SALANS

AVOCATS A LA COUR

Public consultation on the review of the competition rules applicable to vertical agreements

Contribution submitted on behalf of

CHANEL

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INTRODUCTION

1. This paper constitutes CHANEL's contribution to the public consultation launched by the European Commission on 28 July 2009 relating to the review of the competition rules applicable to vertical agreements, and in particular the draft Vertical Restraints Block Exemption (the "Draft VRBE") and the corresponding draft guidelines (the "Draft Guidelines")[1].

2. CHANEL welcomes the opportunity to express its views on this subject at this stage, and congratulates the Commission for the transparency of the process initiated last year with the set up of the Online Commerce Roundtable.

3. The arguments presented by CHANEL and the luxury industry during this process have underlined the importance of the issues at stake for that industry, which relies to a very large extent on selective distribution networks. Accordingly, CHANEL is very pleased with the Commission's overall approach not to modify the basic structure of the VRBE with its presumption of legality for vertical agreements in non-oligopolistic markets and the protection that it grants to selective distribution systems. This approach is crucial for the luxury industry's ability to develop and maintain brand images and provide consumers with quality point-of-sale services, and it also importantly promotes legal certainty and reduces transaction costs in the market.

4. CHANEL is particularly satisfied by the drafting of certain provisions of the Draft VRBE and Draft Guidelines, such as those which expressly recognise the brands' right to defend themselves against the risks of free-riding resulting from Internet distribution. This is the case, for example, of paragraph (54) of the Draft Guidelines which sets forth the so-called "brick and click principle", according to which a supplier may require its authorised distributors to have a bricks and mortar shop before engaging in online distribution[2].

5. However, in CHANEL's view, it is regrettable that the reasoning underlying the Commission's overall approach to the Draft VRBE has not been followed to its full, logical conclusion and that a few provisions have been included in the draft regulations which tend to undermine that global approach. At least in the selective distribution context, the following provisions are not justified by a major competition law concern and if not changed could undo many of the benefits achieved by the rest of the regulatory framework created by the Draft VRBE:

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[1] The current version of the regulation (Regulation No 2790/1999 of 22 December 1999) will be referred to as the "VRBE"; and the current guidelines on vertical restraints of 13 October 2000, will be referred to as the "Guidelines".

[2] Paragraph (54) of the Draft Guidelines.

a) The statement in the Draft Guidelines that limitations on the proportion of overall sales made over the Internet are "hardcore" restrictions[3].

This provision would leave the brands still exposed to certain insidious forms of free-riding: large Internet specialists would be able to open an "alibi" shop that qualifies them for entry into a selective distribution network and assures them unlimited supplies of products to sell on the Internet.

b) A similar provision in the Draft Guidelines that the imposition of criteria for online sales which are not equivalent to the criteria imposed on bricks and mortar sales are hardcore restrictions[4].

By characterising as "hardcore" any restrictions on the use of qualitative selection criteria or limitations on online sales that are not equivalent to those used in the bricks and mortar world, the Draft Guidelines potentially open up a fertile ground for future disputes and litigation. The Commission should ensure that the meaning of anything characterized as "hardcore" is clear and precise and that the competitive harm being addressed is definite and well understood. Neither is the case here.

c) The statement in the Draft VRBE that the block exemption will not apply to agreements in markets in which the buyer (and not only the seller as under the current VRBE) has a market share above 30%[5].

Although less dangerous as it does not directly threaten the business model implemented by luxury brands, this provision will raise the issue of geographic market definition – which in retailing may be narrow – and render considerably more complex the management of selective distribution systems since the same standard agreement will fall in or out of the exemption depending on the market share of the retailer. This provision is likely to give rise to different interpretations and make litigation more complex.

d) The provision in the Draft VRBE that authorized retailers in selective distribution systems can freely sell to unauthorized distributors in markets where no selective distribution system is then being operated[6].

This provision could be interpreted in a way contrary to the principles of selective distribution and in particular to the fact that, to protect the "tight" character of the network, authorised retailers should be prevented from selling to unauthorised retailers, no matter where the latter are located. In its present drafting, this article could lead to an "all or nothing" situation, in which a supplier wishing to set up a

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[3] Paragraph (52) of the Draft Guidelines.

[4] Paragraph (57) of the Draft Guidelines.

[5] Article 3 of the Draft VRBE.

[6] Article 4(b), third indent, of the Draft VRBE.

selective distribution network will have to implement it in all 27 Member States from the very beginning, in order to ensure the "tight" character of the network. This is likely to penalise small brands as well as make it more difficult for established brands to diversify their product lines.

