PUBLIC CONSULTATION ON THE DRAFT REVISED REGULATION ON VERTICAL AGREEMENTS AND VERTICAL GUIDELINES

CONSULTATION RESPONSE

17 SEPTEMBER 2021

ALLEN & OVERY

1. We welcome this opportunity to comment on the Commission's public consultation on the draft revised regulation on vertical agreements (the **Revised Draft VBER**) and vertical guidelines (the **Revised Draft VGL** and, together with the Revised Draft VBER, the **Revised Drafts**).

2. Overall, we think that the Revised Drafts, once they take effect, will greatly improve the self-assessment process in relation to vertical restraints. The updates that have been made to reflect market changes and technological developments over the last 10 years will make the Revised Drafts more relevant for today's competitive landscape. In particular, the addition of the detailed and focused guidance in relation to the digital sector will be helpful for companies. We also welcome that the Revised Drafts have incorporated important updates relating to the Commission's case precedents and enforcement activity from the past decade. Having those updates consolidated into one guidance document will make it more efficient to self-assess vertical restraints.

3. While we think that the Revised Drafts are a great improvement overall, there are a few points where we think that further clarifications and guidance would be beneficial. We set out below our specific comments and suggestions.

1. Non-compete obligations in franchising agreements

4. Paragraph 150 of the Revised Draft VGL states, in relation to franchising agreements, that "*provisions that are strictly necessary for the functioning of such distribution systems can be considered as falling outside Article 101(1)*." Examples are then given, including "*a non-compete obligation with regard to the goods or services purchased by the franchisee that is necessary to maintain the common identity and reputation of the franchise network*". The wording used suggests that non-compete obligations in franchise agreements that are needed for a purpose other than maintaining the common identity and reputation of the franchise network could potentially fall within Article 101(1) TFEU.

5. We reiterate the point made in our previous consultation response that non-compete provisions in genuine franchise arrangements should always be considered as falling outside Article 101(1) TFEU. A key feature of franchise networks is the provision of a complete and uniform business method by the franchisor to its franchisees, as well as the transfer of know-how for this purpose. This is recognised in the description of the franchise model provided in paragraph 80 and again in paragraph 149, which notes that the licence of IPRs *"is an intrinsic component of the business method being franchised"*.

6. According to paragraph 14(f) of the Revised Draft VGL, the substantial transfer of know-how that was not readily available to the buyer, and which is substantial and indispensable for the operation of the agreement, will normally result in non-compete restrictions falling outside Article 101(1) TFEU. Any genuine franchise agreement would likely meet those requirements and, therefore, non-compete provisions in such agreements should fall outside Article 101(1) TFEU. Indeed, paragraph 300 acknowledges that: "*transfer of substantial know-how (paragraph (14)(f) of these Guidelines) usually justifies a non-compete obligation for the whole duration of the supply agreement, as for example in the context of franchising*".

7. We would again encourage the Commission to expressly state that non-compete obligations in franchise agreements fall outside the scope of Article 101(1) TFEU for the whole duration of the relevant agreement. This could be achieved with the following amendment to paragraph 150 of the Revised Draft VGL:

> *Franchising (with the exception of industrial franchise agreements) presents some specific characteristics, such as the use of a uniform business name, the application of uniform business methods (including the licensing of IPRs) and the payment of royalties in return for the benefits granted. In view of these specificities, provisions that are strictly necessary for the functioning of such distribution systems can be considered as falling outside Article*

101(1). This concerns, for instance, restrictions that prevent the know-how and assistance provided by the franchisor from benefiting his competitors and ~~a~~ non-compete obligations with regard to the goods or services purchased by the franchisee ~~that is necessary to maintain the common identity and reputation of the franchise network~~. In the latter case, the duration of the non compete obligation is irrelevant as long as it does not exceed the duration of the franchise agreement itself.

