

28 September 2009

**COMMENTS ON THE EUROPEAN COMMISSION'S PROPOSAL FOR A
REVISED BLOCK EXEMPTION REGULATION AND GUIDELINES ON
VERTICAL RESTRAINTS**

I. Introduction

Covington & Burling welcomes this opportunity to submit the following comments on the proposal for a revised Vertical Restraints Block Exemption Regulation (VRBE) and Guidelines that was published on 28 July 2009. These comments are based on our experience in advising clients on their European distribution and supply agreements under the current regime. As such, our comments focus on certain practical issues raised by the draft revisions.

At the outset, we would emphasize that we believe the current VRBE and Guidelines constitute a meaningful improvement over the previous form-based approach. As practicing lawyers, we have found the rules to be useable and flexible enough to allow clients to structure their supply and distribution agreements in a way that makes the most commercial sense. As discussed below, we believe that some of the proposed revisions could prove unworkable in practice and could give rise to an undesirable degree of legal uncertainty.

II. Definition of Agreement

We are concerned that the new language on the definition of "agreement" contained in the first bullet point of Paragraph 25 of the draft Guidelines risks creating confusion because it suggests that an agreement for the purposes of Article 81 may exist even when the necessary meeting of the minds is absent. The draft states: "if after a supplier's announcement of a unilateral reduction of supplies in order to prevent parallel trade, distributors reduce immediately their orders and stop engaging in parallel trade, then those distributors tacitly acquiesce to the supplier's unilateral policy." Contrary to what is suggested in this example, neither a distributor's reduction of its orders nor its decision to stop engaging in parallel trade necessarily show that the distributor has tacitly agreed with the supplier's policy. With regard to the immediate reduction of orders, the distributor may well disagree with the reduction, but consider it useless to place orders in excess of the amounts that the supplier has said that it will make available. To suggest that an agreement will arise unless the distributor continues to place orders at the previous level would lead to a broadening of the definition of agreement beyond that articulated in the jurisprudence of the Community Courts. In essence, such an approach would be tantamount to be saying that an agreement will be deemed to arise unless the distributor actively contests the reduction in supplies.

With regard to distributor's decision to stop engaging in parallel trade, the distributor may well want to continue to engage in parallel trade, but simply find that it does not have enough product to do so due to the reduction in supplies. For example, in the pharmaceutical

sector, distributors may be required by national law to ensure the supply of products for the domestic market. Thus, if a supplier reduces supplies to an amount that corresponds to demand on the local domestic market, the distributor may have no choice but to no longer engage in parallel trade because it will no longer have product available for export. Clearly, a reduction in the distributor's parallel trade activities in these circumstances should not be viewed as evidence of an agreement between the supplier and the distributor. As the European Court of Justice stated in *Bayer*: “[t]he mere fact that the unilateral policy of quotas implemented by Bayer, combined with the national requirements on the wholesalers to offer a full product range, produces the same effect as an export ban does not mean either that the manufacturer imposed such a ban or that there was an agreement prohibited by Article 85(1) of the Treaty.”¹

The discussion of the level of coercion by the supplier and the number of distributors that are implementing the supplier's unilateral policy also raises concerns. The draft states: “tacit acquiescence may be deduced from the level of coercion exerted by a party to impose its unilateral policy on the other party or parties to the agreement in combination with the number of distributors who are actually implementing in practice the unilateral policy of the supplier.” As an example of coercive measures, the draft mentions a system of monitoring and penalties which “points to” tacit acquiescence by the distributor. This language could be read as suggesting that any time that a supplier puts a system of monitoring and penalties into place and a number of distributors are continuing to deal with the supplier, an agreement will be deemed to arise. In particular, to say that tacit acquiescence may be “deduced” in these circumstances could be read to suggest that an agreement would always be deemed to arise in these circumstances.

Such an approach goes beyond the existing case law. In *Bayer*, the European Court of Justice made it clear that the existence of a system of monitoring and penalties “may ... constitute an indicator of the existence of an agreement”, but “the existence of an agreement does not necessarily flow from the fact that there is a system of subsequent monitoring and penalties.”² With regard to the number of distributors implementing a policy, the draft fails to explain why this is relevant. If a supplier imposes a unilateral restriction on the amount of product available in a given territory, the fact that the distributors in that territory continue to place orders with the supplier does not necessarily mean that any of them agree with the supplier's system. To avoid confusion, we would suggest that the draft be revised to reflect the fact that a system of monitoring and penalties may be one factor indicating the existence of an agreement, but the existence of such a system is not conclusive on this point.