6. The inclusion of these provisions in what are otherwise excellent draft regulations is unfortunate, because they are unnecessary, pose a threat for selective distribution in the luxury industry, and will increase litigation and transaction costs. Throughout the Commission's public consultation process, CHANEL[7] and other brands have explained that:

   - the luxury industry is different from other sectors in that brand image and the bricks and mortar shopping experience are highly significant to how the consumer perceives and experiences the products[8]. The consumer expects to be matched to exactly the right luxury product, and quality service is fundamental to achieving such a match. Brand images are fragile and the level of tolerance for errors very low. The way in which products are presented to consumers and promoted is crucial to brand image, and weaknesses in these areas may lead to a luxury brand being categorized as "in decline or decay", from which it can have enormous difficulty recovering;

   - in order to ensure that this shopping experience is up to the consumer's expectations, luxury brands organise, for all or some of their product lines, <u>selective distribution systems</u> based on qualitative and quantitative criteria. Luxury brands rely on selective distribution systems to ensure that their products are widely distributed while protecting their brand image from the risk of vulgarisation and commoditisation;

   - these systems rely on a <u>constant investment effort</u> carried out both by the members of the distribution network and the brands. Retailers are required to improve and maintain the quality of their points of sale ("POS"), not only to become a member of the network, but also to maintain this membership. In many cases, brands

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7 These points are more fully developed in *Selective distribution of luxury goods in the e-commerce age*, CHANEL's position paper presented to the Commission on 20 December 2008 (http://ec.europa.eu/competition/consultations/2008_online_commerce/index.html), hereinafter the "Position Paper".

8 The importance of bricks and mortar distribution was confirmed once again by the European Court of Justice in its recent ruling in the *Dior/Copad* case (Case C-59/08, 23 April 2009, *Copad v Dior and others*). See in particular paragraphs 24, 28 and 29: "*As the Advocate General stated in point 31 of her Opinion, the quality of luxury goods such as the ones at issue in the main proceedings is not just the result of their material characteristics, but also of the allure and prestigious image which bestows on them an aura of luxury (see also, to that effect, Parfums Christian Dior, paragraph 45). [...] the characteristics and conditions of a selective distribution system can, in themselves, preserve the quality and ensure the proper use of such goods [...]. Setting up a selective distribution system such as that at issue in the main proceedings which, according to the terms of the licence agreement between Dior and SIL, seeks to ensure that the goods are displayed in sales outlets in a manner that enhances their value, "especially as regards the positioning, advertising, packaging as well as business policy" contributes, as Copad acknowledges, to the reputation of the goods at issue and therefore to sustaining the aura of luxury surrounding them*".

contribute to this effort by granting quality bonuses and rebates, in addition to their significant upstream investments in brand image[9];

- the importance of these investments explains why free-riding represents a major and perhaps the most significant threat to the distribution of luxury products through selective distribution systems;

- CHANEL fully recognises the significant advantages that the Internet is able to provide to the consumer. In particular, the Internet is an easily accessible source of information on objective product characteristics. It can reduce distribution costs, facilitate price comparisons and provide a creative space which enables manufacturers and retailers to offer their customers innovative experiences. Most of these advantages are already used by the luxury industry and its authorised retailers who, in CHANEL's experience, are not in any way opposed to online sales;

- however, online sales pose two major concerns: they risk brand devaluation and they can facilitate certain forms of free-riding. It is essential that brands should be able to defend themselves against these threats.

7. In view of these considerations, CHANEL considers that the provisions listed in paragraph 5 a) to d) above should be amended. **Section 1** below presents CHANEL's arguments and proposals for provisions a) and b) (the Internet-related proposed "hardcore" restrictions); and **Section 2** deals with provisions c) and d).

8. As a general observation, CHANEL would like to emphasise two basic principles which, in its view, should act as overriding policy considerations in the context of the review of the Draft VRBE and Draft Guidelines:

   - first, in the area of selective distribution of luxury goods, the Commission should consider whether a regulatory intervention can "do better than the market". For example, the Commission should consider whether prohibiting certain vertical restraints implemented by suppliers would effectively improve consumer welfare or whether, on the contrary, such prohibitions would create disincentives for the retailers and prevent the networks from obtaining the positive effects for which they aim. Unless it is certain that an intervention would have a positive effect, the Commission should refrain from "micro-managing" the way in which suppliers organise their distribution systems;

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[9] The principles and mechanisms of CHANEL's selective distribution system are presented in detail in **Annex 1 (Confidential)**: this system requires retailers to make constant investments, to which CHANEL contributes with significant payments made through an incentive system.

- second, the Draft VRBE, like the text currently in force, is based on a self-assessment mechanism, in which the notification of a proposed distribution agreement is not possible (consistent with the "post-modernisation" competition regime of Regulation No 1/2003 of 16 December 2002). This implies that the provisions of the Draft VRBE and Draft Guidelines must be extremely clear, in particular those relating to "hardcore" restrictions. In the absence of clear rules, there is a significant risk that legal uncertainty will arise out of contradictory interpretations of the rules, from one Member State to the next, by national courts in litigation.

