Why selective distribution makes sense for luxury and premium businesses

While selective distribution can be an excellent option for luxury brand owners, allowing them to control how their products are sold within a certain territory, there are potential clashes with competition law, particularly within the European Union

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'Selective distribution' allows the owner of a brand that wishes to distribute its products in a particular jurisdiction to set out certain criteria allowing it to choose which distributors will have the right to resell its products and how.

Selective distribution is a useful tool for suppliers, as it allows them to refuse to sell to dealers that do not comply with their set criteria. It is particularly popular in the luxury goods sector, as well as for premium products such as high-end cars and hi-fi sound systems.

Selective distribution of luxury and premium products

Luxury brands, always mindful about their image, often use selective distribution to sell their products. This is the most common distribution technique for perfumes, cosmetics, leather accessories and even ready-to-wear clothes.

It is extremely flexible compared to exclusive distribution or franchising, because it allows the supplier to select distributors according to criteria which are mainly qualitative and, consequently, to ensure commercialisation under conditions which befit the prestige of its products.

Selective distribution allows consumers to differentiate between luxury products and potentially competing – albeit more common – products. It allows brand owners to manage scarcity and prestige – two of the essential characteristics of luxury products.

From an economic standpoint, luxury brands face an interesting paradox. On the one hand, they must maintain and even enhance their luxury image; yet on

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the other, they must widen access to their products for an ever-increasing customer base.

Businesses must therefore adapt classic distribution methods to these new economic constraints. Setting some restrictive criteria allows the brand owner to limit the number of distributors, while some flexibility in implementing these same criteria affords wider access to consumers – although this carries the risk of degrading the conditions of commercialisation.

This is why certain luxury and premium brands which in the past relied on distributing their products on their own, via a network of strategic points of sale, now mainly deal with selective dealers. As a result, there has been a proliferation of trading names for genuine selective distribution, such as Sephora and Marionnaud in the cosmetics and perfume sector.

Today, most luxury brands sell particularly prestigious products exclusively in their own shops and over their own networks, while at the same time giving customers wider access to certain products through so-called 'corners' or concessions and 'shops in shops' in spaces frequented by the wider public.

Therefore, the evolution of competition law towards greater flexibility – in particular, insofar as the definition and application of those criteria to select dealers are concerned – is highly valued by luxury and premium brands.

Legal regime

EU Regulation 330/2010 concerning the application of Article 101(3) of the Treaty on the Functioning of the European Union (TFEU) to categories of vertical agreement and concerted practice (which replaced Regulation 2790/1999), as well as the directing guidelines on vertical restrictions, established an exemption system to the general prohibition on vertical agreements (which is set out in Article 101(1) of the TFEU).

This exemption system is mainly based on the market shares held by the companies in question.

From the standpoint of competition law, selective distribution can be seen as limiting intra-brand competition, since it can exclude certain types of distributor from the market, while encouraging some collusive behaviour between suppliers and retailers.

For this reason, the legality of selective distribution agreements is always assessed via the fundamental rules applying to competition law – in particular, Article 101 of the TFEU, which prohibits agreements between companies and any concerted practice that is likely to affect trade between member states where the object or effect is to limit or alter the competition environment within the common market.

However, since the publication of Regulation 2790/1999, it is clear that some selective distribution agreements fall outside the scope of Article 101, while others may be prohibited by antitrust law.

Accordingly, while selective distribution agreements which belong to this second category are, *a priori*, prohibited, they may be exempt if they meet certain standards.

The old vertical agreement block exemption (set out in EU Regulation 2790/1999), which expired on May 31 2010, was drafted so that some selective distribution systems would (if caught by Article 101(1)) qualify for block exemption.

The new vertical agreements block exemption set out in Regulation 330/2010 follows this same pattern and applies to all vertical agreements comprising vertical restrictions.

In the case of motor vehicles, there is even a dedicated block exemption which covers certain forms of selective distribution for the sale of new cars.

In all other instances, suppliers must either structure their systems so that they are not caught by Article 101(1) of the TFEU or consider whether they meet the exemption criteria set out in Article 101(3) (since May 2004, it has not been possible to seek confirmation from the European Commission on this point by way of notification).

