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EU Commission Scales Vertical Block Exemption Mountain

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The European Commission (the Commission) closed out its ambitious 2020 antitrust reform agenda with the long-awaited consultation (the Consultation) on reform of the Vertical Block Exemption Regulation (the VBER) and related Guidelines (the VGL), published on December 18, 2020. The Consultation's proposals, which closely follow the Commission's October 2020 Inception Impact Assessment (the Inception Impact Assessment), are an important step in the long-running VBER and VGL review. The Commission plans to publish drafts of the new VBER and VGL in mid-2021, in plenty of time to adopt new texts in time for the VBER's expiration in May 2022.

The Consultation reflects a sea change in the approach to e-commerce in the decade since the current VBER and VGL were developed. At that time, e-commerce was just taking off, and the VBER and VGL addressed concerns that suppliers might try to stifle their resellers' development of online sales channels to keep prices up. Meanwhile, e-commerce has exploded, with suppliers as well as resellers embracing online sales channels. As a result, the Consultation focuses on new issues raised by increasingly complex business models mixing elements of traditional and online distribution channels and models.

Although the treatment of vertical agreements may seem less topical or controversial than certain antitrust reform topics, such as the treatment of "gatekeeper" platforms or "killer acquisitions," they are extremely important to stakeholders throughout the EU economy. The Consultation is valuable not only as an opportunity to influence EU antitrust policy through the future VBER and VGL, but also as an indicator of current Commission thinking for companies setting up or updating distribution systems that may fall outside the current block exemption.

A number of the proposed changes would give suppliers greater legal certainty in designing their EU distribution systems (and correspondingly allow new restrictions on resellers). In a few areas, however, the Commission proposes to take a more restrictive approach, narrowing the existing exemption.

Background

Like authorities in other jurisdictions, the Commission takes a more benign view of cooperation agreements between suppliers and resellers than agreements among competitors. However, EU law is more restrictive of suppliers' ability to control the distribution of their products than some

other jurisdictions, notably the United States.

Reflecting the over-riding EU policy objective of integrating EU markets, EU law has developed two complementary legal frameworks allowing suppliers to decide how their products will be sold in the EU while still encouraging trade between the EU Member States. In "exclusive distribution networks," suppliers can grant distributors exclusivity, protected from "active" sales by out-of-territory distributors but not against "passive" sales in response to customer orders. Online sales are considered "passive" for these purposes. In "selective distribution systems," suppliers can impose more stringent requirements, but only for certain types of product and so long as distributors are chosen based on objective criteria applied in a non-discriminatory fashion and the requirements are not disproportionate.

Not surprisingly, the distinction between active and passive sales in exclusive distribution networks and the products and criteria allowed in selective distribution networks have generated considerable legal uncertainty and litigation. To provide greater legal certainty, the Commission for many years has adopted so-called "block exemptions" from the application of EU antitrust laws for certain vertical agreements, including exclusive distribution (and customer allocation), selective distribution, franchising (and category management), exclusive supply, agency and sub-contracting agreements. Suppliers have a strong incentive to stay within the block exemption boundaries since qualifying agreements do not create antitrust risk (and do not require expensive legal analysis).

The VBER provides a broadly worded exemption (Article 2) from the EU law prohibition against anti-competitive agreements, Article 101(1) TFEU, for all "vertical agreements" between suppliers and buyers so long as neither has a market share over 30%. However, an agreement containing any of five so-called "hardcore restrictions" (Article 4) loses all protection under the VBER, even if it would otherwise qualify. These include resale price maintenance (RPM), restrictions on sales outside a distributor's territory (with exceptions e.g. for restrictions on active sales into another distributor's territory, requirements that wholesalers sell only to end-users, and sales by selective distributors to unauthorized distributors), and restrictions on sales to end-users by retailer members of a selective distribution system or between members of a selective distribution system.

Three other restrictions, so-called "excluded restrictions," are not covered by the VBER, but their inclusion in an otherwise exempted vertical agreement will not deprive the entire agreement from protection (Article 5). These include non-compete obligations exceeding five years, including tacitly renewable non-compete obligations.

An agreement not covered by the VBER does not automatically fall foul of Article 101(1) TFEU. Rather, the legality of agreements falling outside the VBER must be assessed on a case-by-case basis. In some cases, it is relatively easy to conclude that a non-block-exempted agreement raises little or no competition concern, for instance where the parties slightly exceed the market share thresholds, but their agreement otherwise qualifies. On the other hand, hardcore restrictions are unlikely to pass muster in an individual assessment, while excluded restrictions require close scrutiny. Since the EU eliminated the possibility of seeking comfort from the Commission on a case-by-case basis in 2003, parties have a strong incentive to adhere closely to the VBER in their distribution regimes to reduce legal uncertainty.