1. "Hardcore restrictions" should address serious competitive concerns and be strictly defined

9. The Draft Guidelines state in paragraph (52) that a clause "*requiring a distributor to limit the proportion of overall sales made over the internet*" (referred to as "ancillarity" clauses by CHANEL in its various contributions submitted to the Commission) constitutes a restriction on passive selling – and is therefore considered as a "hardcore" restriction both in exclusive and selective distribution schemes[10].

10. The same "hardcore" term is applied in paragraph (57) to criteria required by a supplier for online sales which are deemed not to be equivalent to those applicable to offline sales, specifically *"any obligation which dissuades appointed dealers from using the internet by imposing criteria for online sales which are not equivalent to the criteria imposed for the sales from the brick and mortar shop*".

11. In CHANEL's view, the characterisation of these restrictions as "hardcore" is excessive and inappropriate and, at least as regards ancillarity clauses, may jeopardise the entire balance of selective distribution systems. CHANEL submits that the scope of the "hardcore restriction" concept should not be expanded to situations where there is no clear justification for the ban, nor should they be applied in situations where what is prohibited is vague and subject to varying interpretations by Member States and in national courts.

12. By definition, selective distribution systems necessarily involve the imposition of certain restrictions on buyers. In selective distribution systems, a supplier, usually selling sophisticated products, seeks to have its products sold only by authorised retailers, who undertake to sell them under certain qualitative conditions and provide POS services.

13. The restraints resulting from this type of distribution may be classified into three different categories:

    ❖ First category – Terms and conditions falling outside article 81(1): most of the restraints inherent in a selective distribution system are considered as falling outside the prohibition of restrictive agreements, since the negative effects of these restrictions are counterbalanced by the positive effects that they bring about. Most vertical agreements in the selective distribution context aim to promote non-price competition and improve quality of service and have been seen to have clear positive economic effects:

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[10] The distinction between active and passive sales is not relevant for selective distribution, only for exclusive distribution.

"It is common ground that agreements constituting a selective system necessarily affect competition in the Common Market. However, it has always been recognised in the case law of the Court that there are legitimate requirements [...] which may justify a reduction of price competition in favour of competition relating to factors other than price"[11].

This is the case in relation to most qualitative requirements imposed on the authorised retailers, whose aim is to ensure that the POS comply with the standards expected by the consumer.

- Second category – Exempted restrictions: other provisions may fall within article 81(1), depending on the circumstances, but are exempted through the VRBE[12]. This is the case in relation to, for example, certain quantitative restrictions, such as a limitation on the number of authorised dealers: according to the Draft Guidelines[13], such restrictions would be covered by the VRBE.

- Third category – "Hardcore" restrictions: the potential negative effects of certain restraints are considered as unlikely to be compensated for by positive effects. Provisions traditionally considered as "hardcore" are, for example, price fixing or prohibiting cross-sales between members of the network. These restrictions lead to the exclusion of the whole agreement from the scope of the VRBE and give rise to a presumption that the agreement is unlikely to fulfil the conditions of article 81(3).

14. When the Commission declares that it regards a provision as a "hardcore restriction", this carries with it the implication of a likely infringement of article 81(1) that is unlikely to fulfil the conditions of Article 81(3), with the consequence that the whole agreement is likely to be unlawful and void.

15. Given the serious consequences linked to the notion of a "hardcore restriction", CHANEL considers, first, that a clear showing of likely competitive harm from such restrictions needs to be made. Also, all hardcore restrictions should be clearly defined within the VRBE so that they are not subject to differing interpretations by the Member States and the courts, thus giving rise to legal uncertainty and litigation[14]. Legal uncertainty is

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[11] Case 107/82, *AEG/Telefunken*, 25 October 1983, §§33-34. See also paragraph (102) of the Draft Guidelines.

[12] If the "safe harbour" 30% market share ceiling is reached, then these restrictions are likely to fulfil the conditions for an individual exemption.

[13] Draft Guidelines, §§ 171-172.

[14] The difficulties resulting from different interpretations have recently been illustrated in the Pierre Fabre case before the French Competition Council. In this case, the French competition authority considered that a ban on Internet sales constituted a "hardcore" restriction and it adopted a very strict position by stating that the possibility that a ban on Internet sales may be objectively justified only exists for exclusive distribution systems and not within selective distribution (Decision of the French Competition Council No 08-D-25 of 29 October 2008, http://www.autoritedelaconcurrence.fr/user/avisdec.php?numero=08D25, see paragraph 66). This case is currently pending before the Paris Court of Appeal and the Commission, appearing as amicus curiae, has expressed that its views are different from those of the Competition Council on this issue: an objective justification is also possible within a selective distribution network, although the interpretation of the "objective justification" concept must be made in a strict manner.

unacceptable to the companies concerned and other interested parties, not least because the definition of a hardcore restriction is such a fundamentally important issue, going to the very validity of the whole agreement of which it forms part.

16. CHANEL is firmly of the view that neither of the two restrictions discussed above ("ancillarity" clauses and non-equivalent qualitative criteria) can be considered as a "hardcore" restriction, but only as a "first category" legitimate provision (i.e. those not falling under article 81(1), due to the fact that they allow obtaining benefits that compensate for any possible negative effects). Alternatively, these restrictions could only be put into the "second category" (exempted restrictions) – under no circumstances they can be qualified of "hardcore".

