INTERNET SALES OF LUXURY PRODUCTS

WHITE PAPER SUBMITTED TO
THE EUROPEAN COMMISSIONER FOR COMPETITION
ON BEHALF OF
LVMH

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# INTERNET SALES OF LUXURY PRODUCTS

## TABLE OF CONTENTS

**Introduction And Summary**

I. An Economic Analysis Of The Use Of Selective Distribution By Luxury Goods Suppliers.................................................................................................................................11

II. Current Framework For The Assessment Of Internet-Related Vertical Restraints In Selective Distribution Networks Under European And French Competition Law......17

III. Evolution of the assessment of vertical restraints under u.s. Antitrust laws.............26

IV. Proposal For The Treatment Of Internet-Related Vertical Restraints In Selective Distribution Networks Under European Competition Law .................................................34

V. Answers To Questions Raised In The Issues Paper.......................................................36
LIST OF ANNEXES

Annex 1  An economic analysis of the use of selective distribution by luxury good suppliers, Report by CRA International, September 2008

Annex 2  Chart: internet-related provisions in the texts leading to the adoption of Regulation 2790/1999 and the Commission Guidelines on vertical restraints

Annex 3  Decisions 06-D-24, 06-D-28 and 07-D-07 of the French Competition Council

Annex 4  April 18, 2008 judgment of the Paris Court of Appeals (Pacific Creation v. PMC Distribution)

Annex 5  Opinion of the U.S. Supreme Court in Leegin Creative Leather Products, Inc. v. PSKS, Inc. (June 28, 2007)


Annex 7  Brief for the United States (Federal Trade Commission and Department of Justice) as Amicus Curiae Supporting Petitioner, Leegin Creative Leather Products, Inc. v. PSKS, Inc.
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INTRODUCTION AND SUMMARY

1. The European Commissioner for Competition has recently decided to establish a high level working group concerning “Opportunities in Online Goods and Services” and has invited the Chairman of the Board of Directors of LVMH to participate in the working group. LVMH understands this initiative to be part of the general review by DG Competition of European regulations concerning the “vertical restraints” authorised in exclusive or selective distribution networks. This regulatory review raises the issue of whether the protection of selective distribution networks for luxury goods should be called into question to increase the commercial space available to the already significant development of online sales for these products.

2. LVMH welcomes the Commissioner’s initiative to convene a working group on online sales, as this will enable a full consideration and discussion of certain key issues for the European luxury sector as well as many other sectors that should be taken into account in making future competition policy decisions. As a contribution to the working group, LVMH has asked Cleary Gottlieb Steen & Hamilton and CRA International to prepare a white paper setting out legal and economic perspectives on the analysis of internet-related vertical restraints in the selective distribution of luxury goods.

3. For the reasons summarized below, LVMH considers that the existence of selective distribution networks is indispensable to the very existence of the luxury goods industry and the preservation of the image and economic value of high-end branded products. The remarkable success of the European luxury industry is based on the possibility to safeguard the economic incentives that result in the creation, the continued innovation and the value of its intangible capital. From an economic standpoint, the importance of investment in brand image and in highly sophisticated capital and labour-intensive distribution networks is only viable if its intangible value is protected from “free-riding”. While online sales have played an important part in the recent growth of many markets including in the luxury area, its ability to reach many potential customers with very limited investments raises a delicate question both for regulators and the luxury good brands.
There Is a Strong Consensus Among Contemporary Economists On the Pro-
Competitive Effects of Vertical Restraints in Most Cases

4. Among contemporary economists, the consensus on vertical restraint issues is strong. The importance of the investments required to create and preserve a brand image has long been recognized as an important dimension of developed economies. In so far as there is consumer demand for luxury goods, that is demand addressed to products with specific characteristics (image, prestige, service, price), economists consider that it is normal for suppliers to organise distribution networks capable of satisfying this demand. From an economic point of view, the choice to invest significant amounts in a selective distribution network is similar in nature to the decision to commit expenses to TV or print advertising. This is the reason why economists consider that competition regulators who, rightfully, have never considered regulating advertising choices or expenses should in principle, and barring special circumstances, equally abstain from regulating investments in the creation and development of distribution networks. To the extent selective distribution networks represent an essential part of the promotion and preservation of the brand image of luxury goods sought after by consumers, defending the existence of such networks is, from an economic point of view, a legitimate task.

5. In this respect, since the beginning of the 1970s, numerous economic studies have emphasized that suppliers and distributors would have no incentive to invest in a luxury distribution network – which requires promotion expenses, training of an important sales force, and significant fixed assets – if competing distributors could “free ride” and benefit from this effort without having to commit to the same expenses. Online sales are but one dimension of this classical issue: the survival of a luxury goods supply network will depend on the network’s ability to control the value of its investments and the incentives to promote the brands. This is particularly true for online sales, which are extremely difficult to control or regulate and may have a very wide-ranging impact all over the world while requiring only minimal investment. It is only in exceptional cases, such as the presence of a dominant supplier which would use its network to prevent market access by its competitors, or where the existence of protected networks facilitates a cartel among suppliers or distributors, that regulatory intervention may be justified. In all the other cases, it is for suppliers
and consumers to choose the right mix level between a service-intensive, higher-priced distribution model, or lower prices for less sophisticated products.

**Compared To U.S. Antitrust Laws, EC Competition Law Takes A Limited View of The Pro-Competitive Benefits of Selective Distribution**

6. EC competition law has long recognized that certain industries, in particular for luxury or high technology products, may legitimately organise protected distribution networks, either in the form of exclusive distribution or selective networks (within which distributors are selected based on specific criteria and agree on specific quality requirements). This policy was defined, among others, in Commission Regulation 2790/1999 and its accompanying Guidelines, which we understand will be revised in the course of 2009. In the selective distribution context, existing precedents and case-law would seem to limit the contractual provisions which may benefit from an exemption from the antitrust prohibitions (essentially, these are the provisions which organise the selection of distributors and the provisions which limit sales at different, or outside of, the network). These provisions are nevertheless regularly challenged by certain online sales operators which would like to gain access to products sold by selective networks without having to bear the corresponding constraints (in particular, the significant costs incurred in order to create a network of points of physical sale and maintain adequate sales personnel).

7. It should be noted in parallel that, in the United States and in most economies with important luxury sectors (in Asia for example), luxury goods industries are not subject to similar legal constraints. U.S. competition authorities have in particular adopted, for many years, a much more liberal position vis-à-vis market players, on the grounds that in the absence of very specific circumstances (such as a dominant position), it is for the industry players to choose the distribution system that is the most adequate for the sale of their products, and regulatory intervention is generally not necessary. Similarly, American courts take the view that vertical restraints do not constitute “per se” competition restrictions: in this respect, it is significant that (i) the U.S. Supreme Court recently decided that among the legitimate means of protection of a distribution network, suppliers could resort to minimum resale price maintenance without necessarily infringing federal antitrust laws (*Leegin*); and (ii) this solution was advocated by both federal antitrust agencies (DOJ and FTC) in the joint opinion they
submitted to the Supreme Court. In the United States, limitations placed on internet sales by luxury goods manufacturers have thus not been subject to regulatory intervention for a very long period of time. By comparison, European competition has traditionally been considerably more interventionist and suspicious vis-à-vis selective distribution, in spite of the criticisms submitted by a significant number of economists.

**The Legitimacy Of Selective Distribution Networks Should Not Be Undermined By A Regulatory Bias In Favour Of Internet Sales**

8. Selective distribution is a key characteristic of the luxury goods industry, not only in Europe but in all advanced economies. It is also a European competitive success story. The luxury sector in Europe is characterized by vigorous competition and numerous players, high growth and constant innovation. Any regulatory intervention on the suppliers’ ability to freely organise their distribution networks, in particular when they choose to invest in costly and complex networks to satisfy consumer demand for high-quality service level, must be very carefully weighed. Both the economic consensus and the U.S. position reflect the fact that regulatory intervention in vertical restraints is only necessary in very limited cases.

9. The development of online sales does not call into question this basic principle. Quite to the contrary, the fact that online sales allow distributors to reach a significant number of potential buyers on the basis of minimum investments reinforces the risk of free-riding that has long been identified by economists. It is thus legitimate, for competition motives, that suppliers be able to implement reasonable measures to balance online sales in accordance with the importance of the investments made and the need to protect the brand image of the entire network.

