DRAFT

The Block Exemption of Vertical Restraints and Online Sales: Some Critical Remarks

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Long abstract

1. The evolution of the distribution sector

Market dynamics in the distribution sector have changed as a result of the growth of e-commerce and the rise of digital platforms and online intermediaries. The rise of the Internet as a prevalent distribution channel has led to the emergence of new players and tools (such as online marketplaces, app stores, and price comparison systems). In many cases, digital operators are intermediaries that operate a multisided platform to facilitate interactions (*e.g.*, exchanges) between distinct types of participants (*e.g.*, sellers and buyers), for which there are usually indirect network effects with other participants. In some cases, digital operators follow a traditional reseller or agency model, in which buyers interact directly with such operators rather than with sellers.

The growth of e-commerce, further spurred by the Covid-19 pandemic, has intensified competition at the distribution level. It has increased price transparency and lowered search costs for customers. Suppliers' and distributors' websites and online intermediaries are easily accessed online. Price comparison websites provide information that facilitate consumers' buying choices. This enables customers instantaneously to obtain and compare product and price information online, and to switch swiftly from one channel (online/offline) to another. Moreover, e-commerce has increased the competitive pressure exerted by firms located in other areas, which may also lead to the definition of broader geographical markets at the distribution level.

E-commerce has also had a profound effect on manufacturers' distribution strategies. The use of the internet significantly lowers the transaction costs of reaching a wide customer base, and facilitates adapting and communicating prices and other terms to customers in response to changing competitive conditions. In this scenario, many manufacturers have integrated vertically into online distribution by launching their own websites. In addition, suppliers have increasingly pursued an omni or multi-channel strategy, directly and through independent distributors and agents.

In this scenario, suppliers have tried to tighten their control over the distribution of their products by integrating vertically into online sales or using vertical restraints. The need to protect the reputation of the brand and to ensure the provision of information and promotional services both in brick-and-mortar and online shops has led to increasing use of vertical restraints that allow for greater control over the distribution of products, such as price restrictions, marketplace bans, restrictions on the use of price comparison tools and the exclusion of pure online players from distribution networks. Suppliers have also increasingly used selective distribution to maintain a coherent brand image across offline and online sales, avoid free riding between different channels and prevent the sale of counterfeit products.

2. The impact of e-commerce on the risk of free-riding

The growth and widespread use of e-commerce has had an ambiguous impact on the risk of free-riding. In theory, the ease of internet searches and low prices offered by online distributors may increase the risk of free-riding on the services provided by traditional distributors. On the other hand, the internet may also mitigate the risk of free-riding, as many pre-sale services – in particular information services – can be (i) provided online at a relatively low cost, and (ii) easily monitored by the supplier through access to distributors' websites. Internet distributors may provide extensive

product information and customer reviews on their websites. The development of e-commerce and ccon
sumers’ willingness to invest time on-line to learn about products have made in-store services less important. In this scenario, free-riding on the efforts of brick-and-mortar stores is frequently limited to products that depend on sensory experience for sales. Moreover, free-riding may also occur in the opposite direction, as customers frequently browse internet retailers’ websites to quickly gather information on goods and services, and then purchase the selected product at brick-and-mortar stores.

Nonetheless, suppliers may need to grant traditional distributors some degree of protection from free-riding by online sellers. Many consumers continue to rely on in-store retail services in some situations, such as the purchase of complex products, experience goods or durable goods. In such cases, e-commerce can exacerbate the risk of free-riding, as consumers can simply visit a brick-and-mortar store to ask questions, try or test a product, and then make the purchase online at a lower price. Free-riding by internet retailers is generally a greater problem than free-riding in the reverse direction, also considering that: (i) much of the effort of brick-and-mortar distributors takes the form of a per customer cost, while online retailers are more likely to incur fixed costs in providing support; (ii) promotional efforts of brick-and-mortar distributors are much more difficult to verify, as they consist of personal interactions between customers and sales consultants.

3. <u>The treatment of online sales in the VBER</u>

The Commission took into account the evolution of the distribution sector in the review of the rules on vertical restraints in 2010 and 2022. In particular, the 2022 review aimed, *inter alia*, at: (i) readjusting the safe harbor provided by the block exemption and improve its accuracy, including in connection with online sales and digital platforms, so as to reduce the risk of false positives and false negatives, and (ii) updating the relevant rules and guidelines in light of the significant changes in the business environment, reshaped by the growth of e-commerce and the rise of online platforms.

The evidence gathered during the review process indicated that online sales have developed into a well-functioning and established sale channel, which no longer needs to be protected by qualifying certain indirect measures restricting online sales as hardcore restrictions. Accordingly, the Commission introduced a more flexible approach in relation to certain aspects, such as the possibility to charge different prices for products intended to be sold online and offline (dual pricing), and to adopt non-equivalent criteria for online and offline sales in selective distribution systems. At the same time, however, the Commission confirmed the strict treatment of certain provisions that may prevent the effective use of the internet, and introduced some additional limits to manufacturers’ ability to control online distribution.