Article 101(1)

The first question to ask is whether the luxury brand's selective distribution agreement or network is caught by Article 101(1) of the TFEU – the main competition provision governing commercial agreements in the European Union.

Under the approach of the European Commission and the European Court of Justice (ECJ), it is generally accepted that selective distribution agreements will not be caught by Article 101(1) if they meet three conditions:

- Nature of the goods – the nature of the goods is such that selective distribution is necessary to ensure they are properly distributed (eg, the European Commission has accepted selective systems which limit supplies to dealers with specific expertise, trained staff, suitable premises or adequate servicing arrangements in cases involving cars, televisions, cameras, hi-fi products, computers, premium watches, jewellery, glass crystal and ceramic tableware).
- Necessity/proportionality – dealers are selected solely on the basis of non-excessive qualitative criteria as a means of ensuring that the goods are distributed under appropriate conditions (eg, a requirement that the dealer provide after-sales service, and a requirement that its staff be technically qualified and that the premises be suitable, including the ability to display the luxury products).
- Objectivity – the qualitative criteria are applied objectively and without discrimination, so that any dealer meeting the criteria will be admitted to the network. Suppliers should be prepared to provide written and reasoned responses to applications (identifying what would need to be done to meet the supplier's criteria) to make the non-discriminatory nature of the criteria more evident.

Quantitative limits on the number of dealers will invariably fall within the scope of Article 101(1), as will restrictions that have similar effects. For example, an obligation to achieve a minimum turnover in the supplier's goods could have the effect of limiting the number of authorised dealers in a territory and thus may fall within the scope of Article 101(1).

Article 101(3)

Where a supplier wishes to impose significant additional restrictions beyond those relating to its distributors' technical qualifications, staff and premises, its distribution system will generally fall within the prohibition set out in Article 101(1) of the TFEU and any justification for additional restrictions will have to be considered under Article 101(3).

Selective distribution systems may qualify for block exemption treatment under the vertical agreements block exemption set out in Article 101(3).

Under the European Commission's policy on the single block exemption applicable to all vertical agreements (including selective distribution arrangements), vertical restraints are presumed legal in the absence of market power. This is defined as a share of 30% of the relevant market.

Below this threshold, no market power is presumed and agreements may benefit from the block exemption. Indeed, Regulation 330/2010 applies where the parties to the vertical agreement do not hold market power.

Above the 30% threshold, there is no presumption of illegality and no obligation to notify an agreement. However, companies must make their own assessment to determine whether an agreement restricts competition. Regulation 330/2010 and the vertical restraints guidelines are intended to help with this analysis.

The safe harbour threshold of 30% will apply to the market share of both the supplier and the dealer.

The following types of restriction have been permitted by the European Commission under Article 101(3) of the TFEU, taking into account the products in question and the structure of the market concerned (and will generally be covered by the vertical agreements block exemption, provided that its other conditions are satisfied):

- quantitative restrictions – in *Omega*, for example, the European Commission accepted a restriction on the number of dealers because Omega was only physically capable of manufacturing a relatively small quantity of its luxury watches and there was only limited demand for such watches;
- territorial limitations on the appointment of dealers – in *BMW* (OJ 1975/L29/1) and *Omega* (OJ1970 L242/22), the European Commission indicated that it is prepared to exempt agreements involving territorial limitations where dealers must undertake substantial investments in order to maintain stocks and servicing facilities. The commission has also stated that it may accept territorial limitations where the specific nature of the products may justify close cooperation between manufacturers and dealers;
- geographical restrictions limiting the number of dealers per area – these may be justifiable if there is insufficient local demand to justify an additional account. For example, in *Chanel* (OJ1994 C334/11), the commission stated its intention to clear a requirement that luxury watch concessionaires be established only in towns with over 20,000 inhabitants or with a substantial tourist trade; and
- obligations on dealers to purchase minimum quantities and to stock the whole or an agreed range of products.