10. Selective distribution is not irreconcilable with the development of online sales, as evidenced by the fact that many luxury products, including LVMH’s, can be purchased online by consumers on a variety of company-owned or distributors’ websites. For clarity of the debate, however, it is important to fully understand the difference between online vendors which operate their websites within the classical requirements of selective distribution (and thus benefit from the positive effects of the
network as any other distributor) and website operators which are not prepared to share in any of the investments necessary to maintain the network.

11. Many online vendors, whether European or world-wide in scope, comply with selective distribution rules for luxury products. In fact, the European Commission’s and the French Competition Council’s and Court’s decisions show that it has been possible to define a general assessment framework allowing regulators and courts to effectively review the legitimacy of individual provisions on a case-by-case basis. In the circumstances, although they still seem in some cases overly restrictive of suppliers choices, the solutions resulting from those cases appear to have struck a balance between the protection of consumers and preserving legitimate distribution networks by recognizing that suppliers may require distributors wishing to engage in online sales of luxury products to:

- Already operate a sufficiently large “brick-and-mortar” outlet satisfying objective quality criteria;

- As the other authorised distributors, commit the necessary investments for the website to be compatible with the brand prestige and to ensure delivery of products in perfect condition;

- Commit to a ratio between outlet- and online-sales to avoid their running of physical outlets becoming an activity merely incidental to online selling.

12. Similarly, solutions exist allowing for the sale of luxury products on auction websites. These sales appear possible as long as the website operators:

- Introduce safeguards against counterfeit products by requiring vendors to disclose their identity (with mere pseudonyms not allowed) and certify the authenticity of the products offered for sale subject to being barred from participating in future auctions;

- Bar vendors who, although not being authorised distributors for a particular brand, offer products for sale with such a frequency or in such quantities that they appear as “professional” vendors;
• Introduce adequate product-tracing requirements, which vary depending on the nature of the products (for instance, for luxury perfumes, the disclosure of the number engraved on the bottle and the packaging, and the provision of pictures showing these serial number).

13. By contrast, website operators who refuse to comply with these reasonable requirements, not only pose a very significant threat to the very existence of selective distribution by jeopardising the basic economic incentives for investing in luxury brands, but also endanger consumers at large. Counterfeiting is one of the most threatening forms of free-riding, and luxury brands are constantly being targeted by illegal cloning activities. As numerous recent examples show, the threat of counterfeiting is compounded by the use of illegal web-sites and uncontrolled web platforms. These threats are of a very serious nature because they can potentially affect the viability of luxury brands. As evidenced by the fate of other industries such as music, the illegal use of internet can have a drastically negative effect because (i) it is easily accessible with no or very little investment, (ii) its reach is potentially worldwide and (iii) it is extremely difficult to police. In addition to these well-known risks of counterfeiting and money laundering, consumer protection considerations should not be overlooked, as consumers who through certain websites unknowingly purchase fake, deteriorated or damaged products, without any guarantee as to the identity of the vendor or the product origin and authenticity, are left without any practical means of redress.

14. We argue in this paper that specific contract provisions intended to regulate online sales and make them compatible with the existence of a selective network must be left to the largest possible extent to the choice of luxury goods suppliers.

15. What is at stake should not be under-estimated: calling into question the existence of selective distribution networks either directly or through an intervention in favour in internet sales without appropriate safeguards would potentially affect the entire economic chain of luxury industry (brand value, service quality, level of employment, development of the European luxury goods industry).
Structure Of The White Paper

16. This white paper is organised as follows: Section I summarizes the economic foundations of vertical restraints as applied to selective distribution; Section II describes the legal framework recently laid out in French decisions analysing in detail, under French and EU law, internet-related vertical restraints in selective distribution networks; Section III presents the evolution of the assessment of vertical restraints under U.S. antitrust laws, leading to the recognition of their potential procompetitive effects and the application of a “rule-of-reason” standard even to resale price maintenance; Section IV submits proposals for the clarification of EU legislation; and Section V addresses the questions in the Issues Paper that are most relevant for LVMH.

17. This paper focuses on online sales of physical products (i.e., the luxury products of the type sold by LVMH) and does not address issues related to digitally-delivered content.
I. AN ECONOMIC ANALYSIS OF THE USE OF SELECTIVE DISTRIBUTION
BY LUXURY GOODS SUPPLIERS

18. LVMH commissioned a group of economic experts\(^1\) to review the economic foundations of vertical restraints on distribution, as applied to the selective distribution of luxury goods. Their report is enclosed as Annex 1 to the white paper, and this section summarizes the issues reviewed by the report and its conclusions.

19. The report provides an overview of the economic foundations of competition policy towards vertical restraints on distribution and then applies the economic analysis to a particular context: the selective distribution of luxury perfumes and cosmetics by Christian Dior Parfums (“Dior”). “Selective distribution” in this case includes the choice by an upstream supplier of luxury goods to place restrictions on, or even to prohibit, distribution of its products through the internet.

20. Is there an economic basis for competition policy to constrain the distribution strategies adopted by the supplier of a set of products? If so, what is the appropriate set of constraints to be imposed by policy and under what conditions should these constraints apply? These questions are highly contentious – and, the report argues there is no aspect of the policy towards restraints on distribution more misunderstood than the role of inter-brand competition, \textit{i.e.}, competition among suppliers. There is general agreement among economists that strong inter-brand competition should be \textit{sufficient} to allow firms to freely choose any vertical restraints they wish to impose on their retailers. A supplier that did not adopt a distribution strategy that served consumers’ interest would not survive in an intensely competitive product market. Consumers would simply choose another product. The more difficult issue is whether intense inter-brand competition is also \textit{necessary} for freedom of choice in distribution, within an optimal policy, that is whether for instance dominant companies should also be free to adopt their desired vertical restraints. A reading of the European Commission’s Guidelines on Vertical Restraints (“the Guidelines”), consistent with European competition policy in general, reveals a suspicion towards business practices adopted by a dominant firm. Essentially, in imposing vertical restraints such

\(^1\) Dr Andrea Coscelli, Vice President, CRA International; Dr Thomas Buettner, Principal, CRA International; Dr Thibaud Vergé, Centre de Recherche en Économie et Statistique (CREST), Paris; and Professor Ralph A. Winter, Senior Consultant, CRA International.
as selective distribution a dominant firm bears the burden of proof in demonstrating that the benefits of vertical restraints (especially in resolving “free rider” problems, as discussed below) more than offset the social costs of any decrease in intra-brand competition.

21. Should strong inter-brand competition be necessary for a supplier to be free to choose its distribution strategy? The report addresses this question by analyzing at the outset the incentives for vertical restraints such as restricted distribution where inter-brand competition is completely absent: the case of a monopolist supplier, without even the threat of competition. To begin, the report notes that in a world where demand depended only on price, a monopolist would have no reason to restrict intra-brand competition. This is because such restrictions can only increase retail price and therefore reduce demand; for any given wholesale price (and wholesale margin) the reduced demand represents a loss of the number of units on which the wholesale margin is earned – i.e. a loss in profits – for the supplier.

22. The key piece of evidence in a vertical restraints case is that the firm is choosing to use the restraints. It follows that demand must depend on more than price (as this strategy would otherwise lead to a loss of profits for the firm). Indeed, demand in a retail market depends, beyond price, on many dimensions of retail activity including point-of-sale service and information, the provision of a comfortable and pleasing shopping environment, the enthusiasm of the sales staff, the retailer’s reputation for post-sales service and product return, the retailer’s reputation for carrying products of high quality, any activities that the retailer undertakes to add to the image of the product, and so on. A monopolist that adopts selective distribution or other restraints on retailers must be doing so to enhance a non-price dimension of demand.

23. How does a vertical restraint enhance non-price retailer activities? Selected distribution increases non-price dimensions of retailer activity, such as service, through three mechanisms:

- The first, or direct, mechanism is simply through the protection of the retail margin: when intra-brand competition is restrained, retail margins are higher, and since the retail margin represents the marginal benefit to a
retailer of attracting demand through non-price instruments, the retailer’s incentive to provide these non-price instruments is enhanced.

