

Analysis of Vertical Distribution Relationships: A Comparative View of EU Competition Law in the European Economic Area and US Antitrust Law

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Distribution Law and Strategies Affinity Group
November 2010

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- **Part I: One Size Does Not Fit All**
 - US antitrust law and EU competition law have different goals, resulting in key differences when analysing distribution strategies
- **Part II: Assessment of Distribution Agreements under EU Competition Law**
 - Article 101 Treaty on the Functioning of the European Union (TFEU)
 - Exemptions and Exclusions
- **Part III: Practical Assessment of Distribution Agreements Under EU Competition Law**
 - Typical restrictions
 - Application: hypothetical examples – AirCo, Sportex

PART I

ONE SIZE DOES NOT FIT ALL

Different goals underlining US antitrust and EU competition law result in divergent approaches to distribution

US and EU Antitrust/Competition Policy: Key Philosophical Differences



US Antitrust Law

- **Central policy goal:**
 - To increase consumer welfare (e.g. to lower prices, improve quality and expand product output by protecting competition, not competitors)
- **US antitrust law and distribution:**
 - Restrictions in distribution agreement are subject to review under the Rule of Reason (at the federal level)
- **Consequence:**
 - significant flexibility for suppliers to tailor restrictions

EU Competition Law

- **Two central policy goals:**
 - **To facilitate single market integration**
 - To increase consumer welfare
- **EU competition law and distribution:**
 - Practices which tend to “seal” off parts of the EU are subject to close scrutiny
 - (e.g. exclusivity; territory, customer and channel restrictions; non-competes, etc)
- **Consequence:**
 - comparatively less flexibility

Rules of the Road, Part 1: US Antitrust Law and Distribution

- **Basic rules established by statute, developed by case-law**
 - Sherman Act, Section 1: prohibits restrictive agreements
 - Sherman Act, Section 2: monopolisation
 - *Distribution by monopolists is outside the scope of this webinar*
 - Robinson-Patman Act (price discrimination)
- **Key analytical framework for evaluating Section 1 Matters**
 - Horizontal vs. vertical restraints
 - Price vs. non-price restraints
- **Vertical restraints subject generally to the “Rule of Reason”**
 - **Rule of Reason:** whether a restraint’s anticompetitive effects substantially outweigh the procompetitive effect for which the restraint is reasonably necessary
 - N.B. Some states still consider vertical price restraints to be *per se* illegal (e.g. NY, MD)
- **Consequences of infringement**
 - Fines and treble damages, plus attorney fees and costs
 - Declaration that an agreement is void
 - Criminal liability (extremely unlikely in a distribution context!)
 - US\$ 100 million for corporations
 - US\$ 1 million for individuals (and up to 10 years in prison)



Rules of the Road, Part 2: EU Competition Law and Distribution

- **Treaty establishes the basic rules**

- **Article 101: prohibits restrictive agreements**
- (Article 102: prohibits abuse of a dominant position
 - *Distribution by dominant firms is outside the scope of this webinar*)



- **Key analytical framework for Article 101 matters**

- Horizontal vs. vertical restraints
- Price vs. non-price restraints

- **Specific exemptions are available for certain distribution agreements**

- Exemptions:
 - “Vertical Block Exemption Regulation” (VBER)
 - *De minimis* exception
 - Exemption available under Article 101(3) using a rule of reason-like analysis
- Exclusion: Pure Agency (Agency arrangements are subject to a different regulatory regime)