As mentioned, the VBER expires in May 2022. The Commission began reviewing the VBER to determine what changes, if any, might be required, in 2018. In parallel, the Commission is reviewing the existing regulations exempting certain horizontal agreements among competitors

(the HBERs) and related guidelines, but the HBER review process is running behind the VBER process.

Proposed changes to increase supplier flexibility under the VBER

Active sales restrictions. As mentioned, agreements between suppliers and exclusive distributors or members of selective distribution systems can benefit from the VBER even if they include restrictions on active sales in exclusive or selective distribution systems. The VBER does not contemplate a mixing of exclusive and selective distribution models, however, or restrictions on active sales from outside the territory of a selective distribution system.

The Commission is considering introducing more flexibility for suppliers to restrict active sales in exclusive and selective distribution systems. Specific examples include allowing suppliers to mix distribution systems, for instance by appointing exclusive distributors at the wholesale level within a selective distribution system or an exclusive distribution system in certain EU Member States and a selective distribution system in others (which would entail allowing restrictions on active sales from exclusive distributors into territories in which selective distributors are operated).

The Commission's proposals to increase flexibility for suppliers to mix elements of exclusive and selective distribution systems seem uncontroversial. It is perhaps regrettable, however, that the Commission is not consulting on other areas of uncertainty, such as the criteria for products eligible for a selective distribution system.

Indirect restrictions of online sales. As mentioned, the VBER and VGL consider online sales to be a form of passive sale, and, as such, the scope for suppliers to control distributors' online sales is limited. The VGL indicate that charging different prices to distributors based on whether they make sales online or through brick-and-mortar stores (para 52(d)) is viewed as a hardcore restriction, although such "dual pricing" is not listed as a hardcore restriction in the VBER itself. Similarly, in the selective distribution context, criteria for members in the system must be applied on an overall equivalent basis (the "equivalence principle") to online and brick-and-mortar sales (para 56 VGL).

These rules limit suppliers' ability to incentivize distributors to invest in brick-and-mortar stores and create legal uncertainty. Accordingly, the Commission is considering allowing greater flexibility in relation to both dual pricing and the equivalence principle. The options under consideration range from block exempting dual pricing or simply ceasing to treat dual pricing as a hardcore restriction so that the competitive effects of any agreement involving dual pricing would have to be assessed on a case-by-case basis but the overall agreement would still be protected.

Since the adoption of the VBER, EU case law has established that suppliers' prohibition of online sales is illegal under EU law. Thus, the Commission also asks what provisions could be included in the new VBER to ensure that dual pricing or non-equivalent criteria in a selective distribution system do not amount to a prohibition of online sales.

Given the revolution in e-commerce since the VBER was adopted, policy debates have shifted from the best way to encourage the development of e-commerce to how much freedom to allow suppliers to mix and match distribution models and to incentivize resellers to invest in traditional distribution channels. While the Commission's intention to give suppliers more flexibility seems

clear, how the Commission chooses to do so can have important practical consequences. Simply removing dual pricing from the category of hardcore restrictions would add some flexibility but do little to provide legal certainty for suppliers seeking to maintain a balance between online and traditional distribution channels. Within the VBER market share thresholds, it could be argued that dual pricing should be block exempted, not just removed from treatment as a hardcore restriction (subject to an anti-avoidance provision to ensure that dual pricing does not amount to a de facto prohibition on online sales). But such a large conceptual step – from hardcore restriction to block exemption – may prove controversial.

RPM. As mentioned**,** the current VBER treats RPM as a hardcore restriction depriving any otherwise exempted agreement from protection under the VBER. RPM is considered a restriction by object under Article 101(1) TFEU and the target of aggressive enforcement by the Commission and Member State authorities. This approach is in marked contrast to the treatment of RPM in the U.S., where since the Supreme Court's *Leegin* decision RPM is evaluated under a "rule of reason" approach.

Even in the EU, however, the VGL acknowledges that supplier-driven RPM may lead to efficiencies in certain circumstances. Reflecting this inconsistency, the Commission is considering relaxing the treatment of RPM. The Commission could move RPM from the hardcore to the excluded restriction category, but the Commission may be more likely to keep RPM in the hardcore restriction category while introducing exceptions, as the VBER currently does for some sales restrictions in exclusive and selective distribution systems. The new VGL would presumably provide more guidance on circumstances in which RPM can be beneficial (e.g., to support a new product launch or a short-term low price campaign in a franchising system).

Tacitly renewable non-compete obligations. As mentioned, tacitly renewable non-compete obligations are considered equivalent to indefinite non-compete obligations and excluded from the benefit of the VBER. This approach has been criticized as unreasonable and as creating needless administrative burdens for business.

The Commission is proposing to extend VBER protection to tacitly renewable non-compete obligations provided there is a reasonable opportunity to terminate or renegotiate the agreement in question on reasonable notice and at a reasonable cost. This change seems likely to be broadly accepted and to generate little controversy.