- Second, in cases where there is any free-riding on services—that is, where a customer obtains pre-sales service (such as expert information, consultation or, for example, sampling perfumes) at a high-priced outlet and then purchases the product at a low-priced outlet that provides no service (such as an internet site) – prohibiting sales through these low-priced, no-service outlets increases the incentive for other stores to provide the informational service since they retain all of the customers that they inform.

- Third, restraining intra-brand competition enhances the profits that outlets earn. If an upstream supplier contracts with outlets for high service and must monitor (at some cost) the provision of this service with the strategy of terminating dealers who under-provide the service, the additional profits represent a “carrot” that is lost with termination and therefore enhance outlets’ incentive to provide the service.

24. Why are vertical restraints necessary to ensure adequate service or other dimensions at the retail level? That is, why does an unrestrained retail market not adopt the mix of price and service (or other variables) that an input supplier would find ideal? Two theories are prominent. The first is the free-riding theory. To the extent that there is free-riding on special services (such as advice or sampling), or on other retailers’ reputations for carrying high-quality products, or on retailers’ efforts to enhance the image of a luxury product, the incentive to provide such services or quality assurance is clearly compromised. The second theory recognizes that consumers are heterogeneous. In an unrestrained downstream market for a supplier’s product, retailers will choose the mix of price and non-price instruments to attract consumers not just into the market (i.e. away from other products) but away from other retailers as well. The consumers that can be attracted from other retailers are those willing to shop and price-compare, and these consumers are often more concerned with price than with services. From the perspective of the upstream supplier, who would like retailers’ strategies to be designed around attracting consumers into the market, retailers are therefore biased towards low prices and away from high service in their strategies to attract demand. The upstream supplier can correct the bias, whether the
bias comes from consumer heterogeneity or free-riding, by adopting restraints on intra-brand competition as explained above. (Note that the same considerations in relation to the efficiency reasons to adopt a selective distribution (e.g., deal with free riding issues and/or consumer heterogeneity) also apply to an upstream supplier competing with other suppliers in a differentiated product market such as Dior.)

25. Given this background, the final question in the case of the upstream monopolist is whether competition policy can reliably enhance consumer welfare or total welfare by restricting the supplier’s use of vertical restraints such as restrictive distribution. Vertical restraints are simply a means of enhancing non-price dimensions of retailer activity such as service, the shopping environment, or expenditure on image, at the expense of higher prices. Just as policy does not restrict a supplier’s direct choice of price versus non-price determinants of demand such as advertising, nor should it intervene when this choice is implemented through vertical restraints. No foundation exists in economics for assuming that a supplier is consistently biased towards excessive non-price dimensions rather than low prices in attracting consumers, and there is thus no sound basis for restricting a monopolist’s use of vertical restraints. When free-riding problems are the source of incentive for vertical restraints, social welfare unambiguously decreases with regulation, but even when consumer heterogeneity is the driving force, a monopolist is not systematically biased in the choice of low prices versus high service. This is true even when the non-price dimension is simply the enhancement of a product image, such as may be true when a supplier of luxury goods insists that the goods be distributed only through up-market retail outlets. Consumers are evidently willing to pay substantial amounts for a high-image product and public policy must respect this revealed value.

26. A central point in the report’s analysis is that the burden of proof, in government intervention in a supplier’s willingness to trade off higher prices for enhanced image or service, must lie on the regulator. To say that restricting a supplier’s choice of distribution strategy is justified because it might increase consumer welfare (i.e. because the monopolist might be biased towards high image and away from low prices) is simply wrong. Competition policy that places the burden of proof on a supplier to justify its strategy, rather than on the regulator to demonstrate a market failure, i.e. that the supplier is biased against low prices, is simply wrong. The
Guidelines as they are currently written contrast in this respect with economic learning.

27. With a liberal approach to competition policy towards vertical restraints justified in the two extreme cases of a pure monopolist and intense inter-brand competition, the only scope for intervention must lie in the intermediate case of a concentrated but not monopolistic inter-brand market (e.g. a duopoly). There are indeed two theories that can support intervention in general vertical restraints cases in markets of intermediate concentration:

- The first theory, which has been applied in resale price maintenance (RPM) cases, is that RPM can facilitate collusion when retail prices are easily observable by rivals but wholesale prices are not and the link between wholesale prices and retail prices is stochastic or variable. This theory, however, has no applicability to restrictive distribution. Preventing internet distributors does not facilitate collusion by a cartel, for example. (Indeed, online prices are more easily observable, not less so.)

- The second theory to justify intervention in suppliers’ decisions on vertical restraint is one that has been offered in the theoretical literature on vertical restraints but not applied to any cases. Suppose that an upstream supplier commits to protecting its downstream retailer margins. This strategy can be shown to commit the supplier to relatively “passive” behaviour in terms of its price competition with its rival(s). The observation by the rival of such commitment, in turn, induces the rival to set a higher price – and this decision by the rival feeds back to higher price on the part of the supplier. The theoretical literature developing this “strategic theory” of vertical restraints and related theories has not offered any guidance as to evidence that could be brought to bear in support of the theory and quite importantly, the models have focused on applications where retailers are exclusive to particular upstream suppliers, which is not the case in the luxury perfumes and cosmetics markets, where suppliers sell through common retailers.

28. The report concludes with an extensive application of the economic analysis to the luxury perfumes and cosmetics offered by Dior. It finds the following:
First, the markets for Dior perfumes and cosmetics tend to be highly competitive. This, as the report has suggested, should in itself be sufficient to reject the position that policy intervention in this firm’s choice of distribution strategies is in the consumers’ interest.

Second, luxury perfumes and cosmetics are highly vulnerable to free-riding because a consumer can sample the product and simply be attracted to the product by its display in an up-market retail store (via the enhancement of the product image that this display entails) and then purchase the product online. The evidence is that Dior undertakes significant investment at the point of sale in product demonstration, in sales forces and in enhancing product image. (The compensation of up-market retailers in the form of high retail mark-ups is a form of compensation for investment by these retailers.)

Third, selective distribution can enhance retailers’ incentives to carry adequate inventories of the product.

Finally, selective distribution helps fight the distribution of counterfeit products that is a very significant problem for luxury goods suppliers.

29. Note that it is enough, in the design of optimal competition policy for a case like this, to suggest plausible efficiency reasons for the use of vertical restraints and to rule out conditions under which the restraints are clearly anticompetitive. The burden of proof must lie on the regulator; a coherent policy cannot be based on the mere possibility that welfare be improved when an input supplier is prevented from implementing its chosen distribution strategy. And in the report’s empirical application, the efficiency reasons in total provide not just a plausible explanation but a very compelling explanation of Dior’s distribution strategy and Dior’s desire to impose restrictions on internet sales.
II. CURRENT FRAMEWORK FOR THE ASSESSMENT OF INTERNET-RELATED VERTICAL RESTRAINTS IN SELECTIVE DISTRIBUTION NETWORKS UNDER EUROPEAN AND FRENCH COMPETITION LAW

30. The basic EU regulation on vertical restraints does not contain any provisions concerning internet sales. In addition, the guidelines issued by the Commission in 2000 only include a few paragraphs, which were adopted apparently without any extensive discussion of the issues at stake. Since 2000, there has been no EU case-law that would have clarified internet-related vertical restraints, although there has been limited (albeit useful) Commission decisional practice. Recent French case-law, however, offers useful and detailed guidance on the application of principles laid out by the EU Guidelines.

The Block Exemption On Vertical Restraints Does Not Address Internet Sales

31. The current framework for the assessment of selective distribution networks under European competition law is Commission Regulation 2790/1999 of December 22, 1999 on the application of Article 81(3) to categories of vertical agreements and concerted practices (“the Block Exemption”). The Block Exemption covers vertical restraints and thus treats selective distribution agreements as vertical agreements which, provided they meet certain conditions, can benefit from the derogation (“exemption”) to the prohibition laid down by Article 81(1).