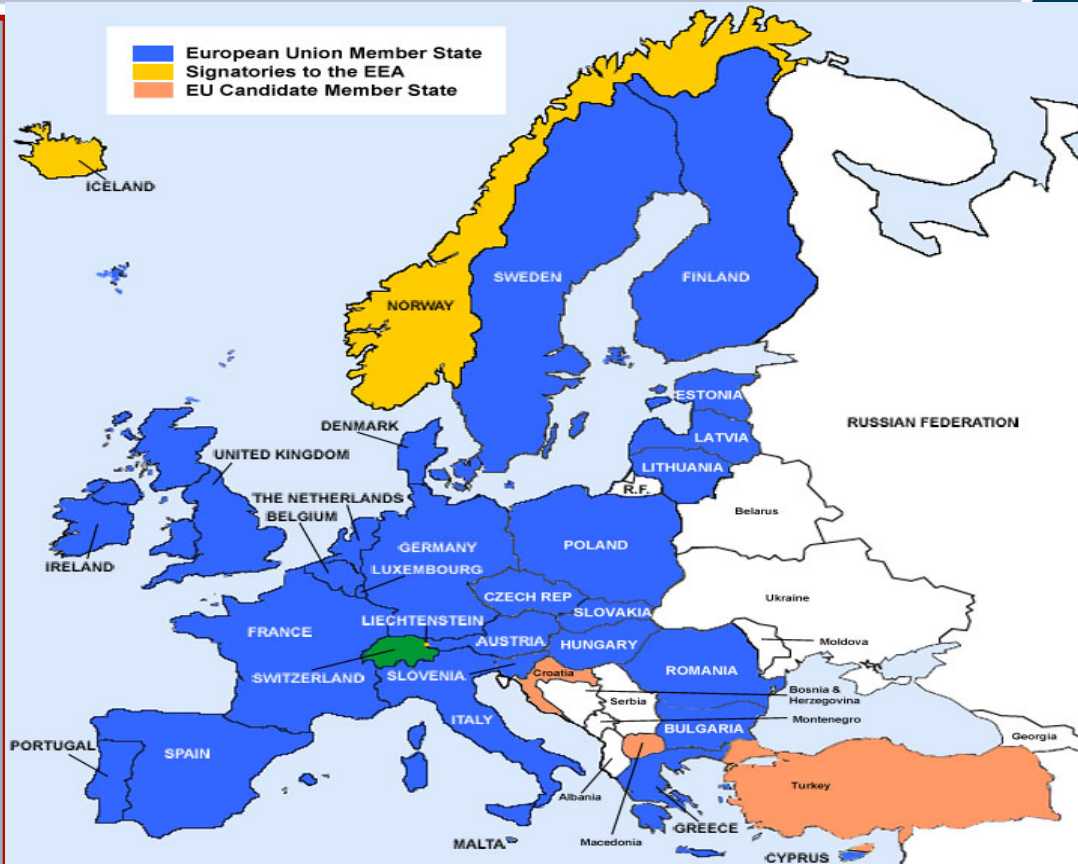
- **Consequences for infringing EU competition law**

- Fine of up to 10 per cent of a company’s worldwide sales (including subsidiaries, etc.)
- Declaration that the agreement at issue is void

All 27 EU Member States also each have their own national competition rules

Members of the EEA to which Article 101 Applies

- Austria
- Belgium
- Bulgaria
- Cyprus
- Czech Republic
- Denmark
- Estonia
- Finland
- France
- Germany
- Greece
- Hungary
- Ireland



- Italy
- Latvia
- Lithuania
- Luxembourg
- Malta
- Netherlands
- Poland
- Portugal
- Romania
- Slovakia
- Slovenia
- Spain
- Sweden
- United Kingdom

**Non-EU countries to which Article 101 applies:
Iceland, Lichtenstein, Norway**

Rules of the Road, Part 3: Conclusions for Global Suppliers

- **The rules applicable to distribution in the EU are comparatively more complex vis-à-vis EU Competition Law**
 - Technical and specific rules (and exemptions) apply in the EU, but US suppliers need worry only about the rule of reason
 - Complexity in the EU derives from “single market” goal of competition law
- **Restrictions that would divide the EU “single market” likely to infringe EU Competition Law – even if consumers not harmed by higher prices, reduced quality or reduced output**
 - This is not a consideration in the US...
 - ...but has obvious implications for suppliers seeking to impose restrictions on distributors relating to territories, customers, channels, etc.