8. If the Commission is of the view that there could be any situations in which such non-compete clauses would not be justified in franchise agreements, for the sake of legal certainty it would be helpful if it provided examples of such situations.

2. RPM - Broadening the guidance provided for price promotions

9. Paragraph 182(b) of the Revised Draft VGL states that RPM in short-term low-price campaigns may lead to efficiencies when a supplier "*applies a uniform distribution format, such as a franchise system*".

10. We reiterate the point made in our previous consultation response that consumers may benefit from these campaigns, regardless of the nature of the distribution system. Therefore, we would encourage the Commission to broaden the description of RPM leading to efficiencies in short-term low-price campaigns to all distribution systems. Alternatively, to provide more clarity, the Revised Draft VGL should at least further elaborate on what kinds of distribution systems have a "*uniform distribution format*". From the wording of paragraph 182(b) of the Revised Draft VGL, the Commission clearly intends this to cover franchise systems; which other types of distribution system have such uniform distribution format? Do they include, for example, selective distribution systems?

3. Single branding obligations exceeding five years

11. Paragraph 285 of the Revised Draft VGL states that "*single branding obligations exceeding five years are for most types of investments not considered necessary to achieve the claimed efficiencies or the efficiencies are not sufficient to outweigh their foreclosure effect*".

12. As noted in our previous consultation response, this guidance seems to apply even where the market shares of the parties to the agreement do not exceed the 30% market share threshold, ie, if the non-compete obligation falls outside the block exemption because its duration exceeds five years. In the case of such small market shares, it is unclear why the Revised Draft VGL proposes what is effectively a presumption of anti-competitive effects and declares that exemption under Article 101(3) TFEU will be unlikely. We would therefore suggest that the Commission explicitly states that single branding obligations exceeding five years are not problematic as long as the market shares of the parties to the agreement remain below the 30% market share threshold.

13. We also suggest that paragraph 285 should be updated to ensure consistency with paragraph 234. Paragraph 234 states that the block exemption covers non-compete obligations (including single branding obligations) that can be tacitly renewed beyond five years if the buyer can effectively renegotiate or terminate them under reasonable terms. Paragraph 285 should be updated to clarify that there is no presumption of anti-competitive effects, or indeed any presumption against an exemption, if a single branding obligation which is tacitly renewable beyond five years is subject to suitable termination or renegotiation in accordance with paragraph 234.

14. The same is true for paragraph 283, which provides that "*[a]Above the market share threshold or beyond the time limit of five years, single branding agreements are no longer covered by the block exemption and therefore must be individually assessed".* We suggest that this should also be updated in the same way to ensure consistency with paragraph 234.

4. Combining exclusive and selective distribution in the same territory

15. We welcome the additional guidance provided in the Revised Draft VGL (paragraphs 209 and 215) confirming that, where a supplier operates exclusive and selective distribution systems in different territories, (i) exclusive distributors and their customers may be prohibited from making active and passive sales to unauthorised dealers in the territories where the supplier applies selective distribution; and (ii) selective distributors and their customers may be prohibited from making active sales into an exclusive territory.

16. Regarding combining selective and exclusive distribution within the same territory, paragraph 222 of the Revised Draft VGL states that "*A selective distribution system cannot be combined with an exclusive distribution system, as defined in Article 1(1)(g) VBER, within the same territory, as this would lead to a hardcore restriction of active or passive sales to end users by the authorised distributors pursuant to Article 4(c)(i) VBER*." To the extent that exclusive and selective distribution are combined at the same level of the supply chain (eg retail), we accept that the guidelines are not controversial: we would agree that there is a potential problem under Article 4(c)(i) if retailers who are members of a selective distribution network cannot make active or passive sales to end-users located in the exclusive territory of another dealer in the same territory. However, combining exclusive and selective distribution in the same territory frequently involves different levels of the supply chain, notably exclusive distribution being used at wholesale level and selective distribution at retail level. Currently, where a supplier wishes to appoint an exclusive wholesaler whilst operating a selective distribution system at retail level, we understand that the supplier may not restrict wholesalers located outside the territory from actively selling to authorised retailers in that territory. It is not permissible to combine full exclusivity at wholesale level with selective distribution at the retail level. In our view, the current rules are excessively strict as they undermine a supplier's ability to incentivise a wholesaler in investing to develop the relevant supplier's brand by offering protection from free riding by wholesalers in other territories. Also, vertical restraints applied at the wholesale level are generally expected to have a limited adverse impact on intra-brand competition compared to at the retail level. We would, therefore, welcome guidance by the Commission on the circumstances where exclusive distribution at the wholesale level could be combined with selective distribution at the retail level of trade.