32. Although covering vertical agreements generally, the Block Exemption includes five provisions that specifically concern selective distribution networks:

- A definition of selective distribution (Article 1(d));
- The express exemption of provisions restraining “sales to unauthorised distributors by the members of a selective distribution system” (Article 4(b));
- The prohibition of restrictions of “active or passive sales to end users by members of a selective distribution system operating at the retail level of trade, without prejudice to the possibility of prohibiting a member of the
system from operating out of an unauthorised place of establishment” (Article 4(c));

- The prohibition of “the restriction of cross-supplies between distributors within a selective distribution system, including between distributors operating at different level of trade” (Article 4(d)); and

- The absence of an exemption of “any direct or indirect obligation causing the members of a selective distribution system not to sell the brands of particular competing suppliers” (Article 5(c)).

33. There are however no provisions concerning online sales or advertising (or any other internet-related issues) in the Block Exemption, either for vertical agreements generally or for selective distribution. Only the guidelines for the application of the Block Exemption\(^2\) include a few paragraphs on this topic. Indeed, a review of the legislative history shows that internet-related issues appeared late in the process and were not the subject of an extensive debate or discussion.

**Internet-related Issues Were Not A Major Topic of Discussion In The Debate Preceding the Adoption of the Block Exemption and Commission Guidelines**

34. Neither the 1997 Green Paper on vertical restraints nor the September 1998 Commission communication include any reference to internet, although they mention generally “new forms of distribution” as a possible development.\(^3\) The first express mention of internet as a means of selling products appears in the draft Commission guidelines of September 1999, which designate the “use of internet to advertise or to sell products” as a form of passive selling. Online sales must thus be permitted, unless the website concerned is clearly designed to reach the customers of another (exclusive) distributor. Unsolicited emails to individual customers is, however, considered active selling which may be prohibited.

35. The final guidelines, adopted six months after the Block Exemption, contain three paragraphs (out of 229) addressing Internet sales, in the general section of the

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\(^3\) Enclosed as Annex 2 is a review of the treatment of internet-related issues in the vertical restraints in the draft materials issued before the adoption of the Regulation and the Guidelines.
document. The Guidelines essentially reiterate the principles laid out in the 1999 draft (*i.e.*, advertising or selling on the internet is considered legitimate passive selling, subject to certain limitations such as not specifically targeting customer outside the territory or sending unsolicited emails to individual customers). Also, the Guidelines indicate that while a supplier (in particular in the context of selective distribution) may impose quality standards for the internet site, an “outright ban...is only possible if there is an objective justification”.  

36. Online sales have thus not been an important topic of consultation and discussion in the elaboration of the Block Exemption and Guidelines, and only appeared, through one short paragraph, in one document before the adoption of the final guidelines. Of course, this situation may be explained by the fact that online sales had not developed to the levels they have reached today, with the consequence that few players, if any, might then have had enough perspective and experience on the subject to provide an extensive and reasoned input. In light of this, LVMH welcomes the Commissioner’s initiative to convene a working group on online sales, as this will enable a full consideration and discussion of the issues that should be taken into account.

37. Since the adoption of the Block Exemption and Guidelines, there has been no case at the European Court of Justice addressing the interplay between selective distribution and online sales under EC competition law. Although the Commission has considered this issue in two cases, in 2001 and 2002, the cases were ultimately closed by means of a comfort letter and provide limited, albeit useful, guidance on specific provisions that may be acceptable. Recent French decisions however offer a more detailed examination of these issues, including by taking into account the EU regulations and the Commission’s decisional practice, and lay out a general analysis framework that could inform the discussion of online sales at the EU level.

4 Guidelines, paragraphs 50, 51 and 53.
Recent French Decisions Offer Useful and Detailed Guidance On the Interpretation of EC competition law Principles When Applied to Internet Sales and Selective Distribution

38. Three decisions recently issued by the French Competition Council (two in 2006 and one in 2007), and a 2008 judgment of the Paris Court of Appeals examined provisions of selective distribution agreements governing internet sales.

39. These cases, copies of which are enclosed at Annexes 3 and 4, concerned the following sectors:

- Luxury watches (Festina),
- High-end electronic products (Hi-Fi),
- High-end cosmetics and personal hygiene products (Cosmetics), and
- Perfumes (Pacific Creation).

40. These cases, which were all decided on the basis of EC and French competition rules, give some guidance on (i) the general principles that govern internet sales of products sold through selective distribution networks, and (ii) the specific conditions that a supplier may lawfully seek, under applicable competition rules, for the online sales of its products.

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6 Council Decision n°06-D-24 of July 24, 2006, Festina France. Festina agreed to amend its master selective distribution agreement by incorporating provisions relating to on-line sales, following a complaint by Bijourama, a company engaged in selling watches exclusively over the Internet. This decision was upheld by the Paris Court of Appeals in a judgment of October 16, 2007.

7 Council decision n°06-D-28 of October 5, 2006 relating to practices in the high-end electronic products sector.

8 Council Decision n°07-D-07 of March 8, 2007 relating to practices in the market for the distribution of high-end cosmetics and personal hygiene products. Ten suppliers of high-end cosmetics (including L’Oréal and Johnson & Johnson) offered undertakings to address the concerns raised by the Council regarding restrictions to on-line sales.


10 In Festina, the Council considered that EC competition law was applicable due to the “number of distributors of Festina located in border regions and the vocation of internet to be a means of communication and sales beyond borders” (para. 77). In the Cosmetics case, the distribution agreements reviewed by the Council covered sales within the EEA (para. 121).
General Principles

41. In the first case, *Festina*, the Council reviewed the internet-related provisions of the standard selective distribution contract of Festina, a luxury watchmaker. Before examining the individual provisions at stake, the Council made the following comments on the issues raised by the case:

> When it comes into competition with an organised physical distribution network, in particular a selective distribution network, exclusive sales on the internet raise issues concerning the allocation of the costs borne for constituting the network and in terms of free-riding, that is, the fact for a company to draw benefits from actions or efforts committed by another company, without sharing in the costs of the latter...If online sales are in one sense beneficial to consumers in that they facilitate price competition, they may also constitute a source of competitive distortions between distributors, and, through their ability to indirectly lead to the disappearance or rarefaction of certain services, induce less positive effects for consumers (*Festina*, paragraph 70).

42. The Council recalled the basic principle of “*the competition policy for vertical restraints since the entry into force of Regulation n°2790/1999* [the Block Exemption]” that manufacturers are free to organise the distribution of their products, subject to the limitation that such organisation implemented does not have as its object or effect to affect the functioning of the market (paragraph 71). In the absence of provisions concerning internet sales in the Block Exemption, the Council reviewed such provisions in the Guidelines, and the press releases issued by the Commission in the cases *Yves Saint Laurent Parfums* and *B&W Loudspeakers*.

43. The Council concluded from this review that “*if no text expressly provides for the possibility for the organiser of a distribution network to reserve internet sales to the members of its network, such a solution appears compatible in a certain number of cases with the competition rules applicable to vertical restraints*”. In particular, in the absence of parallel cumulative networks that may have significant foreclosure effects and as long as the manufacturer’s share is below the 30% threshold of the Block Exemption, a supplier may, without having to provide any justification, “*select its
distributors on the condition that they operate a shop to display the products and receive visits from consumers, that is, by excluding pure internet vendors from its network” (paragraphs 82 and 83).

44. In the subsequent Hi-fi decision, the Council conducted the same review of EC competition law and decisional practice and concluded that, in the context of selective distribution networks:

- An outright prohibition of internet sales cannot be justified absent exceptional circumstances;
- Restrictions to internet sales must be proportionate to the objective sought and comparable with those that apply to the physical points of sales of the distributor concerned (paragraph 32).

45. Finally, in the Cosmetics decision, the Council added that, concerning restrictions or conditions applicable to the internet sales of products sold through selective distribution, although quality standards are admissible, they must meet the two conditions of proportionality and similarity with point-of-sale conditions, and “must not lead to a de facto prohibition of internet sales through the imposition of excessive requirements” (paragraph 97).

**Specific Conditions**

46. The Council applied the analysis framework it had derived from EU legislation and the Commission’s guidance and decisional practice to assess numerous and varied clauses of the selective distribution contracts it reviewed. For example, the following specific conditions were deemed compatible with competition law:

- **Existence Of A Physical Point Of Sale.** The three Council decisions as well as the two Commission cases make clear that a manufacturer may generally reserve the possibility to sell products on the internet to members of its distribution network. In Pacific Creation, the Paris Court of Appeals also considered that a perfume manufacturer could reserve this possibility to members of its network having operated a physical point of sale for more than
one year; in addition, the manufacturer could reserve to physical points of sale the launch of new products for a maximum period of one year.