Suppliers cannot merely import a distribution strategy from the US to the EU

PART II

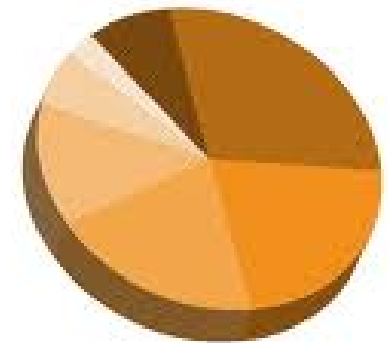
ASSESSMENT OF DISTRIBUTION AGREEMENTS UNDER EU COMPETITION LAW

- **Article 101(1)** prohibits agreements that restrict trade
 - “*The following shall be prohibited as incompatible with the internal market: all agreements ... which have as their object or effect the prevention, restriction or distortion of competition within the internal market*”
- **However, Article 101(3)** says that the agreement is permissible if it:
 - Contributes to improvements in production or distribution of goods or technical or economic progress;
 - Is indispensable to obtaining these objectives;
 - Does not eliminate competition; and
 - Allows consumers a fair share
- **Firms are obliged to analyse their agreements themselves**

A full Article 101 analysis is a complex exercise. Attention should be given to specific exemptions/exclusions which may be available to certain distribution arrangements

Preliminary Matters: Calculating Market Shares

- **Market shares and antitrust /competition analysis**
 - Most EU competition law exemptions are based in part on market shares
 - And even if an exemption is not available, market shares are important to broader antitrust/competition law analysis – in both the US and EU
- **Why are market shares relevant?**
 - Market shares are considered a surrogate for market power... and market power is central to antitrust / competition law
- **How are market shares calculated?**
 - **Step 1: Define the relevant market**
 - Relevant product market
 - Relevant geographic market
 - **Step 2: Estimate the market share**
 - (Including in the EU for the application of possible exemptions!)



- **Genuine agency agreements excluded from Article 101**
 - **All** financial and commercial risk must be incurred by the principal
- ***De minimis* agreements are excluded from Article 101**
 - **Test 1 (where the customer is not a competitor):** (i) Each party has $\leq 15\%$ market share and (ii) the agreement has no “hardcore” restrictions
 - **Test 2 (where the customer is a competitor):** (i) The parties’ aggregate market share (in the market where they compete) is $\leq 10\%$ and (ii) the agreement has no “hardcore” restrictions
- **Vertical Block Exemption Regulation (VBER) (revised 2010)**
 - Supplier and distributor each have $\leq 30\%$ market share
 - The agreement contains no “hardcore” restrictions and
 - (to ensure VBER applies to entire agreement) no “excluded” restrictions

If none of these apply, a full assessment to determine whether the agreement is exempt under Article 101(3) must be conducted

What Are “Hardcore” Restrictions and “Excluded” Restrictions?