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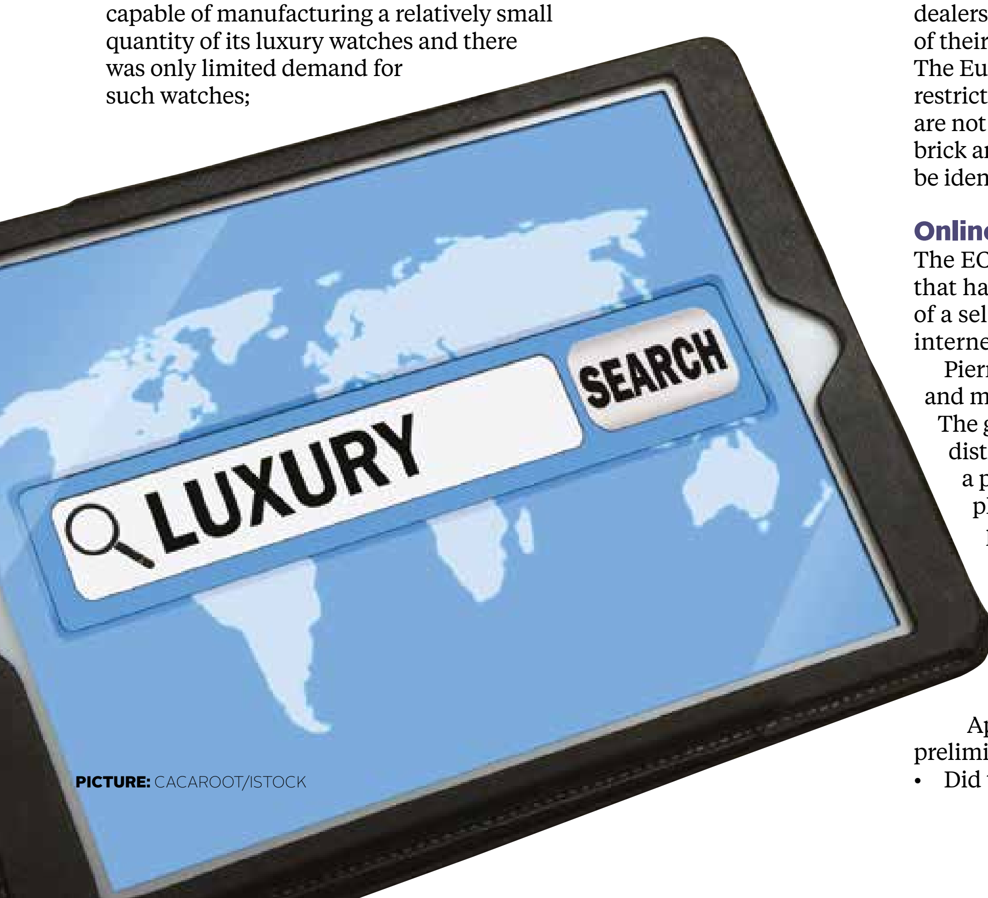

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Article 101(1) restrictions which are unlikely to qualify for an individual exemption (and which are treated as hardcore restrictions under the vertical agreements block exemption) include resale price maintenance obligations, absolute territorial protection and customer restrictions. With regard to the first of these, dealers must be free to determine their own resale prices. However, Article 101(1) of the TFEU does not prohibit a supplier from suggesting or recommending resale prices. When it comes to absolute territorial protection, Article 101(3) does not permit restrictions on resale and exports bans within the European Economic Area. As for customer restrictions, dealers must be free to identify and supply end customers of their choice and are free to use the Internet for this. The European Commission will regard it as a hardcore restriction where criteria are imposed on online sales that are not equivalent to the criteria imposed on sales from brick and mortar shops, albeit that the criteria need not be identical due to differences in the distribution modes.

Online sales

The ECJ has issued a ruling on the legality of a clause that had the *de facto* effect of precluding members of a selective distribution network from engaging in internet sales.

Pierre Fabre Dermo-Cosmetique (PFDC) is a producer and merchant of cosmetics and personal care products. The general terms and conditions of its selective distribution network required sales to be made in a physical space in the presence of a qualified pharmacist, which had the *de facto* effect of preventing all internet sales of the PFDC products.

Following an initial negative ruling by the French Competition Authority (which fined PFDC for anti-competitive practices, holding that this clause unduly restricted the commercial freedom of PFDC's dealers), PFDC brought the case before the Paris Court of Appeal, which referred the matter to the ECJ for a preliminary ruling on the following questions:

- Did the *de facto* ban on internet sales by authorised

dealers in a selective distribution network constitute a restriction *per se*?
- Was the clause covered by the block exemption provided by Regulation 2790/1999?
- If not, could the contract be potentially eligible for an individual exemption?