5. Information exchange

17. The Revised Drafts tighten the rules that apply to dual distribution. They provide that the safe harbour is only fully available in a dual distribution scenario where the parties' aggregate market share in the retail market does not exceed 10%. Where the market share falls between 10% and 30%, the exemption does not apply to any information exchanges between the parties. These would need to be reviewed under the Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements (**Horizontal Guidelines**).[1]

18. We reiterate our invitation to the Commission to provide guidance in the Revised Draft VGL on how rules on information exchange apply in a vertical context, notably in case of dual distribution, whether the relevant agreements fall within or outside the scope of the VBER (eg, where the market share thresholds are not satisfied). In particular, we consider that, in the interest of promoting legal certainty for businesses, it would be important that, as a minimum, the Revised Draft VGL clarify that information exchange between a producer and its distributors does not restrict competition where it is objectively necessary for the producer to run its operations. It would be also helpful if the Revised Draft VGL provided non-exhaustive examples of measures that are considered appropriate and sufficient to address any residual horizontal concerns.

[1] Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements, OJ C 11, 14.1.2011, p. 1–72

19. Information exchange is also relevant in relation to collection of information from downstream parties, eg, retailers. We would be keen to see guidance in the Revised Draft VGL on how far upstream parties (such as manufacturers or wholesale distributors) can go when collecting information from retailers on their own products or competing products. In particular, more guidance would be welcome on reporting obligations from "tier 2" distributors up to "tier 1" distributors and then up to the supplier, ie where a supplier has more than one layer of distributor. From a commercial perspective, it is often desirable for such information to flow up the distribution chain to check the performance of distributors further down the channel.

6. Guidance on single branding of spare parts within an OEM's service network outside the scope of the block exemption

20. It follows from paragraph 231 of the Revised Draft VGL that the obligation imposed by an OEM on *"its own repair and service network to buy spare parts from itself or from other members of its selective distribution system, where it operates such a system*" is not a hardcore restriction in the sense of Article 4(e) Revised Draft VBER. We reiterate the point made in our previous consultation response that we would welcome guidance in relation to obligations imposed on an OEM's service network to use original spare parts in situations outside the scope of the block exemption (ie above the 30% market share threshold). Such guidance would be valuable both in relation to warranty and off-warranty repair services, for the reasons set out below.

21. Warranty repair services are very often carried out by the OEM's service network based on a contract with the OEM. We believe that, in such a case, an obligation to use original spare parts should not be considered a restriction under Article 101(1) TFEU at all. Such an obligation can be justified by the fact that, ultimately, OEMs are liable to ensure that warranty repairs are carried out appropriately. The Commission has already recognised this in relation to the automotive sector, in paragraph 39 of the Motor Vehicle Guidelines:[2] *"an obligation on an authorised repairer to use original spare parts supplied by the motor vehicle manufacturer for repairs carried out under warranty, free servicing and motor vehicle recall work would not be considered to be a single-branding obligation, but rather an objectively justified requirement*". The same principles are applicable in relation to warranty services for any other consumer products. Therefore, we suggest including similar guidance in the Revised Draft VGL as provided for in paragraph 39 of the Motor Vehicle Guidelines, albeit in relation to a wider range of consumer products.