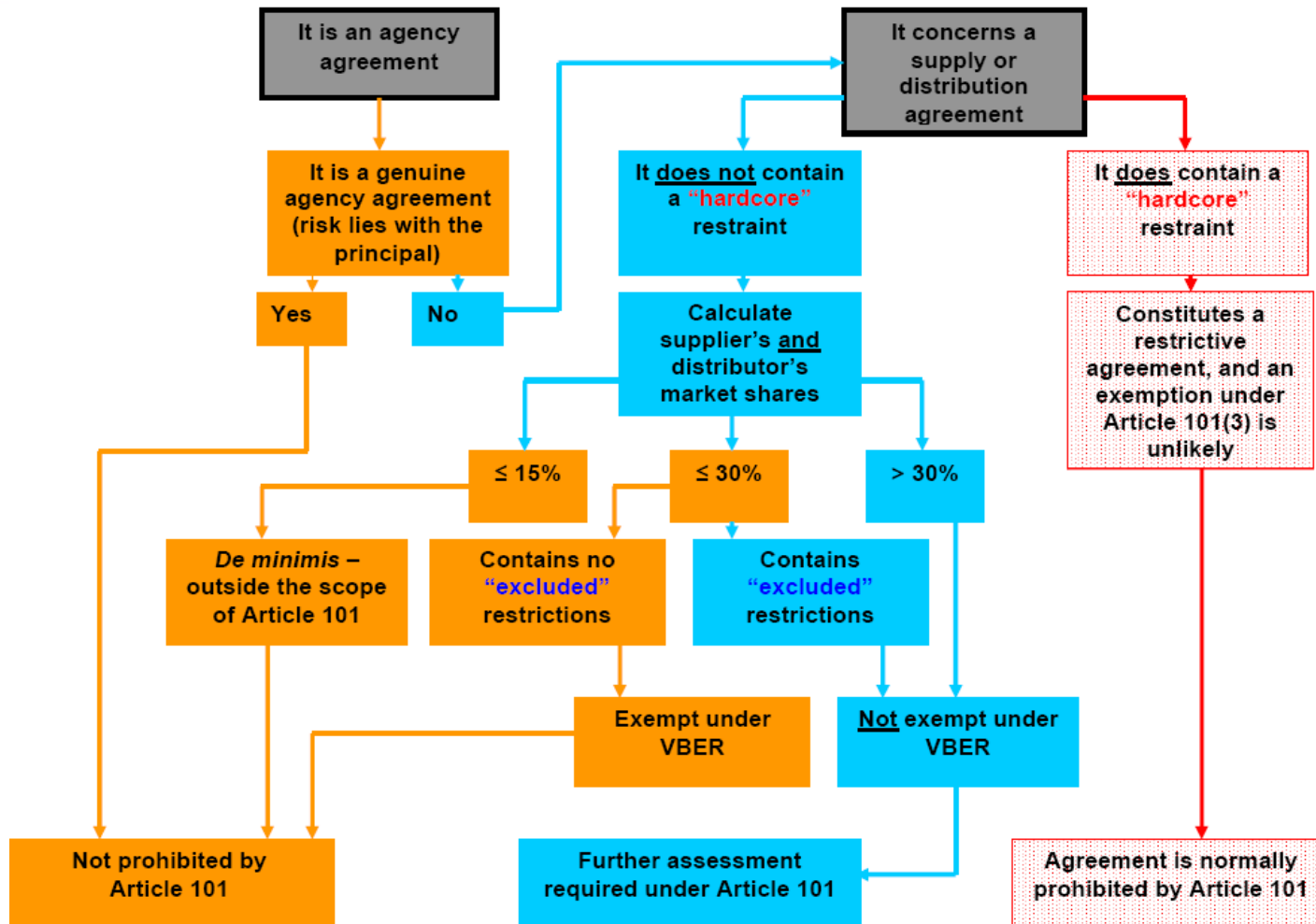
“Hardcore” Restrictions

- Including any of these restrictions disqualify an agreement from any exemption
- They are effectively *per se* illegal and will likely cause an agreement to infringe Article 101
 - **Minimum resale price maintenance**
 - **Prohibiting a distributor from filling unsolicited (“passive”) orders**
 - **Preventing “authorised” distributors from supplying each other**
 - **Preventing “authorised” retailers from supplying end customers**
 - **Preventing supply of spare parts to independent repairer/service provider**

“Excluded” Restrictions

- The following restrictions will not receive the protections of the VBER
- They create a risk that the agreement may infringe Article 101
- Mainly relate to non-competes
 - During the relationship
 - **Non-compete of > 5 years**
 - **Non-compete causing “authorised” distributors not to sell competing brands**
 - After the relationship
 - **Post-term non-compete of > 1 year**
 - **Non-compete causing buyer not to manufacture, purchase, sell or resell goods or services *post-term***

EU Analysis of Distribution Agreements In a Nutshell



PART III

PRACTICAL ASSESSMENT OF DISTRIBUTION AGREEMENTS UNDER EU COMPETITION LAW

Does your client wish to distribute in the EEA?

