

Why selective distribution makes sense for a luxury or premium business

Through selective distribution, a brand wishing to distribute its products on UK soil or on the whole territory of the European Union, has the right to set a certain number of criteria allowing it to select which dealers will have the right to resell its products.



This sales technique has been, and still is, used in particular for luxury goods, as well as products with high technicality such as high-end cars or hi-fi sound systems.

Selective distribution is a useful tool at the disposal of the supplier since it can refuse to sell to those dealers that do not comply with the set criteria.

This system is therefore interesting since it allows the supplier of products to organise its distribution according to its wishes and strategy.

1. Selective distribution of luxury products

Luxury maisons, always mindful about their image, often use selective distribution to sell their products. It is, indeed, the most-used distribution technique for perfumes, cosmetics, leather accessories or even ready-to-wear.

This distribution method presents a lot of flexibility, compared to exclusive distribution or franchising, because it allows a supplier to select dealers according to criteria which are mainly qualitative, and to consequently ensure a commercialisation within conditions which befit the prestige of the luxury products.

Selective distribution allows to differentiate between luxury products and potentially competing – albeit more “common” – products. It mainly allows to manage scarcity and prestige, which constitute two of the essential characteristics of luxury products.

From an economic standpoint, luxury maisons currently face a strong paradox consisting in, on the one hand, maintaining and even enhancing their luxury image and, on the other hand, widening access to their products to an ever-increasing clientele.

Therefore, these luxury businesses must adapt their classical methods of distribution to these new economic constraints. Indeed, setting up some very restrictive criteria would allow to limit the number of dealers, while some flexibility in implementing these same criteria would allow a wider access to consumers with, however, the risk of degrading the conditions

of commercialisation.

This is the reason why certain luxury brands which, in the past, used to rely 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 is a multiplication of trading names for genuine selective distribution, such as Sephora or Marionnaud.

Nowadays, the majority of luxury houses sell particularly prestigious products exclusively in their own shops and network, while, at the same time, they give clients a wider access to certain products through “corners” and “shops-in-shops” in spaces frequented by the wider public. It is certain that selective distribution is the distribution system which is the most adapted to luxury products and that to which luxury maisons are the most attached.

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

European regulation n. 330/2010 of 20 April 2010 concerning the application of article 101 (3) of the treaty on the functioning of the European Union (“**TFEU**”) to categories of vertical agreements and concerted practices (“**Regulation 330/2010**”) (which replaces regulation n. 2790/1999 of 22 December 1999 concerning the application of article 81(3) of the treaty to categories of vertical agreements and concerted practices (“**Regulation 2790/1999**”), as well as the directing guidelines on vertical restrictions, provide for an exemption system to the general prohibition of vertical agreements (set out in article 101(1) of the TFEU).

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

2. Validity of agreements of selective distribution pursuant to competition law

From the standpoint of competition law, selective distribution can have the effect of limiting intra-brands competition since it may exclude a certain type of distributors from the market, while encouraging some colluding behaviour between suppliers and retailers.

This is why the legality of agreements of selective distribution 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, susceptible to affect trade between member-states and which object, or effect, is to limit or alter the competition game, inside the common market.

However, since the publication of Regulation 2790/1999, it is clear that some agreements of selective distribution are outside the scope of article 81 of the EC treaty (now article 101 of the TFUE), while others may be forbidden by anti-trust law.

Accordingly, agreements of selective distribution which belong to this second category are, "*a priori*", prohibited, but they may however be "exempted" if they meet certain standards.

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

The new vertical agreements block exemption (set out in Regulation 330/2010), which replaced it as from 1 June 2010, follows this same pattern (see flowchart 1 and flowchart 2 here).

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, however, 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 of article 101(3) (note that, since May 2004, it has not been possible to seek such confirmation from the European Commission on this point by way of notification).

2.1. Article 101(1) of the TFEU

The first question is whether the selective distribution agreement or network of the luxury house is caught by article 101(1) of the TFEU, the main competition provision governing commercial agreements in the EU.

Under the approach of the European Commission and European Court of Justice ("**ECJ**"), it is generally accepted that selective distribution agreements will not be caught by article 101(1) of the TFEU, provided that three conditions are met:

- **Nature of goods:** the nature of the goods is such that selective distribution is necessary to ensure they are properly distributed (for example, the European Commission has accepted selective systems that limit supplies to dealers having specific expertise, trained staff, suitable premises or adequate servicing arrangements in cases involving cars, TV, cameras, hi-fi products, computers, premium watches, jewellery, glass crystal, ceramic tableware);
- **Necessity/proportionality:** dealers are selected solely on the basis of qualitative criteria that are not excessive as a means of ensuring that the goods are distributed under appropriate conditions (for example, a requirement that the dealer provide after-sales service and a requirement that the dealer's staff be technically

qualified and that the premises be suitable, including the ability to display the luxury products), and

- **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) as this will 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) of the TFEU as will restrictions having 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, so may fall within the scope of article 101(1).

2.2. Article 101(3) of the TFEU

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

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

Under this new policy of the European Commission in relation to the single block exemption applying to all vertical agreements (including selective distribution arrangements), vertical restraints are presumed legal in the absence of market power. The test for the existence of such market power

uses a market share threshold of 30% of the relevant market.

Below this threshold, no market power is presumed and agreements may benefit from the block exemption. Above the 30 percent threshold, there is no presumption of illegality and no obligation to notify an agreement, but companies have to make their own assessment to determine whether an agreement is restrictive of competition.

The vertical restraints guidelines are intended to assist with this analysis.