22. In relation to non-warranty repair services, we would also welcome general guidance in the Revised Draft VGL that recognises the possible efficiencies arising out of an enhanced brand image of the distribution and service network. Currently, such guidance is provided only on a sector specific basis in paragraph 30 of the Motor Vehicle Guidelines: *"positive effect of non-compete obligations in the motor vehicle sector relates to the enhancement of the brand image and reputation of the distribution network. Such restraints may help to create and maintain a brand image by imposing a certain measure of uniformity and quality standardisation on distributors, thereby increasing the attractiveness of that brand to the final consumer and increasing its sales."* Although this efficiency is potentially equally relevant to a number of other consumer goods, the Revised Draft VGL does not currently refer to this in relation to single branding.[3]

7. Long-term and indefinite vertical restraints

7.1 Vertical restraints which should not be justified on a long-term or indefinite basis

2 Commission notice — Supplementary guidelines on vertical restraints in agreements for the sale and repair of motor vehicles and for the distribution of spare parts for motor vehicles OJ C 138, 28.5.2010, p. 16–27

3 See in particular paragraph 296 of the Revised Draft VGL, according to which only the free riding problem, the hold-up problem and capital markets imperfections are particularly relevant in relation to the assessment of single branding under Article 101(3).

23. Several provisions in the Revised Draft VGL indicate that (certain) vertical restrictions may be justified for as long as the agreement which contains the obligation remains in force. For instance:

(a) Paragraph 15 states that this could apply in relation to the following justifications for vertical restraints: (i) the vertical externality issue, (ii) the free-rider problem, (iii) the specific hold-up problem that may arise in the case of the transfer of substantial know-how, (iv) economies of scale in distribution, and (v) uniformity and quality standardisation; and

(b) Paragraph 300 states that this could apply to non-compete obligations in the case of the transfer of substantial know-how.

24. These provisions imply that the application of certain vertical restrictions can be justified for a long-term or indefinite contract period, regardless of how long the restraint has been in force and whether the original circumstances which justified it are still relevant.

25. We are of the opinion that this should not apply if (i) the agreement has an indefinite term, a term exceeding five years or a term which can be tacitly renewed unilaterally beyond five years by the party which benefits from the vertical restraints in question; and (ii) the termination provisions in the agreement do not permit the party which is restrained to terminate the agreement at will with reasonable notice and cost (or to otherwise renegotiate to release themselves from the restraint).

26. Indeed, where there is no mechanism under contract law to release the restrained party from long-term or indefinite vertical restraints, competition law should be available as a potential avenue for doing so. Challenging a vertical restraint under competition law (either through a complaint to the Commission or another national competition authority, or through a claim brought through the courts) will face many additional hurdles if the Revised Draft VGL provide an indefinite justification for the restraint in question, regardless of whether the original circumstances which justified it are still relevant.

27. We think that the most efficient way to address this concern would be to add a short paragraph to the "Limits to the Application of the VBER" section of the Revised Draft VGL (section 4.4) which clarifies that vertical restraints for which the VGL envisages justification for the duration of the relevant agreement, do not benefit from block exemption and/or are not presumed to fulfil the conditions of Article 101(3) TFEU in the event that (i) the agreement containing the obligation has either an indefinite term, a term exceeding five years, or a term which can be tacitly renewed unilaterally beyond five years by the party which benefits from the vertical restraints in question, and (ii) the party which is restrained cannot effectively renegotiate or terminate the agreement containing the obligation with a reasonable notice period and at a reasonable cost.

28. This would provide some protection for companies in the rare scenario where there is no contractual recourse to release them from long-term vertical restraints. It would make it easier for them to bring a challenge under competition law as it would ensure that the restraint in question is fairly assessed for individual exemption under Article 101(3) TFEU according to the current circumstances, rather than according to the conditions which originally justified it for an indefinite period. At the same time, this proposed amendment would otherwise maintain the current functioning of the Revised Draft VGL in relation to long-term or indefinite vertical restraints for the vast majority of cases.

