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Signs of Commission's Verticals Focus Emerge in VBER Evaluation Document

On 8 September 2020, the European Commission ('the Commission') published the results of its evaluation of the Vertical Block Exemption Regulation ('VBER') and associated guidelines in the form of a Staff Working Document. The 232 page document summarises evidence received by the Commission from businesses, their advisers, consumer bodies and national competition authorities ('NCAs') in response to its consultation on the operation of the current vertical agreements regime. It also takes account of the findings of the Commission's E-commerce sector inquiry, which ran from 2015 to 2017, and a detailed 'evaluation support study' that was conducted by external consultants. Although the document is primarily concerned with pulling together the wide-ranging views received through this process, which has been running since 2018, it does contain some broad conclusions and an indication of its priorities for updating the verticals regime.

Background

It will be recalled that the VBER creates a safe harbour, known as a 'block exemption', that protects common forms of distribution agreement from legal challenge under Article 101 of the Treaty on the Functioning of the European Union ('TFEU') and national equivalents. The safe harbour is in principle available for any vertical agreement, provided that the parties are not competitors (i.e. the agreement must be between parties at different levels of the supply chain), the parties' market shares do not exceed 30% and the agreements do not contain any 'hard core' restrictions of competition. If an agreement contains a less-serious 'excluded restriction', that restriction will be unenforceable but the rest of the agreement is protected.

The first modern block exemption regulation for vertical agreements, together with associated interpretive guidelines, entered into force in January 2000. The Commission undertook a wide-ranging review of that regulation and guidelines in the run-up to their renewal in 2010, with the main changes focused on taking account of the growth of e-commerce. Since the 2010 VBER and guidelines will expire on 31 May 2022, the Commission was required to undertake an evaluation to decide whether it should be allowed to lapse or be reviewed and revised.

The heart of the VBER is the list of hardcore restrictions in Article 4. This list defines the limits of the safe harbour by specifying those restrictions that are presumed to be so harmful to competition that they render an entire agreement ineligible for protection, as well as setting out permitted exceptions. As a result, this has been the most contested aspect of the regime.

As well as prohibiting most forms of retail price restriction, the current hardcore list is mainly focused on defining the permitted scope of two alternative distribution models:

- exclusive distribution, which permits suppliers to prevent resellers from actively selling their products outside a defined territory, as long as they remain free to respond to unsolicited orders ('passive sales'); and
- selective distribution, which permits suppliers to create a closed network of authorised resellers who are prohibited from selling to unauthorised resellers, as long as they remain free to sell to each other or (unless appointed as distributors only) end users across the territory covered by the network.

While both models involve trade-offs, selective distribution is more suited to maintaining a degree of control over the entire distribution channel from brand to consumer.

The last iteration of the VBER and Vertical Guidelines was preceded by a fight between brands and brick and mortar retailers, on the one hand, and online retailers and consumer organisations, on the other, over the extent to which brands could limit their products being sold online. The Commission's desire to promote a 'digital single market' meant that it took a hostile stance on restrictions on online retail, which was ultimately upheld by the Court of Justice in 2011 in its seminal Pierre Fabre judgment. On the other hand, the Commission had to take account of long-standing case law that gives brands a high degree of control over where and how their products are sold, as well as the wider policy objective of creating a broad and predictable safe harbour for vertical agreements.

Keen to avoid taking sides, the Commission ultimately adopted a compromise approach, in which it condemned measures that discriminate against online retail, such as charging higher wholesale prices for goods sold online ('dual pricing') or imposing criteria for admission to a selective distribution network that are not equivalent to offline restrictions, while permitting brands a high degree of flexibility to control how their products are sold, for example by allowing brands to require resellers to operate a brick and mortar store, thereby excluding 'pure play' online retailers from their networks, and permitting restrictions on third party marketplace sales. The revised Verticals Guidelines also stressed the high degree of flexibility permitted for selective distribution under the VBER, regardless of the product being sold and the criteria applied. As a fall back, in case it turned out that the VBER was protecting agreements that restricted competition in practice, the Verticals Guidelines hold out the prospect that the Commission will remove such agreements from the protective scope of the VBER safe harbour.