- **Quality Of The Website.** In *Festina*, the following requirements regarding the quality of the distributors’ websites were deemed acceptable by the Council: (i) the products should be displayed on the distributors’ websites in a way that avoids any confusion with competitors’ products; and (ii) the information, banners, logos, colours and formatting related to the products must be approved by Festina. In the *Hi-Fi* decision, the Council accepted the requirement that the website must respect the graphical requirements of the supplier and include a link to the supplier’s website. Similarly, in the *Cosmetics* decision, requirements concerning the quality of the website and the presentation of the products were accepted (the Council however considered that the requirements concerning, e.g., the precise definition of the quality and size of the photographs on the website, and the limitation of on-line sales to sites solely dedicated to the sale of products sold on the advice of a pharmacist were excessive in the circumstances).

- **Sales Through Internet “Platforms”.** In the *Cosmetics* case, some of the conditions regarding the quality of the distributor website (*i.e.*, dedication to products sold with pharmaceutical advice) indirectly prevented distributors from using third-party platforms that act as intermediaries. The Council agreed that such platforms raised serious issues in terms of vendor identification and product authenticity. The Council concluded that the fears of illegal sales (*i.e.*, of counterfeit products or of original products sold by vendors who are not licensed by the selective distribution network) justified the exclusion of this sales channel for the time being, until platforms could provide additional guarantees concerning the quality and the identity of online vendors. The Council also noted that, based on statements made by their representatives, platform providers considered they could work to meet the qualitative criteria for adequate product presentation in “virtual shops” that would be reserved to authorised distributors. Two suppliers did not exclude
the use of platforms by distributors in the future if the platforms could comply with the applicable requirements.\textsuperscript{11}

- \textit{Advice And Services To The Customers}. The supplier may require that online distributors be able to give consumers appropriate advice or information and to answer any questions asked on-line by the consumers within a short period of time. In \textit{Cosmetics}, the Council found that the maximum time-limit for responding should be reasonable (\textit{e.g.}, a maximum of 12 hours would not be acceptable).\textsuperscript{12} Distributors may also be required to provide appropriate after-sale services. In the \textit{Hi-Fi} decision, the Council accepted that the website must be deactivated during periods where the distributor cannot fulfil its service obligations, and that, for the most sophisticated products, the customer must be given the option to test the product in a physical outlet before purchasing it via the Internet.\textsuperscript{13}

- \textit{Advertising and Brand Use}. In \textit{Festina}, the Council accepted that non-tariff advertising and advertising links be approved by Festina. However, such control must be based on a legitimate concern for protecting the reputation of the brand and the distribution network, and should not cover “natural search engines”.\textsuperscript{14} In \textit{Cosmetics}, the Council asked the suppliers to remove from their distribution agreements the prohibition against using the suppliers’ corporate names and brands as key words for listings in search engines.\textsuperscript{15}

- \textit{Sales}. In \textit{Cosmetics}, the Council accepted certain quantitative restrictions to Internet sales, provided they do not exceed what is necessary to avoid the development of a parallel market (\textit{e.g.}, any order of more than 10 identical products must be approved by Johnson & Johnson).\textsuperscript{16} However, the following restrictions to on-line sales were considered excessive in the circumstances: (i) the obligation to insert a message recommending to buy from a physical outlet; (ii) restrictions related to on-line prices; and (iii) territorial restrictions

\begin{itemize}
\item \textsuperscript{11} \textit{Cosmetics}, para. 104-105.
\item \textsuperscript{12} \textit{Cosmetics}, para. 107-110.
\item \textsuperscript{13} \textit{Hi-Fi}, para. 17-20.
\item \textsuperscript{14} \textit{Festina}, para. 88-96.
\item \textsuperscript{15} \textit{Cosmetics}, para. 124-130.
\item \textsuperscript{16} \textit{Cosmetics}, para. 111-115.
\end{itemize}
or restrictions regarding the translation of the website into foreign languages (however, the distributor may be required to be able to answer to the questions of the customers in the languages of all the countries where it accepts to deliver).\textsuperscript{17}

\textsuperscript{17} Cosmetics, para. 116-130.
III. EVOLUTION OF THE ASSESSMENT OF VERTICAL RESTRAINTS UNDER U.S. ANTITRUST LAWS

47. Over the last three decades, the U.S. Supreme Court has developed a new approach to analyzing vertical restraints of trade under U.S. antitrust laws. This jurisprudence rejects prior case law that held that vertical restraints are necessarily harmful to competition and recognizes the potential procompetitive benefits of allowing producers to choose for themselves the most efficient means of distributing their products.

48. Of significant interest is the U.S. Supreme Court’s most recent (June 2007) judgment, *Leegin*, in which the Court conducted a careful examination of the potential procompetitive benefits of vertical restraints, and, against that background, found that even resale price maintenance cannot *a priori* and systematically be considered devoid of such procompetitive benefits. Although the factual situation in *Leegin* (and in previous decisions which applied the “rule-of-reason” scheme of analysis to vertical restraints) did not specifically concern the issue of vertical restraints on internet distribution, its reasoning would likely be found applicable to that setting. Thus, recent U.S. case-law provides valuable commentary on the questions raised by the Issues paper.

Vertical Restraints Are No Longer Per Se Anticompetitive Under U.S. Law

49. There are two categories of unlawful agreements under U.S. antitrust law: agreements that are “*per se*” unlawful and agreements that violate the “rule of reason.” If conduct is deemed per se anticompetitive, U.S. courts will hold the conduct unlawful without examining the circumstances surrounding the conduct or its actual effect on competition. Per se treatment is appropriate under U.S. law, however, only where judicial experience conclusively demonstrates that conduct will have a “*pernicious effect on competition*” and “*lack[s] any redeeming virtue*.”*¹⁸* In contrast, rule of reason analysis is applied to conduct having potential procompetitive benefits, and requires an examination of the likely competitive effect of the conduct in the context

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of prevailing market conditions to determine whether the conduct “promotes competition or . . . suppresses competition.”

50. As a result of the U.S. Supreme Court’s decisions in Dr. Miles Medical Co. v. John D. Park & Sons, Co. and United States v. Arnold, Schwinn & Co. there was a period in U.S. antitrust law during which vertical restraints of trade were deemed per se illegal. Over the last three decades, however, the U.S. Supreme Court has reversed course, rejecting per se treatment of vertical restraints in favour of rule of reason analysis. This trend culminated in the Court’s 2007 decision in Leegin Creative Leather Products, Inc. v. PSKS, Inc., in which the Court held that even vertical price maintenance should be evaluated under the rule of reason due to its potential procompetitive benefits.

51. The Supreme Court’s decision in Continental T.V., Inc. v. GTE Sylvania, Inc. was the Court’s first step towards rejecting per se treatment of vertical restraints. In GTE Sylvania, a television manufacturer sought to increase sales by creating a more aggressive and effective network of distributors. To this end, the manufacturer limited the number of distributor franchises in certain geographic regions and required each franchisee to sell the manufacturer’s products exclusively within its assigned region. Id. at 38.

52. Although the Court had held only a decade earlier that territorial restrictions were per se anticompetitive, the Court declined to apply per se treatment based on its conclusion that vertical territorial restrictions may have considerable procompetitive benefits. Specifically, the Court found that manufacturers may be able to “use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer ... [and] to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient

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20 220 U.S. 373 (1911).
25 GTE Sylvania, 433 U.S. at 54.
marketing of their products." Because distributors would have significantly less incentive to make such investments if other distributors were able to “free ride” off of their efforts, “these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did.” Id.

53. In the years that followed GTE Sylvania, the Court continued to bring U.S. antitrust law in line with the economic evidence demonstrating the procompetitive benefits of vertical restraints. In Business Electronics Corp. v. Sharp Electronics, the Court reaffirmed that non-price vertical restraints should be analyzed under the rule of reason absent an agreement to fix prices. In State Oil v. Khan, the Court held that vertical maximum price restraints were not per se anticompetitive. In both cases, the Court’s decisions were premised on the potential procompetitive benefits of vertical restraints as described in GTE Sylvania.