1.1. Ancillarity clauses have strong justifications and should not be deemed hardcore restrictions

17. Case law has confirmed that article 81(1) does not apply to a selective distribution system if four conditions are satisfied:

- the nature of the products justifies the use of a selective network[15];
- the system has as its aim an improvement in competition, which counterbalances any possible restrictions[16];
- the criteria do not go beyond what is necessary, and no equivalent and less restrictive alternative solution exists[17]; and
- the distributors are selected on the basis of non-discriminatory criteria.

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15 See, for example, Case 31/80, 11 December 1980, *NV L'Oréal and SA L'Oréal v PVBA "De Nieuwe AMCK"*, paragraph 16: *"In order to determine the exact nature of such "qualitative" criteria for the selection of re-sellers, it is also necessary to consider whether the characteristics of the product in question necessitate a selective distribution system in order to preserve its quality and ensure its proper use, and whether those objectives are not already satisfied by national rules governing admission to the re-sale trade or the conditions of sale of the product in question"*.

16 See Case 107/82, *AEG/Telefunken*, 25 October 1983, paragraph 34: *"The limitations inherent in a selective distribution system are however acceptable only on condition that their aim is in fact an improvement in competition in the sense above mentioned. Otherwise they would have no justification inasmuch as their sole effect would be to reduce price competition."*

17 Recital (10) of the Draft VRBE states: *"This Regulation should not exempt vertical agreements containing restrictions which are more likely than not to restrict competition and harm consumer or which are not indispensable to the attainment of the positive effects mentioned above"*. See also Case T-19/91, 27 February 1992, *Vichy v Commission*, paragraph 69.

18. The fact that selective distribution networks are justified for luxury products has been established by case law, particularly in the *Leclerc* cases.[18] Chanel submits that "ancillarity" clauses – clauses ensuring that online sales by authorised retailers remain compatible with the brands' bricks and mortar business models – fulfil the other three criteria as well. They should not be deemed "hardcore" restrictions because (i) they pursue a legitimate interest, that is, the prevention of "free-riding"; (ii) they do not have a significant negative impact on competition or harm consumers; and (iii) they are necessary to attain this aim, since they are the only effective and non-discriminatory solution to certain forms of free-riding.

"Ancillarity" clauses pursue a legitimate interest

19. By admitting the "brick and click" principle, the Commission has acknowledged that the brands' concerns about free-riding are legitimate. Internet distribution facilitates certain types of free-riding and represents a threat to the legitimate business model adopted by the luxury brands, which relies on selective distribution networks.

20. The "brick and click" provision enables brand owners to resist the most obvious form of free-riding, that is, the scenario in which a customer obtains pre-sales services at a bricks and mortar point of sale and then purchases the products from an Internet "pure player". In this scenario, the Internet seller would be benefitting from the chain of investments carried out by the brand owners and their bricks and mortar distributors.

21. However, the "brick and click" clause <u>does not protect the brands against more insidious forms of free-riding</u>. This refers to the "alibi shop" scenario, in which an Internet pure player opens or purchases a small but high quality bricks and mortar point of sale, allowing it to become an authorised retailer. Under the current drafting of the texts, it would then be entirely free to make most of its sales online, thus <u>obtaining a maximum benefit with a minimum investment</u>.

22. The "ancillarity" clause is the only way to reintroduce a measure of proportionality and ensure that all retailers contribute to the building of the network in a comparable manner and that they compete with each other on equal terms. For Internet sellers not to be

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[18] Case T-19/92, 12 December 1996, *Leclerc v Commission (YSL)* and Case T-88/92, 12 December 1996, *Leclerc v Commission (Givenchy)*, see paragraphs 114-115: *"It is common ground, first, that luxury cosmetics, and in particular the luxury perfumes which constitute the bulk of the products at issue, are sophisticated and high-quality products which are the result of meticulous research, and which use materials of high quality, in particular in their presentation and packaging; secondly, that those products enjoy a "luxury image" which distinguishes them from other similar products lacking such an image; and, thirdly, that that luxury image is important in the eyes of consumers, who appreciate the opportunity of purchasing luxury cosmetics, and luxury perfumes in particular. There is, in consumers' minds, only a low degree of substitutability between luxury cosmetic products and similar products falling within other segments of the sector (see Paragraph II.A.8 of the Decision). Accordingly, the Court considers that the concept of the "characteristics" of luxury cosmetics, within the meaning of the judgment in L'Oréal, cannot be limited to their material characteristics but also encompasses the specific perception that consumers have of them, in particular their "aura of luxury". This case is therefore concerned with products which, on the one hand, are of a high intrinsic quality and, on the other, have a luxury character arising from their very nature."*

motivated to free-ride on the investments made by bricks and mortar retailers, the interests of the two types of distributors must be aligned. The "ancillarity" clause makes this possible by ensuring that Internet sellers contribute appropriately to the investments that make the network possible.