Overall findings

Unsurprisingly, the Commission's evaluation confirms that the VBER and Vertical Guidelines are viewed as valuable by market participants and should therefore be retained. A clear need is nevertheless identified to update the regime to take account of market developments that have taken place since 2010, notably the growth of online sales and new market players such as online platforms.

In particular, the Commission notes that an increasing number of consumer-facing brands are responding to the relentless growth of online sales by abandoning the traditional territorial model, based on exclusive distribution, in favour of a combination of direct sales and selective distribution. The Commission has also recognised that consumers are increasingly expecting an integrated multichannel retail offering, in which they are able to switch easily between online and offline sales experiences and in which free riding can occur in both directions. The model reflected in the current VBER, which is based on a more rigid distinction between

online and offline retail, with restrictions justified mainly by the need to protect offline retailers from online free-riding and brand erosion, thus needs updating.

There is a particularly pressing need to provide more guidance on how relationships with third party platforms or marketplaces should be analysed under VBER. While the Commission and NCAs have opened a number of cases involving platforms over recent years, fundamental questions regarding how platform relationships should be analysed are currently unclear.

As well as updating the guidelines to fill such gaps, and to take account of new case law and decisions since 2010, the Commission identifies a need for simplification of the regime, to increase legal certainty and reduce complexity and costs for business. The Commission also observes that more clarity is required to avoid unwelcome divergence between NCAs and national courts, given the need to ensure a consistent and coherent EU-wide competition regime.

Findings on Specific Issues

While it is not possible to list all of the Commission's findings, the following are particularly noteworthy.

Distribution models – selective and exclusive distribution

Reflecting the structure of Article 4 VBER, as well as the Commission's underlying policy priority of promoting a single EU-wide market in which businesses are free to trade on a cross-border basis, businesses tend to be forced to choose between approved distribution models. In particular, it is difficult to combine selective and exclusive distribution within the EU or to apply either model on a partial basis.

Although the current Vertical Guidelines contain extensive guidance on the interplay between distribution models, the evaluation report identifies important areas of uncertainty, including for example over the extent to which authorised resellers within a selective distribution territory covering part of the EU can be prevented from selling to unauthorised resellers elsewhere in the EU or the compatibility with the VBER of the widespread practice of combining exclusive distribution at the wholesale level and selective distribution at the retail level. The report also notes the need for more clarity on application of the 'equivalence principle', i.e. the circumstances in which online or marketplace criteria applied in the context of selective distribution will be viewed as not 'equivalent' to offline criteria and hence as de facto online sales restrictions.

There is also a need for more guidance on the analysis of so-called 'dual distribution'. This arises where a manufacturer sells directly to the public, as well as through a resale channel, and is generally treated for VBER purposes as primarily a vertical relationship, notwithstanding the fact that the manufacturer and its resellers compete downstream in selling to end customers. This has become more important as an issue since the last iteration of VBER, as more manufacturers are now selling direct to consumers at scale through their own websites or via marketplaces. Adding complexity, the manufacturer may itself own the marketplace on which resellers sell its products. An increased focus on the potential for sharing of commercially sensitive information between the parties to such arrangements to raise competition law concerns has also increased risk and uncertainty in this area.

Marketplace restrictions

Reflecting the increased importance of third-party online marketplaces such as Amazon and eBay since 2010, the extent to which brands are able to prevent resellers selling their products on such platforms has become a controversial topic over recent years. Although the Verticals Guidelines were updated in 2010 to include some rather clumsily worded guidance indicating that such bans were generally permitted, it was not until the landmark Coty judgment of the ECJ in 2017, which upheld a blanket ban on marketplace sales of luxury cosmetics and perfumes as not caught by Article 101 TFEU, that the issue was largely resolved in favour of brands.