54. After the Supreme Court’s decision in Khan, vertical price maintenance (“VPM”) was the sole vertical restraint deemed per se illegal by U.S. courts. In its recent decision Leegin Creative Leather Products, Inc. v. PSKS, Inc., the Court completed its dismantling of per se treatment for vertical restraints by holding that even VPM may have procompetitive benefits and should be analyzed under the rule of reason. The Court’s analysis in Leegin sets forth the new framework for analyzing vertical restraints under U.S. antitrust law.

55. In Leegin, a manufacturer refused to sell to retailers that discounted its products below suggested prices. Noting that “economics literature is replete with procompetitive justifications” for VPM and that the “justifications for vertical price restraints are similar to those for other vertical restraints,” the Supreme Court

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26 Id.
30 127 S. Ct. 2705 (2007). The Court’s opinion in Leegin is enclosed as Annex 5.
31 Id. at 2711.
32 Id. at 2714-15. In support of this contention and many of its other economic conclusions, the Court relied heavily on an amici brief submitted by a group of leading economists and antitrust scholars. See Brief for Economists as Amici Curiae, Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S. Ct. 2705 (2007). This brief is enclosed as Annex 6.
rejected per se treatment of VPM based on the following potential procompetitive benefits of vertical restraints:

- Vertical restraints restrain intrabrand competition and thereby encourage “retailers to invest in tangible or intangible services or promotional efforts that aid the manufacturer’s position against its rival manufacturers”

- Vertical restraints prevent free riders from undermining the incentive of retailers to invest in a manufacturer’s product. “Consumers might learn, for example, about the benefits of a manufacturer’s product from a retailer that invests in fine showrooms, offers product demonstrations, or hires and trains knowledgeable employees ... [but] if the consumer can buy the product from a retailer that discounts because it has not spent capital providing services or developing a quality reputation, the high-service retailer will lose sales ... forcing it to cut back its services ...”

- Vertical restraints facilitate market entry for new firms and new products by inducing “competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to consumers.”

- Vertical restraints offer retailers “guaranteed margin[s] and threatening termination if [a retailer] does not live up to expectations may be the most efficient way to expand the manufacturer’s market share by inducing the retailer’s performance and allowing it to use its own initiative and experience in providing valuable services.”

56. In addition, because manufacturers have no incentive to overcompensate retailers and distributors with unjustified profit margins, the Court concluded that, as a general matter, manufacturers are unlikely to impose vertical restraints unless they believe that the restraints will result in such benefits.34

57. At the same time that it recognized the potential procompetitive benefits of vertical restraints, the Court also recognized that vertical restraints may have anticompetitive

33 Id. at 2715-17.
34 Id. at 2719.
effects if the restraints are used to organize cartels at the retail level, are commonly
used by manufacturers, or are abused by a dominant manufacturer or retailer. According to the court, courts applying the rule of reason to vertical constraints should consider the market power of the manufacturer imposing the restraints, whether the restraint has been imposed at the behest of a dominant retailer, and the number of manufacturers imposing similar restraints. Lower courts applying *Leegin* in recent cases have focused their analysis on these factors.

**U.S. Antitrust Enforcers Have Also Recognized the Procompetitive Benefits of Vertical Restraints**

58. The treatment of vertical restraints by the two enforcers of U.S. antitrust laws, the Federal Trade Commission and Department of Justice, has evolved in concert with that of U.S. courts. From 1961 to 1980, the agencies brought a total of 190 vertical contractual restraint cases. From 1981 to 2000, they brought twenty five. Neither agency has brought many vertical restraints cases in recent years, and the cases that the agencies have brought rely heavily on an economic approach that is similar to the one adopted by the U.S. Supreme Court in *Leegin*. Indeed, the DOJ and FTC filed a joint amicus brief in *Leegin* arguing that per se treatment of vertical price maintenance was based on “*reasoning and economic assumptions that predate and conflict with modern economic theory.*”

59. Of the two agencies, the FTC has been more active in setting forth its views on vertical restraints by publishing a “Guide to Antitrust Laws” which sets forth the agency’s position on, among other things, “dealings in the supply chain.” As regards, exclusive dealing restraints, the FTC takes the position that “[m]ost exclusive dealing contracts are beneficial because they encourage marketing support for the

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35. *Id.* at 2717.
36. *Id.* at 2719-20.
39. *Id.*
manufacturer’s brand.” As a result, the FTC has focused on two varieties of exclusive dealing cases in recent years. First, exclusive arrangements that deny competitors access to markets or inputs that are necessary to successful competition, because the arrangements involve either dominant entities with the power to unilaterally deny access, or multiple parties that collectively possess such power. Second, cases in which manufacturers have used exclusive dealing arrangements to allocate markets or customers. In this second category of cases, although the conduct at issue has involved a vertical restraint, it is primarily the horizontal nature of the restraint that raises the competitive issue.

60. As regards nonexclusive vertical restraints, such as price, territorial, and customer restraints, the FTC has again taken a position consistent with the economic reasoning in Leegin, that such restraints can increase interbrand competition by decreasing intrabrand competition, and that any reduction in competition resulting from the restraints must be weighed against these benefits. In addition to the question of market power, the FTC’s focus in these cases often centers on whether the manufacturer unilaterally imposed the restraints, or whether the restraints were imposed in collaboration with other manufacturers or at the request of dealers, thereby injecting a horizontal aspect to the restraint. For example, in Toys "R" Us, the FTC found vertical restraints on the terms and products that manufacturers could offer to other retailers anticompetitive in part because the restraints were instigated and coordinated by a powerful retailer.

44 Id. at ¶ 22 (“At this time, Profarmaco (through Gyma) was the only source selling lorazepam and clorazepate API . . . [w]ith complete control of Profarmaco’s supply of these products, and by refusing to sell any to its competitors, Mylan could deny its competitors access to the most important ingredient for producing lorazepam and clorazepate tablets.”)
47 Id.; see also In the Matter of Nine West Group, 2008 FTC LEXIS 53 at *15 (May, 6 2008) (“One factor is the source of the resale price maintenance program: if retailers were the impetus for the adoption of RPM, that could indicate the existence of a retailer cartel or support for a dominant, inefficient retailer.”)
48 Toys “R” Us, Inc. v. FTC, 221 F.3d 928, 937-38 (7th Cir. 2000).
The Application of U.S. Law to Vertical Restraints on Internet Distribution

61. U.S. courts have yet to apply the doctrine of vertical restraints established in *Leegin* and its predecessors to internet distribution and the questions posed by the Issues paper. U.S. courts would likely resolve these questions, however, by resort to the same legal approach and economic rationales set forth above. For example, in the case of selective distribution, U.S. courts and antitrust enforcers would likely begin their analysis with the presumption that producers have no incentive to inflate the profit margins of their dealers by imposing restraints that bias against the use of the internet, impose selective distribution unnecessarily, or hinder the development of new methods of distribution. To the contrary, producers generally have the opposite incentive. Thus, efficient distribution is most likely to result from allowing producers to determine for themselves the most effective means of distributing their products.

62. Based on this presumption and the potential procompetitive benefits of vertical restraints, U.S. courts would almost certainly apply a rule of reason analysis to selective distribution and would likely focus on whether selective distribution is necessary to encourage dealers to invest in promoting and supporting the producer’s product. Included in this analysis would be a consideration of the free-riding problem that may result if internet-only shops are allowed to capture customers from brick-and-mortar shops that have borne the expense of introducing customers to the producer’s product.