III. The 30% Market Share Threshold for Buyers

The current VRBE makes the availability of the block exemption safe harbour dependant on the supplier's market share not exceeding 30%. The buyer's market share is only relevant in relation to the narrowly-defined context of exclusive supply contracts. Specifically, where the supplier contractually agrees to sell the contract goods to a single buyer for resale or for a specific use in the European Union, the availability of the VRBE is dependent on both the supplier and the buyer not exceeding a 30% market share threshold on

¹ Joined Cases C-2/01P and C-3/01, *BAI and Commission v. Bayer* [2004] ECR I-23 at ¶88.

² *Id.* at ¶83.

their respective markets. In contrast, the draft Regulation would make the 30% buyer market share threshold relevant in all circumstances.

We believe that the current regime offers ample protection against the dangers of buyer power and that the proposed 30% buyer market share threshold only introduces uncertainty without achieving any meaningful benefits. As a general rule, buyer power is more likely to be an issue where a buyer has exclusive supply rights over a large territory. Thus, under the current regime, the safe harbour afforded by the VRBE is not available if the buyer has exclusive rights for the entire Community and its market share exceeds 30%. If the buyer does not have exclusive supply rights or only has such rights over a more limited territory, the safe harbour is still available even if the buyer's market share exceeds 30%, which reflects the fact that the issue of buyer power is less problematic because customers can always obtain supplies by going to the supplier's other distributors in the Community. In those cases where buyer power is nevertheless an issue (perhaps because the buyer's market share is particularly high or it has exclusive rights over a large portion of the Community), the current regime provides an adequate solution – the withdrawal of the exemption on a case-by-case basis.

If a 30% buyer market share threshold is adopted, we would urge the Commission to allow the parties to continue to benefit from the block exemption despite any increase in market share for a period that is longer than that contemplated in the current draft. Under Article 8 of the draft VRBE, the block exemption would continue to apply for two years if the market share rises above the 30% threshold but does not exceed 35%, or for only one year if it exceeds 35%. With market share thresholds for both the supplier and the buyer, the chances of fluctuations over time are much greater than with a market share threshold for only the supplier. These fluctuations could require the parties to the distribution agreement to renegotiate the terms of the agreement, which is time-consuming, costly and detracts the parties from concentrating on the market and creating the efficiencies that any distribution agreement is meant to create, to the benefit of all parties involved, including the consumer. Suppliers may be deterred from making long-term commitments, and buyers may be deterred from investing heavily in their distribution chains. None of this is desirable, yet it is a realistic prospect.

We submit that, if the Commission decides to maintain the 30% threshold for buyers, it should introduce a system whereby the block exemption would apply for at least five years from signature of the agreement regardless of any increases in market share, which would coincide with the typical five-year term of a non-compete. Such a system would mean that the supplier who gets assurances from the buyer at the time the contract is entered into or renewed that the buyer has less than 30% of the relevant market(s), is assured that the terms of the contract will remain the same during a number of years, allowing all parties to concentrate on the market. Of course, the supplier's market share may change during that period and this may still lead to changes in the distribution agreement, but at least this is a variable where the supplier has the necessary market data to evaluate its position without being dependent on the buyer.

IV. Online Sales

A. Active/Passive Distinction

The draft VRBE retains the distinction between restrictions on “active” and “passive” sales in that it will continue to remain possible for a supplier to restrict active (but not passive) sales by buyers into territories (and to customer groups) exclusively allocated to either another buyer or reserved to the supplier itself. Given the growing importance of “online” sales, the draft Guidelines seek to clarify the distinction between “active” and “passive” sales in the context of online distribution.

Maintaining the current position, the draft Guidelines provide that online sales generally are passive sales, so that a supplier cannot, in principle, impose restrictions on its distributors regarding online sales. Essentially, distributors must be allowed to have websites that promote their products and can be accessed by consumers throughout the Community. The draft Guidelines moreover make it clear that suppliers may not attempt to restrict cross-border online sales in any of the following ways:

- preventing customers in another territory from viewing websites;
- automatically rerouting customers away from a website; and
- terminating consumers’ transactions over the Internet once their credit card (or other address data) reveals that they are located not within a particular territory.

The draft Guidelines appear to contemplate an online environment in which customers navigate directly to the website on which they want to make a purchase, but provide little guidance in relation to the increasingly important proportion of sales that are made to customers using sites identified through online searches and online search advertisements. Paragraph 53 simply states that sales through a website will not be considered to be active sales unless “specifically targeted” at certain customers. As an example, Paragraph 53 provides that “online advertisements specifically addressed to certain customers” are considered to be a form of active selling to these customers. This example would clearly cover advertisements that are emailed to potential customers, since such emails are essentially only the natural successors to direct mailings (which have always been considered to amount to active selling).