23. This risk is far from being theoretical. For example, concerning cosmetic products, a pure player could conceivably purchase a small perfumery, located in a Member state, and achieve massive sales from its Web site. Moreover, if the POS complies with all qualitative requirements, it could benefit from the qualitative rebates granted by CHANEL. This situation would be particularly unfair, considering that the qualitative rebates would apply not only to the small portion of sales made in the bricks and mortar POS, but also to online sales. In this situation, the reseller would not only be able to take advantage of the investments made by the network but CHANEL would also bear a risk of commoditisation of its cosmetic products, resulting in brand image devaluation. This scenario would in fact jeopardise the entire CHANEL business model.

24. If "ancillarity" clauses remain hardcore restrictions, pure players would be able to circumvent the "brick and click" requirement, thereby undermining the principle accepted by the Draft VRBE and Draft Guidelines according to which it is legitimate for brand owners to seek protection from Internet free-riding and have "first level" protection through the "brick and click".

25. It is important to underline that the **only** interest brand owners may have in using "ancillarity" provisions is protecting themselves against free-riding. This is the consequence of a basic economic reality which should be kept in mind in all debates concerning vertical restraints, that is, in principle, suppliers have no interest in restricting sales. In fact, restricting Internet distribution represents a cost for the supplier, and a significant one. The only rational reason for a supplier to incur this cost is if it considers that it will encourage retailers to invest in POS services[19].

26. It results from the above that "ancillarity" clauses pursue a legitimate interest and cannot therefore be considered as being anticompetitive "by object"; this makes it impossible to put them in the "hardcore" category.

"Ancillarity" clauses will not have a negative impact on consumers

27. Many participants in the current debate concerning Internet sales have presented themselves as "consumer champions" and they have based their arguments on the assumption that any restriction on Internet sales would necessarily damage consumer welfare. However, provisions such as the ancillarity clause have the opposite effect: they ensure that consumers who favour features such as service and advice, and for whom the shopping experience is essential, retain the ability to purchase luxury goods at a high-quality bricks and mortar POS. Free-riding has the power to eliminate that choice.

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19 *Selective distribution by luxury goods suppliers: a response to Kinsella et al.*, Thomas Buettner, Andrea Coscelli, Thibaud Vergé and Ralph A. Winter, European Competition Journal, August 2009, p. 613, particularly at p.615.

28. Some might argue that, in certain geographic areas or Member States, luxury POS are less developed, making it more difficult for consumers in those areas to have access to luxury products than elsewhere. In addition, the few luxury POS that do exist in these areas or Member States may set prices that are above those in more developed luxury markets. In these cases, the Internet may be seen as a good way to facilitate access to the products, and at a lower price.

29. However, the ancillarity clause does not prevent authorised retailers from selling via the Internet into such markets. It is in no way a total ban on online sales and does not eliminate intra-brand competition. In most selective distribution systems, authorised retailers have the possibility to sell online to any consumer located within the EEA, and the Draft Guidelines clearly provide that geographic restrictions on Internet sales within the EEA are hardcore restrictions. Therefore, Internet sites operated by authorised retailers should be available to consumers in areas where the retail market is less developed with pricing the same as in other Member States.

30. In CHANEL's view, the ancillarity clause is a way of promoting Internet distribution and not a way of discouraging it. CHANEL's products are currently distributed in the EEA by a total of 9,205 retailers, among which a high percentage have the real possibility of engaging in Internet distribution, particularly considering that more than 50% of those retailers belong to national or international distribution chains with significant financial strength.

31. This represents an enormous potential for the development of online sales, in a manner that would preserve the integrity of the selective distribution network, and protect investments in bricks and mortar POS.

32. On the contrary, if pure players holding "alibi shops" were allowed to market CHANEL products online, this could discourage authorised retailers from launching their own sites, since they would have the impression that the Internet market has already been occupied by pure players. Alternatively, they could be tempted to switch their investment efforts to Internet sales, by meeting only minimum bricks and mortar POS requirements, limiting services available to in-store customers.

33. The ancillarity solution protects the interests of all players. If pure Internet sellers were allowed to sell into those territories under the pretext of making products available, they would in fact be free-riding on the efforts of local luxury POS.

34. If consumers in areas with less developed retail networks purchase luxury products online as a matter of course, then there will be no incentive for local retailers to invest in POS, thereby hindering local economic development and foreclosing the opportunity for consumers in these areas who wish to do so from having the exceptional shopping experience that is an integral part of the luxury products offering. In this scenario, the Internet may in fact have the effect of crystallising differences between Member States: there would then be "high level retail" States and "low-level retail" States.

35. As pointed out in the report prepared by CRA for CHANEL[20] (the "Economists' Report"), restrictions such as the ancillarity clause are reasonable given the potential for free-riding problems[21], and they do in fact result in enhanced efficiencies and, in the end, an improvement in consumer welfare.