63. U.S. courts would also consider whether it was possible for the vertical restraint in question to result in anticompetitive effects. Two obvious examples in which anticompetitive effects might result is if the restraint was used as a means to coordinate a horizontal agreement on price or output, or if the restraint was imposed on a producer by a dominant (and perhaps inefficient) dealer in order to protect the dealer from competition. Assuming that the restraint was unilaterally imposed by the producer, U.S. courts would look to whether the company imposing the restraint had market power (either alone or in conjunction with other manufacturers employing similar restraints). If not, U.S. courts would be unlikely to find an antitrust violation because such a restraint could only result in the producer losing sales to other competing producers. And even if a producer did have market power, U.S. courts would nevertheless weigh any anticompetitive effects resulting from the restraint.
against the potential procompetitive benefits discussed above to determine if, on balance, the restraint was anticompetitive.
IV. PROPOSAL FOR THE TREATMENT OF INTERNET-RELATED VERTICAL RESTRAINTS IN SELECTIVE DISTRIBUTION NETWORKS UNDER EUROPEAN COMPETITION LAW

64. Specific answers to the relevant questions raised in part III of the Issues paper are contained in Section V. In addition, LVMH would like to submit the following proposal.

65. In light of the rapid growth of online sales of luxury goods, as well as the constant introduction of new technologies and features concerning internet advertising and sales, LVMH considers that it would be difficult to devise exhaustive legislation that would not rapidly become obsolete. In fact, the Commission’s and the French Competition Council’s and Court’s decisions show that it has been possible to define a general assessment framework under the currently applicable regulations, and that, based on this framework, regulators and courts are able to effectively review the legitimacy of individual provisions on a case-by-case basis. In the circumstances, although they still seem in some cases overly restrictive of suppliers choices, the solutions resulting from those cases appear to have struck a balance between the protection of consumers and preserving legitimate distribution networks by recognizing that suppliers may require distributors wishing to engage in online sales of luxury products to:

- Already operate a sufficiently large “brick-and-mortar” outlet satisfying objective quality criteria;
- As the other authorised distributors, commit the necessary investments for the website to be compatible with the brand prestige and to ensure delivery of products in perfect condition;
- Commit to a ratio between outlet- and online-sales to avoid their running of physical outlets becoming an activity merely incidental to online selling.

66. For legal certainty and clarification purposes, the Guidelines could be amended as follows, in order to expressly include the general principle that results both from the Commission and the French Competition Council decisions:
In any case, the supplier cannot reserve to itself sales and/or advertising over the Internet. The supplier may, however, reserve the possibility to sell and/or advertise products over the Internet to members of its “brick and mortar” distribution network. (New sentence added to the end of paragraph 51 of the Guidelines).

67. Beyond this simple modification, LVMH does not believe that it would be useful to try and include in the Guidelines a clause-by-clause assessment of the specific conditions that may be found in agreements for the online sales of products typically sold through selective distribution networks. As illustrated by the four French cases described in Section III, there are a large number of possible clauses which may vary depending on the nature of the products concerned (e.g., availability of health-related advice for certain cosmetics; requirements concerning the actual testing of certain loudspeakers with unique acoustic characteristics), and new contractual provisions are being developed as more and more products become subject to online sales. As illustrated by the Competition Council’s practice, a judicial case-by-case assessment of these specific provisions is possible and represents a flexible and balanced approach.

68. LVMH is however willing to have a detailed discussion with DG Competition in respect of individual clauses and the specifics of the luxury trade.
V. ANSWERS TO QUESTIONS RAISED IN THE ISSUES PAPER

The questions addressed below are those that are most relevant for LVMH among those included in the Issues Paper.49

1. For exclusive distribution systems (territorial exclusivity) EU competition policy distinguishes between active and passive sales. In particular, restrictions on active sales, such as restrictions on sending e-mails directly addressed to customers in the exclusive territory of another distributor, are permitted under certain circumstances.

   a. Do you agree that this distinction between active and passive sales is useful in an internet context? Could you elaborate further on the criteria used for this distinction in addition to those foreseen in the Guidelines?

   b. What other clarifications or changes of policy would you consider necessary or useful?

Contemporary economic analysis as well as the competitive experience of luxury groups shows that there is a clear efficiency rationale for suppliers to restrict active sales by retailers operating in different territories. In particular this prevents free-riding on the effort of retailers operating in the territory. The rationale applies with equal force to passive sales. Economic analysis suggests that except in special circumstances (dominant positions or collusion) suppliers should be free to restrict passive sales as well.

An important difference between the traditional “brick-and-mortar” case and internet sales is related to the magnitude of search costs. Prior to the development of the internet, when an exclusive distribution system had been set up, with active sales prohibited but passive sales permitted, search costs were nonetheless significant for consumers. Consumers are in practice unlikely to drive long distances to compare the prices in different geographical markets. In this setting, passive sales were unlikely to be a very important issue for retailers, and territorial clauses solved the free-riding issues even if passive sales were permitted. The internet has upset this situation by eliminating search costs: consumers can now check prices on many websites within minutes (through price comparison sites for instance) without any need to restrict attention to their own geographical area. In addition, shipping costs are often not much higher for international sales. It follows that internet dramatically reduces distances, and creating a website to offer some products can essentially be viewed as a

49 This is a slightly revised version of the document provided by LVMH to the Commission at the September 17, 2008 meeting of the working group.
means of generating active sales.

Once it is correctly accepted that there are good reasons for a supplier to set up an exclusive distribution system, and that such a choice does not harm consumers, we believe that this supplier should also be allowed to prevent or restrict sales from “pure-play” internet sellers, wherever these internet sellers may be based and independently of whether these sales would be classified as “active” or “passive”.

2. For selective distribution systems, EU competition policy requires that selected dealers also be allowed to fully use the internet for active and passive sales, but otherwise does not generally interfere with the selection criteria the producer applies to select its dealers.

a. Do you think it is in the interest of consumers that a producer can use as one of its selection criteria that its dealers have a brick and mortar shop or showroom to taste/feel/experience the product and thus exclude internet-only-shops from its distribution network?

Yes. Selective distribution is a mode of distribution designed to satisfy consumer preferences for a prestigious and consistent brand image, a refined sales experience, and a high level of service. As correctly identified by the French Competition Council and the Paris Court of Appeals, we believe that a requirement for a physical (and genuine) point of sale is economically efficient, and legitimate both under applicable EC and French competition laws.50 It also serves consumer interests by addressing up-market demand, offering a consistently high-level of service, and ensuring that throughout the entire supply chain effective training and high investment ratios are complied with, and consumer preferences for a high level of service are satisfied: As stated by the French Competition Council:

When it comes into competition with an organised physical distribution network, in particular a selective distribution network, exclusive sales on the internet raise issues concerning the allocation of the costs borne for constituting the network and in terms of free-riding, that is, the fact for a company to draw benefits from

50 Council Decision n°06-D-24 of July 24, 2006, Festina France; Council decision n°06-D-28 of October 5, 2006 relating to practices in the high-end electronic products sector; Council Decision n°07-D-07 of March 8, 2007 relating to practices in the market for the distribution of high-end cosmetics and personal hygiene products; Judgment of the Paris Court of Appeals dated April 18, 2008 in case 07/04360 Pacific Creation v. PMC Distribution (upholding in part and reforming in part the judgment of the tribunal of commerce of Paris dated February 15, 2007). In these four cases, requirements that the retailers wishing to engage in online sales operate a brick-and-mortar outlet were considered compatible with EC and French competition law.
actions or efforts committed by another company, without sharing in the costs of the latter...If online sales are in one sense beneficial to consumers in that they facilitate price competition, they may also constitute a source of competitive distortions between distributors, and, through their ability to indirectly lead to the disappearance or rarefaction of certain services, induce less positive effects for consumers (Competition Council, Festina case, paragraph 70).

Internet-only shops would necessarily free ride on the significant investments made by brick and mortar retailers. This would lead to underinvestment in activities that consumers value and are willing to pay for, and lead to a reduction in consumer choice and welfare. It is also important that suppliers are able to decide whether retailers are making a sufficient investment in brick and mortar shops and in sales assistance more generally before accepting them into their network. A simple formal requirement for the existence of a brick and mortar shop might attract retailers aiming only to pay lip-service to the obligation to invest in their brick and mortar outlet and focusing almost exclusively on internet sales. This would generate similar negative externalities to those generated by “pure-play” internet sellers.

b. How would you ensure that the criteria used to select dealers do not bias against their use of the internet by imposing criteria for internet selling which are comparatively more severe than the criteria for sales from the brick and mortar shop?