Proposed changes narrowing supplier flexibility under the VBER

Dual distribution. Although the VBER covers only vertical agreements, with agreements among competitors being assessed under the HBERs, the VGL provides an exception for dual distribution structures, in which suppliers sell both to distributors and to end-users, thereby potentially competing with their own distributors (para 28). Under the VGL, therefore, agreements between suppliers and distributors may qualify for exemption even if the supplier competes with its distributor at the retail level.

In view of the growth in direct online sales by suppliers who also operate distribution systems, the Commission is considering narrowing or removing the VBER's protection for suppliers' dual distribution systems. If VBER coverage were removed entirely, distribution agreements of suppliers who also sell directly to end-users would all need to be assessed on a case-by-case basis.

The Commission is also considering intermediate solutions, for example extending VBER protection to suppliers operating dual distribution systems only on certain conditions. For example, the VBER could apply only where the supplier's and distributor's combined market share at the retail level are below a certain threshold (e.g., 20%, the current threshold in the HBER for specialization agreements). Another alternative would be for the VBER to continue to apply to dual distribution systems, but only when operated by wholesalers and/or distributors.

Parity obligations. Parity obligations, or "most-favoured nation" clauses, are not included in the list of hardcore or excluded restrictions and as such are covered by the VBER if included in an agreement that otherwise qualifies. In recent years, a number of cases at the Member State level and commentary (especially in the digital sector) have identified antitrust concerns with parity clauses.

As a result of these developments, the Commission is considering removing VBER protection for some or all parity clauses. The Commission could do so by adding all parity clauses to the list of excluded restrictions, or only parity clauses considered more likely to give rise to competition issues, such as clauses requiring parity between indirect marketing channels, such as online platforms and other intermediaries. Alternatively, parity clauses could be added to the list of excluded restrictions only at certain levels of trade (retail vs wholesale), or for certain sectors or specific competitive criteria (e.g., price vs other criteria).

The competitive effects of treating some or all parity clauses as excluded restrictions would be that such clauses would need to be assessed on a case-by-case basis. Their use in an agreement would not deprive the entire agreement of protection or otherwise imply illegality (as would be the case if parity clauses were added to the list of hardcore restrictions), but the need for a case-by-case assessment would create legal uncertainty.

The treatment of parity obligations seems likely to be one of the most controversial areas of the Consultation. In view of recent precedents, maintaining the current block-exempted status for all parity clauses would likely be untenable for the Commission. On the other hand, changing the treatment of parity provisions from complete exemption to complete exclusion would be a major shift for the Commission. The Commission seems likely to seek a compromise allowing some parity clauses to continue to benefit from the VBER.

Other areas

The Commission further requested comment on two areas not covered by previous VBER consultations: the treatment of agreements between supply chain operators to foster sustainability objectives (sustainability agreements) and changes that may appear advisable as a result of experience adapting to the Covid-19 crisis.

In relation to sustainability agreements, questions arise regarding the assessment of benefits that can be taken into account to determine whether an otherwise restrictive agreement qualifies for exemption. This issue comes up most often in the context of agreements among competitors, so sustainability agreements are likely to be a greater focus of the HBER review than the new VBER and VGL.

In response to the Covid-19 crisis, many antitrust authorities, including the Commission, expanded

businesses' ability to seek informal guidance on emergency agreements. Hopefully, the Commission will consider building such options into the new VBER (and HBERs). The Commission can also learn from the experience of other authorities, many of whom have been more proactive in the pandemic about giving practical guidance to business than the Commission.

On the other hand, the Consultation does not cover all areas the Inception Impact Assessment describes as having given rise to concerns in the prior VBER consultations, such as when online platforms qualify as agents (whose agreements are considered unlikely to be caught by Article 101 TFEU). Greater guidance would also be helpful in situations where distributors act in a mixed capacity, for instance participating in the fulfilment of a contract negotiated directly by the supplier and the end customer. Hopefully, these and other topics will be clarified in the new VBER and VGL, even if they are not specifically addressed in the Consultation.

Key takeaways

The VBER and HBER reviews are among the Commission's most important – even if not highest profile – antitrust reform workstreams. The Consultation represents an important opportunity for business, and the antitrust community, to affect the direction of EU policy.

The Consultation is also important as an indication of the Commission's current thinking on issues important to a wide range of business activities, in particular as companies adapt their distribution strategies in response to the explosion of e-commerce. Where an agreement falls outside the VBER, companies must make their own assessment of the legality of new distribution systems or changes to existing systems. The Consultation offers helpful insights for this purpose, including not only such relatively simple issues as the treatment of tacitly renewable non-compete clauses but also more complex issues like mixing exclusive and selective distribution systems.

Conversely, the Consultation offers a warning that some practices currently exempted under the VBER, such as parity clauses, may be riskier than previously thought. In some cases, such as RPM, the direction of EU policy remains difficult to predict, and great caution continues to be required.

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