The VBER and the Vertical Guidelines attempt to strike a balance between the need to ensure that e-commerce is not restricted and placed at a disadvantage *vis à vis* other forms of marketing and sales techniques, on the one hand, and the need to allow suppliers to exercise some form of control on the use of the internet by distributors, on the other. The question arises as to whether certain provisions of the VBER adequately take into account the characteristics and competitive dynamics of online distribution.

(a) The restriction of active sales in territories or to customer groups allocated to other distributors

Pursuant to Article 4(b), (c) and (d) of the VBER, in principle, the block exemption does not apply to agreements that, directly or indirectly, have as their object the restriction of the territory into which, or the customers to whom, a buyer may actively or passively sell the contract goods or services. However, the VBER provides for a number of exceptions to the above-mentioned hardcore restriction.

One of the exceptions is based on the traditional distinction between active and passive sales. Based on the VBER, the supplier may restrict active sales by the exclusive distributor into a territory or to a customer group reserved to the supplier or exclusively allocated to a maximum of five buyers. This restriction is considered justified by the need to grant exclusive distributors a certain degree of protection to preserve their incentive to invest and promote contract products. However, to benefit from the block exemption, the supplier cannot restrict passive sales into such territories or to such customer groups. The restriction of passive sales is considered particularly harmful, also because it results in market partitioning, which interferes with the political objective of market integration and deprives EU citizens of their right to make their purchases in any Member State.

The distinction between active and passive sales may be uncertain in some cases, especially in e-commerce. The Vertical Guidelines provide some indications on online sales, which reflect the Commission's intent to guarantee the possibility to use the internet. In principle, suppliers are entitled to impose restrictions on distributors over the internet for activities that can be assimilated to active selling into exclusive territories or to customer groups allocated to other distributors. However, the fact that the use of a website may have effects beyond the distributor's territory or customer group is not considered an indication of active selling, but a consequence of the technology used, which allows easy access from everywhere. Thus, a number of provisions limiting the distributors' freedom to use the internet to sell products, without implementing initiatives specifically targeted at the territories or customers of other distributors, are considered restrictions of passive sales. Similar criteria apply to online advertising and promotions.

(b) The restriction of active or passive sales to end users in a selective distribution system

According to Article 4(c)(iii) of the VBER, the block exemption does not apply to agreements that, directly or indirectly, have as their object the restriction of active or passive sales to end users by members of a selective distribution system operating at the retail level of trade. Authorized distributors must be free to sell actively and passively to end users also with the help of the internet. In *Pierre Fabre Dermo-Cosmétique*, the ECJ stated that, in a selective distribution system, a contractual clause prohibiting *de facto* the use of the internet as a method of marketing amounts, in principle, to a restriction by object. Furthermore, the ECJ held that a ban on the use of the internet by members of a selective distribution system operating at the retail level of trade does not benefit from the block exemption, since it has as its object the restriction of sales to end users under Article 4(c) of Regulation No. 2790/1999 (currently Article 4(c)(iii) of the VBER).

In order to preserve the characteristics of selective distribution networks, the supplier may require distributors to comply with certain criteria and quality standards when selling over the internet. Under Regulation No. 330/2010 and the related guidelines, any obligations imposing on appointed dealers criteria for online sales that were not overall equivalent to those imposed for sales from brick-and-mortar stores were considered hardcore restrictions. The Vertical Guidelines currently in force no longer qualify lack of equivalence as hardcore restriction. The Commission acknowledged that the offline and online channels are inherently different in nature and may require different criteria. Accordingly, based on the rules currently in force, the criteria imposed by suppliers on authorized distributors in a selective distribution system no longer have to be overall equivalent to the criteria imposed on brick-and-mortar shops.

However, the possibility to impose non-equivalent criteria is subject to the general limiting principle that applies to online sale restrictions pursuant to Article 4(e) of the VBER: requiring different criteria for online sales may be exempted only to the extent that it does not have as its object to prevent buyers or their customers from effectively using the internet to sell their goods or services.

(c) <u>The prevention of the effective use of the internet</u>

The VBER introduced a specific hardcore restriction regarding online sales. Pursuant to Article 4(e) of the VBER, the block exemption does not apply to agreements that, directly or indirectly, have as their object the prevention of the effective use of the internet by the buyer or its customers to sell the contract goods or services, without prejudice to the possibility of imposing on the buyer (i) other restrictions of online sales, or (ii) restrictions of online advertising that do not have the object of preventing the use of an entire online advertising channel.