However, the evaluation has shown that different interpretations of the Coty judgment persist, notably concerning the applicability of the judgment beyond luxury goods and the extent to which specific market circumstances should be taken into account when assessing the legality of marketplace bans. The diverging views of different NCAs further complicates this issue, with the German Federal Cartel Office, in particular, arguing that marketplace bans may be unlawful when applied to non-luxury products or in circumstances where access to marketplaces is particularly important for retailers. On the other hand, the Commission has made it clear in a position paper that it takes the view that the logic underlying the Coty judgment is equally applicable to non-luxury products. Given this unhelpful divergence, the evaluation concludes that more guidance is needed on the compatibility of marketplace bans with Article 101 TFEU.

Dual pricing

The Commission's hostility towards discrimination against online sales is reflected in the Verticals Guidelines' condemnation of dual pricing (i.e. the practice of setting more favourable wholesale prices for offline sales, for example to reflect the higher costs of operating a brick and mortar store or to deter online sales). This approach has been challenged in practice, however, as it can imply that suppliers are unable to negotiate different wholesale prices for different retailers, depending on whether they sell on- or offline, thereby introducing unwelcome rigidity to normal commercial interactions. Although the Verticals Guidelines offer alternative methods for suppliers wishing to support offline sales, such as paying resellers flat fees to support in-store promotions, these are hard to apply in practice without amounting to de facto dual pricing.

Taking account of conclusions already set out in the E-commerce Sector Inquiry report, it appears likely that the Commission will update the Verticals Guidelines to make it clear that, while charging the same retailer different prices depending on whether products are sold on- or offline will remain prohibited, suppliers can take account of differences in business models between retailers when negotiating a retailer's wholesale prices.

Active and passive sales distinction

Although the Commission received a large number of comments on the need for more clarity on the distinction between active and passive sales, they will presumably treat these with a degree of caution, as the underlying principles are reasonably clear and explained in the Verticals Guidelines. In particular, the characterisation of online sales as essentially passive in nature, on the basis that a website should in principle be accessible from across Europe, is central to the Commission's entire approach to restrictions on online sales. As a result, the Commission is unlikely to make material

changes in this area. There may, however, be clarification on where precisely the boundary between active and passive lies, for example the extent to which a website's language or web suffix (such as .fr or .de) may be indicative of active sales.

Online advertising restrictions

A key area of uncertainty is the extent to which restrictions on online advertising may amount to de facto restrictions on online sales (and thus a hardcore restriction). In its 2018 Guess decision, the Commission found that a brand's ban on retailers bidding on its name and trade mark to obtain a better position in Google AdWords was a hardcore infringement of Article 101, when deployed as part of a broader strategy aimed at limiting online sales and restricting trade between Member States. This approach reflected Commission policy foreshadowed in the E-commerce Sector Inquiry report.

Given the widespread practice of brands imposing some form of restriction on AdWord bidding, this decision has clearly resulted in some pushback from brands and a desire for greater clarification of permitted brand protection measures and prohibited conduct.

A lack of EU-level precedent on the legality of restrictions on the use by resellers of price comparison websites has also prompted calls for more guidance in this area. This will be a challenge for the Commission, given the need to reconcile the very different legal treatment of restrictions on marketplace bans, online search advertising and price comparison sites, all of which are simply means by which sellers seek to attract customers online.

Resale Price Maintenance (RPM)

Unlike many of the topics covered in the Evaluation Report, the current legal position on RPM is rather clear cut. Specifically, RPM is presumptively unlawful and, although the Vertical Guidelines set out examples of situations where it may be permitted in specific circumstances, in practice the Commission and NCAs have adopted a uniformly hostile approach amounting to per se prohibition. The only variation has been in the extent to which NCAs prioritise RPM cases and how far RPM has been implied from policies such as reminding resellers of the supplier's recommended pricing. Ultimately, the need to protect price competition and deliver 'quick win' cases has won out over the economic arguments, which tend to take a more nuanced approach to the pros and cons of RPM.

Notwithstanding the settled legal position, brands have taken the opportunity offered by the consultation to push for a more flexible approach. As a result of the divergent approaches of NCAs, Commission guidance is also sought on the circumstances in which RPM can arise indirectly from certain forms of conduct, such as combining recommended prices and price monitoring software. The Commission is far more likely to accede to this request for expanded guidance than fundamentally altering its approach to RPM.