"Ancillarity" clauses are the only way to protect this legitimate interest

36. CHANEL has considered whether any other contractual terms might help to solve this major issue, and it has concluded that "ancillarity" clauses are the only efficient solution to the "alibi shop" problem.

37. For example, CHANEL has analysed whether it could obtain the same protection through a "location" clause, by which the retailer undertakes to sell only from the physical location of the authorised POS. It could be argued that an Internet seller with an "alibi shop", that is probably shipping most of its sales from an external warehouse, is selling products from a location which is not the authorised POS. However, since Internet sales are almost always organized from external warehouses, including by authorised retailers, banning sales from external warehouses would in fact prevent all Internet sales, including those legitimately made by authorised retailers.

38. It has also been argued that footnote 29 to paragraph (52) of the Draft Guidelines would enable brand owners to protect themselves from the "alibi shop" risk by requiring that a minimum volume of sales be carried out offline. There is no question about the fact that this provision is a positive feature: fixing a reasonable minimum sales objective is a good way in which to motivate retailers and to ensure that their POS investments are effective. However, it does not provide satisfactory protection against free riding and may even have negative effects if used to this purpose: to prevent the "alibi shop" scenario, minimum selling objectives would have to be set at a very high level, and therefore would become difficult or impossible to attain for many retailers.

39. Therefore, it appears that ancillarity clauses are the only effective solution to the problem of the "alibi shop" and the only one that avoids any discrimination. Indeed, the volume of sales that can be made online is proportionate to the volume of sales made offline, and this proportion is the same for every distributor.

40. It results from the above that it is excessive and inappropriate to use the term "hardcore" when referring to ancillarity provisions which have a strong justification, are consistent with the development of online sales, and are necessary to preserve the equilibrium of selective distribution.

41. At most, such provisions should be considered as falling within the second category mentioned (i.e. restrictions exempted by the VBRE). In this regard, it appears that the

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[20] *Selective distribution of luxury goods in the age of e-commerce*, Dr. Cristina Caffarra and Prof. Kai-Uwe Kühn, 15 December 2008.
http://ec.europa.eu/competition/consultations/2008_online_commerce/index.html

[21] Economists' Report, §90.

terminology used in paragraph (52) of the Draft Guidelines is contradictory to paragraphs (171-172) of that document, which define qualitative and quantitative selective distribution and which indicate that both are exempted by the VRBE. Quantitative selective distribution is defined as adding *"further criteria for selection that more directly limit the potential number of dealers by, for instance, requiring minimum or maximum sales, by fixing the number of dealers, etc."*[22]

42. Therefore, the Draft Guidelines expressly recognise that a maximum sales requirement (which is not essentially different from an ancillarity requirement) is considered to be a legitimate restriction which may be exempted under the VRBE. This seems inconsistent with the "hardcore" approach adopted under paragraph (52) which, in CHANEL's view, is excessively strict and should be modified.

43. It should also be pointed out that the approach of the Draft Guidelines is contrary to the approach adopted by the German Supreme Court in the *Lancaster* case[23] in which the *Bundesgerichtshof* held that a clause requiring that at least 50% of the sales of a retailer be carried out offline is legitimate.

44. The approach of the Draft Guidelines is also inconsistent with the past practice of the Commission regarding the validation of selective distribution networks by way of comfort letter. For example, in CHANEL's case, the set of selective criteria that was validated by comfort letter in 2001 included an ancillarity provision. This would not have been possible if this provision had been considered as "hardcore".

CHANEL's alternative proposal

In CHANEL's view, the third indent of paragraph (52) should be entirely removed and the following wording, which incorporates the key idea expressed in footnote 29 should be added in paragraph (54):

> *"Notwithstanding what has been said before, under the block exemption the supplier may require quality standards for the use of the Internet site to resell his goods, just as the supplier may require quality standards for a shop or for advertising and promotion in general. The latter may be relevant in particular for selective distribution, where under the block exemption the supplier may require its distributors to have a brick and mortar shop or showroom before engaging in online distribution and* ***may ensure that the distributor's online activity remains consistent with the supplier's business model.*** *The same considerations apply to selling by catalogue."*

We believe that this wording will be sufficient to protect the brand's rights in the "alibi"-shop scenario. CHANEL's aim is not to limit Internet sales to a certain percentage, but to protect the coherence of its selective distribution system.

22 Emphasis added.

23 KZR 2/02, 4 November 2003.

1.2. The requirement for equivalent criteria online and offline is inappropriate as a "hardcore" restriction

45. CHANEL congratulates the Commission for the wording adopted in paragraph (57) of the Draft Guidelines, according to which criteria for online sales must be equivalent (although not identical) to criteria for offline sales. CHANEL entirely agrees with this principle, and the criteria currently applicable to Internet sales within the CHANEL network are already based on this "equivalence" principle.