This "safe harbour" threshold of 30 percent will apply to both the market share of the supplier and the market share of the buying dealer.

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

- **Quantitative restrictions:** in the Omega case for example, the European Commission accepted a restriction on the number of dealers because Omega was only physically capable of manufacturing a relatively restricted 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 was prepared to exempt agreements involving territorial limitations where dealers have to undertake substantial investments in order to maintain stocks and servicing facilities. The European Commission has also stated that it may accept territorial limitations where the specific nature of the products may justify close co-operation between

manufacturers and dealers.

- **Geographic 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 (0J1994 C334/11), the Commission stated its intention to clear a requirement that luxury watch concessionaires only be established in towns with over 20,000 inhabitants or with a substantial tourist trade.
- Obligations on dealers to purchase minimum quantities and to stock the whole or an agreed range of products.

However, article 101(1) restrictions which are most unlikely to qualify for individual exemption (and which are treated as "hardcore" restrictions under the vertical agreements block exemption) include:

- **Resale price maintenance obligations:** 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.
- **Absolute territorial protection:** restrictions on resale and exports bans within the European Economic Area will not be permitted under article 101(3).
- **Customer restrictions:** dealers must be free to identify and supply end-customers of their choice, also with the help of the internet. The European Commission will regard it as a "hardcore" restriction where criteria are imposed for online sales that are not overall 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.

3. Internet sales in a selective distribution network

3.1. Pierre Fabre Dermo-Cosmétique SAS v Président de l'Autorité de la concurrence and Ministre de l'Économie, de l'Industrie et de l'Emploi

In 2011, the ECJ 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 cosmetic 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 a first negative ruling by the French competition authority (which fined PFDC for anticompetitive practices, holding that this clause excessively restricted the commercial freedom of PFDC's dealers), PFDC brought the case before the Court of Appeal of Paris, which referred the matter to the ECJ for a preliminary ruling on the following questions:

(i) did the "*de facto*" ban on internet sales by authorised dealers in a selective distribution network constitute a restriction per se?

(ii) was the clause covered by the block exemption provided by Regulation 2790/1999?

(iii) if not, could the contract be potentially eligible for an individual exemption?

The ECJ applied a classical method to its analysis of the antitrust legislation (article 101 of the TFEU).

On each of the three questions, it held that:

(i) Article 101(1) of the TFEU 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) of the TFEU) 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 necessity to provide customers with personal advice to ensure their safeguard nor the necessity to protect the prestigious brand image, constituted a legitimate purpose justifying such a clause.

(ii) In principle, an agreement which is anti-competitive under the meaning of article 101(1) of the TFEU, may nevertheless be exempted pursuant to article 101(3) of the TFEU (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.

(iii) 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 we could eventually see such a clause being justified, even individually exempted, but unfortunately the ECJ did not provide any concrete advice for such an analysis in practice to be made.

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 they are comfortable that their network conditions either 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.

3.2. Coty Germany GmbH v Parfümerie Akzente GmbH

In 2017, the ECJ issued a ruling on the legality of a clause that prohibited members of a selective distribution network from selling Coty cosmetics on online marketplaces, such as Amazon.

Relying on the PFDC case-law above-mentioned, the ECJ first reminded that selective distribution systems of luxury products can escape the qualification of anti-competitive agreements, pursuant to article 101 (1) of the TFEU. To waive such qualification, resellers must be chosen on the basis of objective criteria of a qualitative nature, laid down uniformly for all potential resellers and not applied in a discriminatory fashion. Moreover, the characteristics of the product in question necessitate such a network in order to preserve its quality and ensure its proper use. And, finally, the criteria laid down do not go beyond what is necessary.

In its Coty ruling, the ECJ draws a distinction between luxury goods and other products, and reminds that the quality of such goods is not just the result of their material characteristics, but also of the allure and prestigious image which bestow on them an aura of luxury, that that aura is essential in that it enables consumers to distinguish them from similar goods and, therefore, that an impairment to that

aura of luxury is likely to affect the actual quality of those goods. In that regard, the ECJ has considered that the characteristics and conditions of a selective distribution system may, in themselves, preserve the quality and ensure the proper use of such luxury goods.

Then, the ECJ decides that article 101(1) TFEU cannot be interpreted as precluding a contractual clause, such as that at issue in the Coty proceedings, which prohibits authorised distributors in a selective distribution system for luxury goods designed, primarily, to preserve the luxury image of those goods from using, in a discernible manner, third-party platforms for the online sale of the contract goods.

Indeed, provided that the specific contractual clause, designed to preserve the luxury image of the goods at issue, meets the objective criteria above-mentioned, it is lawful under article 101(1) of the TFEU.

Further to an exhaustive "*in concreto*" analysis of the contractual clause in question, the ECJ reaches the conclusion that it complies with all these criteria, in particular because it is proportionate in its pursuit of preserving the image of Coty cosmetics and perfumes, and is therefore lawful under article 101 (1) of the TFEU. Moreover, such contractual clause does not prohibit distributors from selling the Coty products on their own online ecommerce site, provided that some quality criteria are met.

This new ECJ case-law is useful guidance for the national courts, in each member-state, on how to assess, in concrete terms, the prohibition of selling luxury products on marketplaces. For example, the Paris court of appeal has already handed down a judgment in relation to the validity of a similar clause set out in the contracts for Coty France, on 28 February 2018. The court of appeal used the ECJ analysis, in order to confirm the validity of the prohibition, in relation to a marketplace which sold Coty perfumes during

private sales.

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