Retail Parity or Most-Favoured Nation clauses

One of the key gaps in the current regime is the absence of any analysis of how retail parity clauses (also described as most favoured nation clauses or MFNs) should be analysed under Article 101. This has proved to be a controversial topic over the last decade, particularly as a result of a flurry of investigations into the use of such clauses by online hotel booking sites and other intermediaries such as comparison sites, as

well as investigations by the UK and German competition authorities into Amazon's adoption of a marketplace price parity policy. Although this topic has been extensively addressed in the economics literature, as well as in individual NCA decisions and court judgments, the remains uncertainty over how such clauses should be analysed under the VBER. Unsurprisingly, the evaluation has confirmed the need for guidance in this area.

Agency

The current Verticals Guidelines set out the boundaries of an important exception to the application of Article 101, namely that agreements between a principal and agent may fall outside the reach of competition law altogether if the agent (or 'commercial representative', in some languages) is essentially acting as the arm of the principal rather than as an autonomous economic actor. This allows the principal, for example, to set the price at which the agent sells its products without giving rise to RPM concerns, since this is viewed as de facto a sale by the principal.

The test applied by the Commission for determining what is known as 'genuine agency', which draws on long-standing case law, is based on the extent to which the agent takes on commercial risk. The application of this test to online or hybrid retail situations has proved to be challenging. Questions have also arisen over whether the relationship between a third party marketplace and individual sellers is one of agency, notwithstanding the usual commercial understanding that platforms provide a service to facilitate direct sales between sellers and end customers. Any new guidance in this area will be particularly interesting.

Next steps

Following publication of the report, the Commission's attention will now switch to the next stage of the review process, namely the launch of an impact assessment of the options for revision. This will carefully assess the problems identified through the consultation and weigh up the options for addressing them. This will be followed by a public consultation on the impact assessment at the end of this year. A draft of the new VBER and Vertical Guidelines, taking account of the results of that consultation and input from Member States, is due to be published at some point next year, well in advance of the May 2022 deadline.

While recognising that an enormous amount of work has gone into gathering comments and identifying areas where action is needed, the really difficult bit comes next, from the Commission's perspective. It is one thing to identify that clarification is needed but quite another to provide that clarification in a manner that is viewed as helpful by a range of businesses, while remaining deferential to the case law.

Most of the future changes to the regime are likely to come through the Commission updating the Verticals Guidelines. It is worth remembering that, while Commission guidance can certainly be helpful and is an influential form of soft law, it cannot change the law itself and is not directly binding on NCAs or courts. While the Commission can change the law by amending the text of the VBER, it will be reluctant to do so in a dramatic way, given the need for legal predictability and stability. While the Commission is not ruling out changes to the VBER at this stage, especially where these are to simplify what is still a rather formalistic instrument, it does not appear to have the appetite to touch the heart of the VBER in Article 4. It remains to be seen how much can be achieved by updating the Verticals Guidelines and how far any such revisions will go.

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Before joining Euclid Law in June 2020, Becket McGrath was a partner at US firm Cooley. Becket advises clients on all aspects of EU and UK competition law, with an emphasis on defending companies against investigations, online distribution and merger control. Becket is a UK non-governmental advisor to the International Competition Network and is listed in the Who's Who Legal/Global Competition Review directory of leading competition lawyers.

Sarah Long

Sarah Long has been a Partner at Euclid Law since 2016. Sarah advises on all aspects of UK and EU competition law, with particular expertise in online markets and the digital economy. Sarah is listed in GCR's 40 under 40 for 2020, recognised as a 'Next Generation Partner' for 2020 by Legal 500, a 'Future Leader' by Who's Who Legal for 2019 and as one of 30 most notable competition professionals in private practice (Women@competition/Parr, February 2017).

Aakash Kumbhat

Aakash Kumbhat joined Euclid Law as a Paralegal in August 2020. He is pursuing a specialised LLM in Competition Law at University College London for which his graduation with a First Class has been confirmed. Before his LLM, Aakash worked as an in-house lawyer at ICICI Bank Ltd, Mumbai, India's largest private bank.

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