Article 4(e) of the VBER specifies that preventing the effective use of the internet is a hardcore restriction because it restricts the territory into which, or the customers to whom, the contract goods or services may be sold within the meaning of letters (b), (c) and (d). Thus, letter (e) seems to reflect prohibitions that are already inherent in other provisions of the same Article. The main function of Article 4(e) of the VBER, read jointly with the Vertical Guidelines, seems to be to clarify the application of EU principles in the online scenario. Nonetheless, the introduction of a new provision raises the doubt as to whether it simply refers to a subset of restrictions already declared hardcore by Article 4(b), (c) and (d) of the VBER, and thus is ultimately redundant, or it introduces further hypotheses of hardcore restrictions, which do not fall within the scope of other provisions of Article 4.

According to the Vertical Guidelines, restrictions of online sales or online advertising that *de facto* prohibit the buyer from using the internet to sell the contract goods or services have at the very least the object of restricting passive sales to end users located outside the buyer's physical trading area, who wish to purchase online. The same is true for vertical agreements that do not directly prohibit, but indirectly prevent the effective use of the internet by a buyer or its customers to sell the contract goods or services to particular territories or customers.

Apart from the most evident cases, such as a total ban on the use of internet, the question is when a provision can be deemed to prevent the effective use of the internet to sell goods or services. The Vertical Guidelines suggest that a restriction may prevent the effective use of the internet if it has the object of (i) significantly diminishing the aggregate volume of online sales of the contract products or the possibility for end users to buy them online, (ii) preventing the use of one or more entire online advertising channels by the buyer, or (iii) preventing the buyer from establishing or using its own online store. The first case (significant decrease in the volume of online sales) may be difficult to assess in practice. Estimating the impact of a restriction on the volume of online sales may require an analysis not only of the content of the provision, but also of the likely impact of the restriction on the market. This is somehow difficult to reconcile with the traditional approach to hardcore restrictions, which should be clearly identifiable based on their content, without also analyzing in detail the object or effect of the restriction in light of the legal and economic context. In any case, the Vertical Guidelines a number of obligations considered capable of preventing the effective use of the internet.

In line with certain precedents at the UE and national level, the VBER and the Vertical Guidelines specify that the supplier cannot prohibit the buyer from using an entire online advertising channel, such as search engines, or price comparison services. However, the Vertical Guidelines do not seem to consider the possibility that different online advertising channels may compete with each other and represent valid alternatives for the promotion of certain goods or services in all territories and customer groups. In the offline world, suppliers may limit the use of certain forms of advertising, for instance if they are not considered consistent with the characteristics, image and reputation of certain products.

The supplier can impose requirements on the buyer relating to the manner in which the contract goods or services are to be sold online, such as a ban on the use of online marketplaces, or quality standards for online sales. Even in this case, however, the restrictions must not indirectly have the object of preventing the effective use of the internet by the buyer to sell the contract goods or services to particular territories or customers.

The Vertical Guidelines introduced a more flexible approach with regard to dual pricing schemes, *i.e.*, agreements requiring the buyer to pay different wholesale prices for products sold online and offline. According to the Vertical Guidelines, in principle dual pricing can benefit from the block exemption, as it may encourage an appropriate level of investments in online or offline sales channels. In particular, dual pricing can benefit from the block exemption where the difference in the wholesale price is reasonably related to differences in investments or costs relating to sales in each channel. However, dual pricing is considered a hardcore restriction under Article 4(e) of the VBER if the difference in wholesale prices has the object of preventing the effective use of the internet by the buyer, in particular by making online sales unprofitable or financially unsustainable, or by limiting the quantity of products available for online sales. Even in this case, in order to verify whether a clause may benefit from the block exemption, it may be necessary to carry out an in-depth assessment of the impact of the clause in light of the legal and economic context, which goes beyond the analysis traditionally conducted under block exemption regulations.

4. Some concluding remarks

The adaptation of the traditional principles on territorial and customer restrictions to online sales has resulted in a limitation of the protection that suppliers can grant to their distributors. The internet has indeed blurred the boundaries between active and passive sales, by eliminating or significantly reducing search costs for consumers. In many cases, it is not necessary to actively target customers to sell products in territories or to customer groups allocated to other dealers, even for a significant portion of the distributor’s turnover. This raises the question of whether the distinction between active and passive sales is still meaningful in the online scenario.

Furthermore, certain provisions of the VBER seem to require an assessment not only of the content of the provision, but also of the likely impact of the restriction, which goes beyond the analysis traditionally conducted under block exemption regulations. This seem to reflect a more general trend of the European institutions to prefer the of more open standards rather than rigid rules or presumptions, confirmed also by the recent *Super Bock* ruling of the ECJ, stating that hardcore restrictions cannot be presumed to constitute restrictions by object under Article 101(1) TFEU. However, this approach seems difficult to reconcile with the traditional function of block exemption regulations, which should allow firms to comply with Article 101 TFEU without carrying out an in-depth assessment of the likely impact of the restriction.