46. However, CHANEL considers as dangerous the statement in this paragraph that use of "non-equivalent" criteria would amount to a hardcore restriction. As already outlined, the use of the term "hardcore" has significant negative consequences for suppliers: it implies that, if one single criterion for online sales may be considered as not-being equivalent to a criterion defined for offline sales, then <u>the whole distribution agreement may fall outside the scope of the VRBE</u>.

47. This is an excessive sanction for a matter which is essentially subject to interpretation. In many cases, assessing the level of equivalence between two criteria will not be a straightforward exercise and "punishing" any difference of interpretation with the loss of the exemption appears to be a disproportionate and counterproductive approach.

CHANEL's alternative proposal

CHANEL therefore proposes that the word "hardcore" be deleted from paragraph (57), which should be redrafted as follows:

> *"(57) [...] Within a selective distribution system the dealers should be free to sell, both actively and passively, to all end users, also with the help of the Internet. Therefore, ~~the Commission regards as a hardcore restriction~~ any obligation which dissuades appointed dealers from using the internet by imposing criteria for online sales which are not equivalent to the criteria imposed for the sales from the brick and mortar shop* ***may be regarded as potentially anti-competitive****. This does not mean that the criteria imposed for online sales must be identical to those imposed for off-line sales, but rather that they should pursue the same objectives and achieve comparable results and that the difference between the criteria must be justified by the different nature of these two distribution modes".*

2. Other provisions which may have a negative impact on selective distribution

48. CHANEL wishes to highlight certain provisions of the Draft VRBE which, while they do not have the same harmful potential as those analysed above, will create legal uncertainty and increase litigation risk.

2.1 The 30% distributor market share threshold

49. The scope of the block exemption has been limited by the proposed provision[24] by which it will not apply to agreements in which the buyer (and not only the supplier as under the current VRBE) has a market share above 30%.

50. CHANEL submits that this limitation of the "safe harbour" provided by the VRBE is unjustified and will significantly increase legal uncertainty. It might be argued that the consequences of this restriction are limited, since an agreement falling out of the scope of the block exemption is not automatically considered to be anti-competitive and therefore void. However, these agreements are thereby pushed into a "grey area", in which a delicate self-assessment exercise is to be carried out. In practice, this represents an unreasonable burden for the parties to an agreement.

51. Extending the market share threshold to the distributor side will, first of all, raise the issue of geographic market definition. In retailing, it may be difficult to consider that the market is EEA-wide, considering that consumers rarely travel long distances to shop and that population density and retail rents vary significantly from region to region and city to town. In many cases, authorities may consider that markets are national or even local in scope. This implies that many retailers could reach the 30% threshold: if the market is considered to be national, agreements with large distribution chains will probably be excluded from the exemption; if the markets are local, even contracts with smaller retailers might be excluded from the benefit of the exemption.

52. This will have many practical negative consequences:

    - It will render considerably more complex the management of selective distribution systems since the same standard agreement will fall in or out of the exemption depending on the market share of the retailer. Besides, distributor market shares may evolve over time, thus requiring a monitoring exercise from the supplier; and, if the markets are defined as being local in scope, the same distributor may be over the threshold in certain areas and below it in others, within the same Member State.

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[24] Article 3 of the Draft VRBE.

- ❖ Distributor market share will be an argument used in courts by those parties who wish to challenge a distribution agreement, which will render litigation more complicated.

53. In CHANEL's view, this aspect of the Draft VRBE will result in significant legal uncertainty, and it does not seem to be justified by actual competitive concerns, at least in the selective distribution context.

54. A distributor's market share could raise difficulties if, for example, a very large distributor requested an exclusivity obligation from certain suppliers, thus precluding other distributors from having access to the suppliers' products. However, this type of foreclosure scenario resulting from an exclusivity provision is not coherent within selective distribution systems in which there are no such provisions. Quite to the contrary, selective distribution is a system which encourages inter-brand competition.

CHANEL's alternative proposal

In view of the above arguments, CHANEL suggests that the market share threshold should remain limited to the supplier side, at least within selective distribution systems. This clarification could be provided for in paragraph (23) of the Draft Guidelines.

2.2 Sales to unauthorised retailers

55. The current wording of article 4(b), third indent, of the Draft VRBE, provides that a territorial restriction on sales will be considered as a hardcore restriction except for "*the restriction of sales by the members of a selective distribution system to unauthorised distributors* ***in markets where such a system is operated.***" The wording in bold has been added to the current version of the VRBE, although it already existed in the previous Guidelines.

56. This wording appears to contradict one of the most important principles on which selective distribution relies: the "tight" character of the network. In its various contributions, CHANEL has underlined the importance of the investments required to implement a selective distribution network, and the need to protect these investments. The equilibrium of the whole system depends on the absence of any "leaks": authorised retailers should be prevented from selling to unauthorised retailers, <u>no matter where the latter are located</u>.