- **If your client wishes to enter into distribution agreements in the EEA, it must consider EU competition law**
- Even the most basic vertical restrictions are subject to EU competition law, such as:
 - Price restrictions
 - Sales channel restrictions
 - Territorial restrictions
 - Customer restrictions
 - Internet restrictions
 - Qualitative characteristics

Six key categories of vertical restrictions that may create risks vis-à-vis EU competition law (Article 101)

EU competition law (i.e. Article 101) requires analysis to determine if the restriction imposed on a distributor is permitted!

Hypothetical No. 1: AirCo

- AirCo produces basic screws for use in aircraft, which it sells in the US and has a global share of approximately 18%
- AirCo wishes to begin distributing in the EU, beginning with France and Germany only (and with the rest of EU reserved to itself)
 - Its distributors will accept significant financial risk
- AirCo has the following initial objectives:
 - **Appoint one exclusive distributor in each of France and Germany**
 - AirCo wishes to (i) prohibit these distributors from making sales into another territory; and (ii) ensure that restriction applies to its distributors' customers
 - Its chosen distributors each have about 20% shares in their respective markets
 - **Reserve “global” customers to itself (regardless of order origin)**
 - **Prohibit its distributors from using the Internet under any circumstances**



- **Article 101 applies**

- The agreement is between separate firms

- **Possible exemptions/exclusions**

- Agency unavailable (distributor accepts risk)
- *De minimis* unavailable (market shares exceeded)
- **VBER – possible, assessment of market shares and specific restrictions required**
 - Unavailable if “**hardcore**” restrictions or if market shares exceeded
 - Only limited availability if “**excluded**” restrictions are present

- **If VBER unavailable, a full assessment under Article 101(3) is necessary**

- **Market shares within VBER limits ($\leq 30\%$)**
 - AirCo has a global share of 18%
 - AirCo's distributors each have approximately 20% share
- **Assessment of specific restrictions required**
 - **Territorial restrictions**
 - Each distributor is only permitted to sell in its allocated territory
 - **Customer restrictions**
 - AirCo reserves "global" customers to itself
 - **Channel restrictions**
 - Distributors are not permitted to use the Internet under any circumstances

■ Territorial restrictions under EU competition law

- AirCo's territorial restriction is '**hardcore**' and would make the VBER unavailable – and likely cause the agreement to infringe Art. 101
- **Why is AirCo's restriction "hardcore"?**
 - A supplier may prohibit a distributor from "actively" seeking sales outside its territory
 - BUT, a supplier may not prohibit a distributor from filling unsolicited ("passive") orders requested by customers outside its territory. (Generally includes Internet sales!).
- **Potential fix to enable AirCo to confer maximum exclusivity, while still applying the VBER (or reducing risk of infringing Article 101)**
 - AirCo can prohibit its distributors in France and Germany from making "active" sales outside of France and Germany, but not from filling unsolicited orders (including over the Internet)
 - What constitutes a "passive" Internet sale is complex; subject to individual assessment

- **“Exclusive” distribution in the US and the EU mean different things!**

- In the US, airtight exclusive arrangements are generally permissible...
- ...but this is not the case in the EU, where restrictions on “passive” (unsolicited) sales are not permissible



EU Competition Law prohibits suppliers from carving up the EU with exclusive arrangements that completely seal off markets!

■ **Customer restrictions under EU competition law**

- This restriction is **potentially hardcore**.
 - A supplier is permitted to reserve a customer group to itself (or to another distributor) consistent with the VBER and, more broadly, EU competition law
 - BUT, a supplier cannot prohibit a distributor from filling unsolicited (passive) orders sought by customers in that group
- **Why is AirCo's customer restriction potentially hardcore?**
 - Because it threatens a distributor's ability to fill passive orders, which creates risks to the single market
- **Potential fix to enable AirCo to reserve global customers, while still applying the VBER (or reducing risk of infringing Article 101)**
 - AirCo can reserve to itself global customers, but it cannot prohibit its distributors in the EU from filling unsolicited orders from these customers