7.2 Long-term and indefinite term agreements that should benefit from the block exemption

29. In the second sentence of paragraph 234, the Revised Draft VGL recognises that the crucial distinction is not between indefinite and fixed-term non-compete agreements. Instead, it makes a key distinction between two types of non-compete obligations, even if they can be tacitly renewed beyond five years, depending on the restricted party's termination rights. Either:

(a) the block exemption applies if the restricted party can exit from the relevant non-compete obligation on reasonable terms (*"the buyer can effectively renegotiate or terminate the vertical agreement containing the obligation with a reasonable notice period and at a reasonable cost, thus allowing the buyer to effectively switch its supplier after the expiry of the five-year period"*); or

(b) the block exemption does not apply if the restricted party's exit from the relevant non-compete obligation is hindered in some way (e.g., *"if, for instance, the vertical agreement provides for a five-year non-compete obligation and the supplier provides a loan to the buyer, the repayment of that loan should not hinder the buyer from effectively terminating the non-compete obligation at the end of the five-year period"*)

30. Despite this very logical distinction, Article 5(a) of the Revised Draft VBER maintains a sweeping exclusion from the block exemption for any restrictions whose term is *"indefinite or exceeds five years"*. We suggest that the Commission consider refining Article 5(a) of the Revised Draft VBER to reflect the distinction as set out in paragraph 234 of the Revised Draft VGL. As a result, Article 5(a) should cover restrictions even if: (i) the agreement containing the obligation has either an indefinite term, a term exceeding five years, or a term which can be tacitly renewed unilaterally beyond five years by the party which benefits from the vertical restraints in question, and (ii) the party which is restrained can effectively renegotiate or terminate the agreement containing the obligation with a reasonable notice period and at a reasonable cost. Article 5(a) should only exclude restrictions which genuinely "lock in" the restricted party indefinitely or for a period that is longer than five years.

8. Depreciation period for investments as guide for the justified allocation period in the case of territorial exclusivity

31. Paragraph 126 of the Revised Draft VGL contains the following guidance regarding the justified exclusivity period for the allocation of exclusive customer groups (emphasis added):

"*Exclusive customer allocation may lead to efficiencies where the investments of the distributors are necessary to build the brand image or where the distributors are required to invest in, for instance, specific equipment, skills or know-how to adapt to the requirements of the exclusive customer group that has been allocated to them or when these investments lead to economies*[4] *of scale or scope in logistics (for instance, having a dedicated retailer dealing with public administrations' tenders for computers or office supplies). The depreciation period for these investments is an indication of the duration for which an exclusive distribution system based on the allocation of exclusive customer groups may be justified*."

32. The depreciation period of a relationship-specific investment is only mentioned in one other place in the Revised Draft VGL. Paragraph 298 states that it can be used as an indicator of the period for which a non-compete will generally fulfil the conditions of Article 101(3) TFEU. No guidance is offered regarding the relevance of the depreciation period for relationship-specific investments in the context of territorial exclusivity.

33. We note that incentivising relationship-specific investments is described in the Revised Draft VGL as being an important efficiency for both territorial and customer group exclusivity. Paragraph 101 states that suppliers often use exclusive distribution to *"incentivise distributors to make the financial and non-financial investments needed to develop their brand in a territory where it is not well-known or to sell a new product in a particular territory or to a particular customer group or to increase the focus of the distributors' activities on a particular product (eg, special marketing or display efforts)*". That suggests that relationship-specific investments are often required in relation to both territorial and customer group exclusive distribution. In our view, the investment depreciation period should,

4 We note a typo in paragraph 126 of the Revised Draft VGL: *"(...) when these investments to lead economies of scale ..."*.

therefore, be considered as relevant to both when considering what is a justified allocation period. We would welcome clarification on this point in the Revised Draft VGL.