Luxury goods suppliers need to be able to decide whether retailers make a sufficient contribution to the investment in the brand image in order to belong to the sales network. The supplier has every incentive to welcome in its network as many retail outlets as possible including internet sites as long as they contribute to product demand by making the required investments and as long as they do not undermine incentives to invest by retail outlets already in the network. The supplier must therefore be able to exclude any retailers who generate negative externalities. This includes being able to exclude retailers who invest “too much” in internet sales and “too little” in their brick and mortar outlets as they focus too much on winning sales away from other retailers as opposed to increasing the demand for the product.

This also implies that the suppliers should be able to freely set (and review over time) the criteria used to select dealers without having to fear regulatory intervention. These criteria are necessarily different in order to specifically address the requirements for online sales. From an economic standpoint, there appears to be no basis for a policy to “ensure that the
criteria used to select dealers do not bias against their use of the internet by imposing criteria for internet selling which are comparatively more severe.”

c. **How would you ensure that selective distribution systems and consequent limitations on internet sales are not used for products the nature of which does not require selective distribution?**

We believe this question to be based on a misconception. For a company like Dior choosing a selective distribution system instead of adopting a “mass market” distribution model has a significant cost: (a) the number of retail outlets is more limited thereby reducing sales all else equal and (b) asking retailers to invest in their stores (or investing directly through the employment of beauty consultants) has a significant cost for Dior as the mark-up offered to retailers has to increase to ensure the retailers’ commercial viability. Dior (and many other suppliers like Dior) believe that employing this expensive distribution method increases the demand for their product and is ultimately more profitable than adopting a less selective (and cheaper) distribution method. If the characteristics of the product were different, Dior (and many suppliers like Dior) would move to a cheaper distribution system. The suppliers’ incentives to choose a particular distribution system is therefore closely aligned with whether the nature of – and demand for – the product is such that it requires selective distribution.

The issue should therefore not be whether the “nature” of a product somehow justifies selective distribution, on the contrary, it is the market positioning decided by a supplier, e.g., to concentrate on the up-market segments, which justifies resorting to selective distribution and adapting the product to the brand requirements. Obviously certain types of branded products which are of high value and/or may require particular services (e.g., cosmetics) are more likely to be successfully promoted within a selective distribution network.

Regulatory intervention should not try to second-guess what distribution mode is better for any particular industry or consumer group unless there is a clear competitive issue. Luxury markets remain highly competitive, there are no conceivable single- or collective dominance issues, and consumer choice is better served by a variety of channels, whether internet-based or not, that are freely chosen by the suppliers to meet the various forms of market demand.
d. How would you ensure that selective distribution systems do not hinder the development of new methods of distribution?

Suppliers have no interest in hindering new methods of distribution that are suitable to distribute their product. A selective distribution system is a very expensive way for the suppliers to sell to consumers, as it is based on expensive point of sale investment by the retailer and/or the supplier. Suppliers choose this system because demand for the product is significantly enhanced by this investment in sales activities (product image is enhanced, more consumers buy make-up or skincare products if they can test the product and discuss their needs with beauty consultants etc). Each supplier chooses the mix of price and non-price factors that it considers appropriate for its products. For example, in the perfumes/cosmetics area, some suppliers such as P&G (Hugo Boss and Lacoste) and Coty (Calvin Klein) have devised a distribution strategy including both upscale retail outlets and more “mass market” outlets. Others, such as LVMH group companies have traditionally a more focused up-market approach that relies on high-value brand images and consistent, high-quality sales outlets. In a highly competitive marketplace, this choice enables the suppliers to meet diverse expectations from consumers and are all pro-competitive.

Selective distribution may for example also include online sales. For this to be workable, however, a luxury brand supplier must be in a position to discriminate between online vendors which operate their websites within the requirements of the selective distribution network (and thus benefit from the positive effects of the network) and website operators which are not prepared to share in any of the investments necessary to maintain the network.

Most online vendors, whether European or world-wide in scope comply with selective distribution rules for luxury products. In fact, the Commission’s and the French Competition Council’s and Court’s decisions show that it has been possible in the past to define a general assessment framework, allowing regulators and Courts to effectively review online sales agreements on a case-by-case basis. In the circumstances, although they still seem in some cases overly restrictive of suppliers choices, the solutions resulting from those cases appear to have struck a balance between the protection of consumers and preserving legitimate distribution networks by recognizing that suppliers may require distributors wishing to engage in online sales of luxury products to:

- Already operate a sufficiently large “brick-and-mortar” outlet satisfying objective quality criteria;
• As the other authorised distributors, commit the necessary investments for the website to be compatible with the brand prestige and to ensure delivery of products in perfect condition;

• Commit to a ratio between outlet- and online-sales to avoid their running of physical outlets becoming an activity merely incidental to online selling.

Similarly, solutions exist allowing for the sale of luxury products on auction websites. These sales appear possible as long as the website operators:

• Introduce safeguards against counterfeit products by requiring vendors to disclose their identity (with mere pseudonyms not allowed) and certify the authenticity of the products offered for sale subject to being barred from participating in future auctions;

• Bar vendors who, although not being authorised distributors for a particular brand, offer products for sale with such a frequency or in such quantities that they appear as “professional” vendors;

• Introduce adequate product-tracing requirements, which vary depending on the nature of the products (for instance, for luxury perfumes, the disclosure of the number engraved on the bottle and the packaging, and the provision of pictures showing these serial number).

By contrast, website operators who refuse to comply with these reasonable requirements, not only pose a very significant threat to the very existence of selective distribution by jeopardising the basic economic incentives for investing in luxury brands, but also endanger consumers at large. As evidenced by the fate of other industries such as music, the illegal use of internet can have a drastically negative effect on investment because (i) internet is easily accessible with no or very little investment, (ii) its reach is potentially world-wide and (iii) it is extremely difficult to police. In addition to these well-known risks of counterfeiting and money laundering, consumer protection considerations should not be overlooked, as consumers are left without any practical means of redress when they unknowingly purchase fake, deteriorated or damaged products, without any guarantee as to the identity of the vendor or the product origin and authenticity through unregulated websites.
Incidentally, in other industries, the fact that suppliers have decided against using internet “pure-players” to distribute their goods does not seem to have hindered the development of internet distribution. For example, although most airlines now sell tickets through their own websites but also through online agents (such as Lastminute, Expedia, and Orbitz), some have decided against it. Ryanair for instance is continuously fighting against websites trying to sell their tickets. It does not seem that this has been to the detriment of consumers or allowed Ryanair to maintain abusively high prices.

3. The rules on Vertical Restraints are applicable to agreements between firms but are not applicable to unilateral conduct (i.e. behavior which is decided on by an individual company and does not derive from any agreement that company has with a third party). For example, these rules do not apply if a company directs its local subsidiary in a particular territory not to sell goods/services online to customers located in other territories in which the distribution is carried out by other subsidiaries. However, such practices can also restrict online sales and may support price discrimination between final consumers located in different territories (i.e. by rerouting the consumer to the company's website of the country where he/she is located and where prices for the same products are higher).

a. Should competition law or regulation prevent such unilateral conduct, where the company has market power? What, if any, circumstances could justify such unilateral conduct?

A company with market power might decide to price discriminate across different territories (for instance across different EU countries) to reflect different cost and demand conditions when there are barriers to resale and arbitrage. The economics literature indicates that such price discrimination may be welfare enhancing or reducing.\footnote{See for instance the discussion at page 496 in Motta, M. (2004), Competition Policy: Theory and Practice, Cambridge University Press.} Banning price discrimination across different territories may well harm consumers. It might induce a firm to stop selling in some low price markets to avoid reducing its profit on the most profitable markets. This would then harm the consumers that can no longer have access to the product, while not benefiting the others since retail prices would not be lowered in these territories. There is hence no reason why competition law or regulation should generally prevent such unilateral conduct or why this conduct should only be allowed under specific circumstances.
b. *Should competition law or regulation prevent such unilateral conduct, where the company does not have market power? What, if any, circumstances could justify such unilateral conduct?*

A company without (significant) market power would not have any anti-competitive motives in its pricing in different territories. To the extent that the actual prices charged by the company in different EU countries vary, this would simply reflect cost and demand differences. There would therefore be absolutely no rationale for the competition authorities to intervene in the company’s pricing policies.