■ Channel restrictions under EU competition law

- This restriction is **hardcore**
- **Why is AirCo's Internet restriction hardcore?**
 - The Internet must be available to all distributors, consistent with the VBER and a total restriction on use of the Internet is unlikely to be compliant with EU competition law (absent compelling health or safety reasons)
- **There is no fix for this restriction, but AirCo can create guidelines for Internet use**
 - If AirCo wishes to benefit from the VBER (and avoid infringing Article 101) it must not prohibit its distributors from using the Internet
 - BUT, AirCo can impose reasonable guidelines on how its distributors use the Internet

- To ensure that the VBER is available, AirCo should amend its restrictions as follows:
 - **Territories:** AirCo can appoint an exclusive distributor for France and one for Germany.
 - In this context, “exclusive” means that each distributor can be prohibited from making active sales outside of its territory, but not from filling passive (unsolicited) orders
 - **Customers:** AirCo can reserve global customers to itself, but it cannot prohibit its distributors from filling passive (unsolicited) orders received from these customers
 - **Channel:** AirCo cannot prohibit its distributors from using the Internet to sell its products, but it can introduce reasonable quality standards

Hypothetical No. 2: Sportex

- Sportex is a well-known supplier of athletic wear in the US
 - It has carefully managed its brand in the US, and a global share of 25%
- Sportex distributes in the EU on a limited scale, but wishes to expand with the following objectives, which it hopes will promote its brand in the EU:
 - **Distribution may only be made by “authorised” distributors based on their quality**
 - Once authorised, a distributor should have as much territorial protection as possible to incentivise them to promote the Sportex brand
 - **“Authorised” distributors’ use of the Internet should be controlled**
 - **Sportex’s “authorised” distributors must agree not to sell competing products**
 - **Finally, Sportex wishes to reward distributors that respect its recommended price schedule**



- **Article 101 applies**

- The agreement is between separate firms

- **Possible exemptions/exclusions**

- Agency unavailable (distributor expected to invest in promoting the brand)
- *De minimis* unavailable (market shares exceeded)
- **VBER – possible, assessment of market shares and specific restrictions required**
 - Unavailable if “**hardcore**” restrictions or if market shares exceeded
 - Limited availability if “excluded” restrictions

- **If VBER unavailable, a full assessment under Article 101(3) is necessary**

- **Market shares possibly within VBER limits ($\leq 30\%$)**
 - Sportex's global share 25%
 - Sportex's "authorised" distributors shares should be determined
- **Assessment of specific restrictions required**
 - **Qualitative restrictions**
 - Only "authorised" distributors are permitted (and exclusivity is conveyed as much as possible to "authorised" distributors)
 - **Internet restrictions**
 - Sportex wishes to impose quality standards for use of the internet
 - **Price restrictions**
 - Sportex wishes to reward distributors that respect its recommended resale prices
 - **Non-competition provisions**
 - Sportex requires "authorised" distributors not to sell competitors' products
 - Sportex requires that "authorised" distributors not compete with it for 2 years after termination

Assessment of Sportex's Restrictions on "Authorised" Distributors

- **Distribution limited to "authorised" distributors ("selective distribution")**
 - **Selecting (and "authorising") qualified distributors is permissible under the VBER (and more broadly Article 101)**
 - In EU competition law, an "authorised" distributor means a distributor that satisfies objective criteria created by the supplier
 - Examples of such criteria could include: experience in sportswear sales, access to retail space of a certain size, experience of personnel
 - **Certain "hardcore" restrictions in the VBER specifically apply to suppliers seeking to use "authorised" distributors**
 - Sportex must not prohibit its "authorised" retail distributors from supplying end users
 - Sportex must not prohibit its "authorised" wholesale and retail distributors from cross-supplying one another in the EU
 - **Conclusion: Sportex's proposed distribution structure is consistent with the VBER if no hardcore restrictions are included**
 - Territorial "exclusivity" is not available for the "authorised" distributors because they must be able to supply end users and other "authorised" distributors