However, it is unclear to whether this language would cover newer, more sophisticated forms of online advertising such as search and banner advertisements. Search advertisements provide customers with textual ads that are placed through real-time auctions in which advertisers, using information about the searcher’s profile and history, bid to have their advertisements listed on the pages that the searcher views. Thus, a Belgian distributor of Company A’s specialized tooling machinery could bid to have its advertisements displayed on the search results page of German customers conducting online searches for such machinery. It is unclear under the current draft whether such advertisements would be considered to be active or passive selling. Banner or display advertisements also increasingly use the same type of “key word” auctions that make it possible to bid for ads aimed at potential customers in particular geographies. Given that all types of online advertisements are now in this way “tailored” to individual searchers, it would be helpful if the guidelines clarified what it means for an online ad to be “specifically addressed” to a customer.

If the Commission does not intend to treat search and banner ads as “active” selling, it should explicitly state this. Given the increasing sophistication (and use) of real-time key word auctioning technology, the Commission should take a policy decision regarding its intention to treat such ads as passive (or not), and should clearly articulate this in the Guidelines. The treatment of banner and search ads as active or passive would clearly have a significant impact on whether or not suppliers can attempt to constrain the participation of their distributors in certain key word auctions (particularly for ads for customers outside their territories).

In addition, if the Commission takes the view that some or all of such online ads amount to passive selling, it should consider whether it is appropriate to provide examples of circumstances in which the Commission considers that any attempt by a supplier to restrict a buyer’s ability to provide such ads would amount to a hard core restriction of passive selling (as it does in Paragraph 52).

We appreciate that the Commission walks a fine line in providing guidance, balancing the need to ensure that its guidance is not so technologically-specific that it becomes obsolete, on the one hand, with the need to provide guidance that is relevant and useful, on the other. Our concern over Paragraph 53 is that it uses terms, such as “online advertisement” and “specifically targeted”, without regard to the fact that the former term tends to be used in relation to search and banner ads, when the latter is a more appropriate descriptor of emailed ads. As a result, the technological-specificity of the text perpetuates, rather than removes, uncertainty.

B. Requirement of Sales Through Brick-and-Mortar Store

We are concerned that, in the context of a selective distribution system, the draft Guidelines do not give suppliers sufficient control over the channels through which their products are sold and, in particular, over online distribution. The Commission undoubtedly will receive many submissions in the context of this consultation that will explain why suppliers should be able to place limits on the online sale of their products in the context of their selective distribution systems. In particular, suppliers need to be able to place meaningful restrictions on online sales to protect brand image, combat counterfeiting, and avoid free riding by pure online distributors on the efforts of traditional distributors. While we share these concerns, we will not repeat these points here. Rather, we will focus on explaining why the proposed system is unlikely to achieve its goal of promoting online sales and, in fact, risks creating inefficiencies in the distribution chain as suppliers seek to restrict online sales.

The draft Guidelines would allow a supplier to require that a distributor have a brick-and-mortar store before it may engage in online distribution. (Paragraph 54) They also would allow the supplier to require that the distributor sell a certain absolute amount of products offline through the brick-and-mortar store. However, the supplier would not be allowed to restrict the proportion of its products that are sold online.

Under the proposed system, there is nothing that would prevent an online retailer in a selective distribution system from setting up a brick-and-mortar store in France through which it sold whatever minimum amount of offline sales were specified in its distribution agreement and then selling large amounts of product online throughout the Community. Theoretically,

the supplier could attempt to prevent this from happening by placing a limit on the number of distributors in its selective system (i.e. by instituting a so-called “quantitative” selective distribution system), but it would have to do this from the outset. Moreover, even in the case of a system with a specified number of distributors, an online retailer could always “break into” the system by purchasing one of the existing distributors. Over time, change-of-control provisions may be inserted into distribution agreements to prevent this from happening, but it is not clear how effective such provisions will be.

If a supplier is operating a selective distribution system that does not place restrictions on the number of distributors, it could restrict the volume of online sales by instituting a supply quota system. Under such a system, the supplier would limit the volume of product available to each distributor. Such a system would be difficult to implement and would necessitate a cumbersome administrative structure. Rather than inviting suppliers to engage in legal gymnastics to restrict online sales, it would seem far preferable to have a system that gave suppliers greater ability to control the channels through which their products are sold. If online sales are a profitable outlet, presumably suppliers will naturally increase their sales over this channel. But attempts to force them to do so risk creating distortions in the marketplace and inefficiencies in the supply chain.