57. In its present drafting, the added wording could be interpreted in a manner that would jeopardise this principle. A luxury brand may, as a first stage in its distribution development, implement a selective distribution network in certain Member States but not in others.

58. This does not mean that it does not wish to sell into those territories but it may wish to develop its brand or see how the network functions in part of the EEA before investing in a fully-developed network. The current wording could be interpreted as meaning that, in such case, the supplier would not be able to prevent authorised retailers from selling to unauthorised retailers located in a Member State where the network has not been implemented yet.

59. This would lead to an "all or nothing" situation: if a supplier wishes to have a "tight" network (and this is the premise on which selective distribution is founded), it will have to put in place its network in all 27 Member States from the very beginning. This will represent a significant burden for small and new brands, which could in the end discourage them altogether from implementing a selective distribution system. This risk is not theoretical, considering that luxury is an active sector and that new brands are regularly created in different Member States[25].

60. Such an interpretation would also penalise more established brand owners who wish to diversify their product lines. Well-known brands may launch a new line of products, different but complementary to their core business: this was the case, for example, when CHANEL launched its fine jewellery line, complementary to its apparel and accessories products. In this situation, the brand may initially wish to launch the new product only in a few Member States.

61. Moreover, the current wording could also be interpreted as meaning that a supplier cannot restrict sales to distributors located in a territory in which it distributes its products through its own shops and not through a selective distribution network.

62. It could even be inferred from this wording that the VRBE does not cover restrictions of sales to unauthorised retailers located outside the EEA, which would be contrary to selective distribution principles.

63. In CHANEL's view, the Commission did not intend to modify this provision in a way that could give rise to so many uncertainties and potential litigation in Member States in which a network has not been implemented yet or a brand sells through its own shops.

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[25] See, for example, brands such as Bottega Veneta, Lorenz Bäumer, Frédéric Malle or Vertu, cited by CHANEL in its Position Paper.

CHANEL's alternative proposal

CHANEL suggests that the Commission revert to the previous wording of article 4(b) third indent.

Alternatively, the following clarification could be inserted in paragraph (55) of the Draft Guidelines:

> *"The wording "in markets where such a system is operated" aims at excluding the possibility of restricting sales to unauthorised distributors in territories where the supplier itself distributes its products through non-selective distribution. It does not concern situations in which a supplier wishes to restrict sales to territories in which it sells its products through its own points of sale, or does not yet have any distribution network".*

CONCLUSION

64. A basic principle should be at the forefront of the debate on selective distribution and sales through the Internet, namely that neither the European Commission nor any other competition authority should restrict by regulatory intervention the distribution system that a manufacturer considers most appropriate for its brand, unless such action is necessary to prevent or remedy a major restriction of competition.

65. As recently pointed out by a group of economists:

"the policy-relevant question is not "do unregulated markets always and inevitably serve the consumer interest". Taking this question as the basis for policy is known to economists as "the Nirvana fallacy". The question that the design of optimal regulatory policy must ask instead is "can regulatory intervention systematically do better than the market?". In the context of selective distribution adopted by a luxury goods supplier, the question is whether the regulator can systematically improve markets by intervening, through legal restrictions on suppliers' distribution strategies that affect the price-image mix"[26].

66. Until now, the Commission, the Court of First Instance and the European Court of Justice have consistently held that vertical restraints were not restrictive of competition[27]. None of the participants in the debate over sales through the Internet has been able to point, in a precise manner, to the negative effects that restrictions such as the "ancillarity" clause could have.

67. From the economic point of view, it would be counterproductive for the Commission or any national competition authority to "micro-manage" distribution networks, unless such an intervention were justified by a major competition law concern.

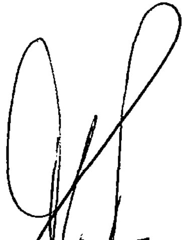
68. It appears that the Commission agrees with this approach on a global level, since it has not modified the basic structure of the VRBE and the protection it grants to selective distribution systems. It has also recognised the legitimate need for a protection against free-riding through the "brick and click" principle.

[26] *Selective distribution by luxury goods suppliers: a response to Kinsella et al.*, Thomas Buettner, Andrea Coscelli, Thibaud Vergé and Ralph A. Winter, European Competition Journal, August 2009, p. 613, particularly at p.616.

[27] See Case 107/82, *AEG/Telefunken*, 25 October 1983, §§33-34 and paragraph (102) of the Draft Guidelines.

69. However, certain provisions included in the Draft VRBE and Draft Guidelines go beyond the limits of justified regulatory intervention, and particularly the provisions which expand the definition of "hardcore" restrictions. CHANEL invites the Commission to modify these provisions, as they not only represent a serious threat to the selective distribution systems legitimately operated by many brands, but they will also give rise to a considerable risk of litigation before national authorities and courts, thus possibly resulting in contradictory decisions. This will have the effect of increasing legal uncertainty, which is precisely the contrary of the effect sought by the regulations adopted in this area.

Paris, 25 September 2009



Mélanie Thill-Tayara