■ **Control of Internet use**

- It is not a hardcore restraint to impose reasonable limitations on how a distributor uses the Internet
 - *Provided that the distributor is genuinely able to use the internet to sell products*
- **Conclusion: if Sportex's Internet quality guidelines are reasonably tailored to only promote its brand in Europe, this will not interfere with the application of the VBER, or create risks under Article 101**
 - However, Sportex should ensure that its proposed guidelines are closely reviewed by counsel

- **Rewarding distributors that adhere to Sportex's "recommended" resale prices**

- This is a **hardcore** restriction and would also infringe Article 101.
- Minimum resale price maintenance is illegal in the EU. *Recommended* resale prices are not presumptively illegal, unless it operates as resale price maintenance in practice
 - N.B. Maximum resale prices are not presumptively illegal either, unless they operate as minimum resale price maintenance in practice
- Here, Sportex is seeking to "reward" distributors that follow its recommended pricing, which could likely be seen as establishing an illegal agreement to adhere to minimum resale prices
- **Conclusion: Sportex cannot include this provision in its distribution strategy and comply with EU competition law**

- **Non-competition provision #1 – Competing Products**
 - In the context of selective distribution, a non-compete prohibiting an “authorised” distributor from selling competing goods is an **excluded** restriction; that is, it is excluded from the protection of the VBER and thus could be prohibited by Article 101
 - **Conclusion: Sportex, absent a compelling reason, should not prohibit its “authorised” distributors from carrying competing brands**
- **Non-competition provision #2 – Post-term**
 - As structured, a 2 year post-term non-compete is an **excluded** restriction because it is greater than the 1 year post-termination non-competition limit permitted under the VBER
 - **Conclusion; Sportex should reduce the term of the post-term non-compete to 1 year, consistent with the VBER**

- **Selecting “authorised” distributors based on objectively-applied criteria is consistent with the VBER (and Art. 101)**
 - But cross-supply between “authorised” distributors cannot be prevented
 - “Authorised” distributor sales to end users cannot be prevented
- **Reasonable quality standards for distributors’ use of the Internet is permissible under the VBER (and Art. 101)**
- **Mandatory price restrictions are not permissible**
- **“Authorised” distributors should not be prohibited from carrying competing brands**
- **Post-termination non-competes should be limited to 1 year under the VBER**

- **Key distinctions in US antitrust and EU competition law show that one size clearly does not fit all for clients' global distribution strategies**
 - Clients must not merely import their distribution agreements from the US to Europe
 - Members of the Distribution Law and Strategies Affinity group have the experience in US antitrust and EU competition law to help clients adapt distribution strategies that align with their commercial goals and comply with the applicable legal rules
- **Moreover, there are other issues that, although beyond the scope of today's discussion, are of critical importance for clients operating in the EU, namely:**
 - Distribution by “dominant” companies
 - EU competition law imposes special rules on dominant firms that directly impact their commercial strategy, including distribution
 - “Dominance” presumed at a market share of 50%, but a company may be dominant with a lower share – even below 40%!
 - The line between intellectual property (e.g. licensing) and product distribution
 - EU competition law has distinct rules applicable to both activities. Understanding these distinctions can give clients a distinct commercial advantage, and help avoid pitfalls

CONCLUSION

- The Distribution Group with almost forty members located in the US, Europe and China can assist you and your clients:
 - 1. To evaluate the ramifications of proposed domestic and international distribution agreements, relationships and related transactions;
 - 2. To consider contractual provisions to expand sales, increase efficiencies and reduce litigation risks;
 - 3. To develop antitrust compliant incentive and pricing programs; and
 - 4. Implement distribution system modifications and terminations.
- We are an MWE resource we hope you will call upon to assist you and your clients' with their distribution related needs.

THANK YOU

We hope that you have found this webinar informative and will invite your clients to attend the next presentation of it we have planned for their benefit.