9. Definition of passive selling in the Revised Draft VBER

34. Paragraph 200 of the Revised Draft VGL states that responding to tenders (both public and private) is always considered a form of passive selling. The definition of "passive" sales in Article 1(m) of the Revised Draft VBER includes "*participating in public procurement*", however it does not explicitly mention private tenders.

35. While we accept the Commission's reasoning for classifying responding to tenders as a form of passive selling (on the basis that tenders are a form of unsolicited sales request addressed to multiple potential suppliers), we do not think that this is necessarily an intuitive position. Preparing a response to a tender requires positive actions to be taken, and is targeted at a particular company or territory; therefore, many companies will likely assume that responding to tenders is a form of active selling. We consider that this point needs to be given due prominence and clarity in the Revised Drafts, and this can be best achieved by amending the Revised Draft VBER to be consistent with the Revised Draft VGL.

36. We would, therefore, suggest that the definition of "passive" sales in the Revised Draft VBER should be revised as follows:

> *'passive' sales mean sales in response to unsolicited requests from individual customers, including delivery of goods or services to such customers without having initiated the sale through advertising actively targeting the particular customer group or territory, and ~~participating in public procurement~~ responding to tenders (both public and private);*

10. Definition of online advertising channel

37. Several parts of the Revised Draft VGL provide guidance in relation to restrictions against the use of online advertising channels (see for example paragraphs 188, 194, 196 and 316). In particular, paragraph 188 sets out that "*Restrictions that prevent the effective use of one or more online advertising channels by the buyers or their customers have as their object to prevent the buyers or their customers from effectively using the internet to sell their goods or services online and thus restrict sales to customers wishing to purchase online and located outside the physical trading area of the buyers or their customers, as they limit the buyers' or their customers' ability to target them, inform them of their offering and to attract them to their online shop or other channels*." The consequence of this provision is that such restrictions are classified as hardcore restrictions of active or passive sales. This is reflected in the definition of "'restriction of active or passive' sales" in Article 1(n) of the Revised Draft VBER.

38. Given the importance which this new provision in the Revised Drafts will have for businesses, we think that there should be a clear and comprehensive definition of "online advertising channel". While the paragraphs mentioned above do provide price comparison tools and online search engines as examples of online advertising channels, the Revised Drafts do not otherwise contain a definition. In addition, footnotes to those paragraphs refer to the *Guess* and *Coty* judgments, however the paragraphs referenced in those judgments also do not contain a definition of "online sales channel". For the sake of legal certainty, we suggest that a comprehensive definition of "online advertising channel" should be added to both the Revised Draft VBER and the Revised Draft VGL.

11. Consistency in the description of the *Metro* criteria

39. Paragraphs 134 and 319 of the Revised Draft VGL both explain that selective distribution systems will fall outside of Article 101(1) TFEU when the *Metro* criteria are met. Paragraph 319 refers back to the description of the *Metro* criteria provided in paragraph 134 and then proceeds to describe the *Metro*

criteria again in a different order and in a more abbreviated form. While we do not think that there are any material inconsistencies between the two descriptions, our view is that the description in paragraph 134 should track across to paragraph 319 for the sake of consistency and clarity.

12. Informal guidance

40. Although it is technically possible to request informal guidance through the Commission's Guidance Letters Notice,[5] in practice this opportunity seems to have remained largely unused.

41. It may be useful for the Commission to take a more flexible approach and more readily allow companies to ask for informal guidance on novel vertical issues. As noted in our previous consultation response, the Revised Draft VGL could be an opportunity to set out criteria under which the Commission would consider the conditions in its Guidance Letters Notice to be met in the case of vertical agreements.

5 Commission Notice on informal guidance relating to novel questions concerning Articles 81 and 82 of the EC Treaty that arise in individual cases (guidance letters) OJ C 101, 27.4.2004