The ECJ applied a classic method to analysing the antitrust legislation (Article 101 of the TFEU).

On the first question, it held that Article 101(1) prohibits all agreements between undertakings which may affect trade between member states and which have as their objective or effect the prevention, restriction or distortion of competition within the internal market. The ECJ considered that a *de facto* prohibition of any internet sales constituted a restriction *per se* (and so was incompatible with Article 101(1)) if the clause could not be objectively justified.

The ECJ then excluded the two most commonly used arguments to justify such a clause, considering that neither the need to provide customers with personal advice to safeguard them nor the need to protect a prestigious brand image constituted a legitimate reason to justify such a clause.

With regard to the second question, in principle, an agreement which is anti-competitive under the meaning of Article 101(1) may nevertheless be exempted pursuant to Article 101(3) (individual or block exemption). However, the ECJ held that the agreement had as its object the restriction of passive sales to online end users outside the dealer's area and consequently excluded the application of the block exemption.

As to the third question, the ECJ held that it did not have enough elements to appreciate whether the agreement could benefit from an individual exemption and left this point to be determined by the French courts. It is clear that the prohibition of internet sales constitutes an anti-competitive restriction.

In reality, each case will turn on its facts, so such a clause may eventually be considered justified or even individually exempted. However, unfortunately the ECJ provided no concrete advice for such an analysis in practice.

This case highlights the hurdles which luxury brands face when using selective distribution networks to generate and control brand exclusivity.

Bearing in mind the ECJ's rejection of "maintaining a prestigious image" as a legitimate aim for restricting competition, brand owners must ensure that they are comfortable either that their network conditions apply equally to online and bricks and mortar dealers, or at least that any differences are objectively justifiable on the basis of the practical distinctions between the two retail structures.

That said, EU guidelines on vertical restraints make it clear that suppliers can impose some quality norms in relation to the use of websites that are managed or used by their distributors. However, these must be proportional to the targeted goal and comparable to those that apply to bricks and mortar points of sale.

Several decisions of EU member states national competition authorities have provided clarity on those restrictions on online distribution which are acceptable and those which are not.

Insofar as the denomination is concerned, the site must have a lawful and registered domain name. It must not reproduce a name that is already in use for a product or another trade name.

Insofar as website quality is concerned, the supplier can impose some quality norms relating to the distributor's website because its products and brand will be displayed on the site. In particular, the supplier can impose a corporate identity and style guide, and prohibit the use of any slogan, picture or deprecatory term. The supplier can also request that its products be presented on dedicated pages or in a dedicated area within the reseller's website. However, in the case of multi-brand distributors, the supplier cannot demand that they create a website dedicated to its products as this would place too heavy a cost burden on the distributor and potentially affect the resale of these products online.

The supplier can request that an individual description be included for each product, along with a high-resolution picture. However, the supplier cannot demand that the distributor's site use pictures, videos or animations which it has created itself.

Insofar as the qualitative aspect of the website is concerned, the supplier has some leeway when it comes to imposing its quality requirements on online resellers. However, suppliers must bear in mind that if they impose a long list of qualitative criteria, the cumulative effect of these could be analysed as a severe restriction on online sales. The line between necessary and excessive restrictions is a fine one.

Insofar as online referencing and search engine optimisation are concerned, rights holders which are also suppliers cannot restrict their accredited distributors from using their trade names or trademarks as keywords in search engine optimisation – it can only ask that distributors comply with the brand image of their products.

Finally, EU national competition regulators have condoned restrictions imposed on the sale of their products through e-commerce platforms. Often these platforms are channels for parallel imports as well as counterfeits, which are detrimental to the integrity of selective distribution networks and to the image of these products. For example, the French Competition Authority has confirmed that suppliers of dermo-cosmectic products could lawfully prohibit the use of e-commerce platforms until these provide additional warranties as to the quality and identity of the sellers (*Conseil de la Concurrence*, March 8 2007, n 07-D-07).

Comment

Selective distribution is an exciting and ever-evolving element of the distribution and marketing strategies for luxury and premium brands – especially since the rise of e-commerce and online sales pushed the boundaries of what selective distributors can do in the face of competition law. **WTR**

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