictions could be beneficial when a new product is being introduced if they induce distributors to promote the product and increase sales efforts, thereby increasing demand and ensuring the success of the launch. Also, the new guidelines note that RPM restrictions could be necessary in a franchise context (or another "similar distribution system") for the organization of a short-term (the new guidelines suggest two to six weeks), low-price campaign that may provide benefits to consumers.

Given the history of the treatment of RPM in the EU and the likelihood that extreme

⁹ Guidelines, ¶ 53.

¹⁰ Guidelines, ¶ 56.

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evidence regarding the justifications for RPM agreements will be required, a firm is unlikely to go forward with a RPM clause with the expectation that it will meet the high burden of proof required to establish the exception, especially during this uncertain period at the genesis of the new regime.

OTHER SUBSTANTIVE CHANGES

Agreements between Competitors

Generally, the block exemption is not available for agreements between competitors. One exception under the old guidelines was for non-reciprocal agreements between competitors where the buyer had turnover of less than €100 million in the previous fiscal year. However, the new guidelines do not include this turnover-based exception, and thus competitors now have even fewer opportunities to rely upon the block exemption.

Category Management

The new guidelines address the practice of "category management," where the downstream party to a vertical agreement designates the upstream party (commonly referred to as the "category captain") to direct the downstream party's marketing efforts for a particular category of products, including products of the upstream party's competitors. Category management is most often seen with retailers who collaborate with a leading supplier of a category of products. The new guidelines acknowledge that such arrangements can provide efficiencies, and clearly state that in most cases, category management agreements are not problematic (this was a change from the initial consultation draft).

Upfront Access Payments

The new guidelines define upfront access payments as "fixed fees that suppliers pay to distributors in the framework of a vertical

relationship at the beginning of a relevant period, in order to get access to their distribution network and remunerate services provided to the suppliers by the retailers."¹¹ Examples include slotting allowances, pay-to-stay fees, and payments for access to distribution networks. The new guidelines recognize that upfront access payments can result in beneficial effects such as efficient allocation of shelf space or decreased incentives for suppliers to free-ride on the promotional efforts of distributors.

The new guidelines suggest that negative effects from such practices will arise only in exceptional circumstances. However, firms should note that investigations of these practices traditionally have been an area of enforcement with national competition authorities (some of whom have more restrictive treatments of upfront access payments than the new guidelines), rather than the EC, so firms now will need to consider the wider EU implications of upfront access payments.

PROCEDURAL CONSIDERATIONS

Withdrawal Rights

The new guidelines provide detail and examples that should assist companies as they navigate through their supplier and distribution agreements. However, as is the case with most applications of new regulations and applications of guidelines that may be influential but not necessarily binding upon courts,¹² there is uncertainty associated with the new guidelines. Adding to the uncertainty of the new regime is the warning given by the EC in the guidelines that the block exemption may be withdrawn in certain circumstances if the EC believes that appreciable anticompetitive effects are occurring (particularly with selective distribution networks). Moreover, Member States have certain rights to make the block exemption unavailable within their territories.

Transitional Grace Period

Under the new guidelines, a one-year grace period applies (ending May 31, 2011) for agreements in existence before June 1, 2010, during which the parties will need to determine whether such agreements still qualify for the safe harbor under the new guidelines. After the grace period, existing agreements that do not qualify for the block exemption will be assessed on a case-by-case basis under Article 101(3).

For more information regarding the EU's new Vertical Agreements Block Exemption Regulation and the accompanying guidelines, please contact any member of Wilson Sonsini Goodrich & Rosati's antitrust or technology transactions practice.



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¹¹ Guidelines, ¶ 203.

¹² While the Vertical Agreements Block Exemption Regulation is binding, the accompanying guidelines are not. Nonetheless, in practice they will be very influential on how courts and national competition authorities apply the regulation.