K&L GATES' VERTICALS PREDICTIONS FOR 2023: TOP TRENDS, OPPORTUNITIES, AND PITFALLS

Date: 11 January 2023

Policy and Regulatory Alert

By: Gabriela da Costa, Jennifer P.M. Marsh, Dr. Annette Mutschler-Siebert, M. Jur. (Oxon), Francesco Carloni, Michal Kocon, Nikolaos Peristerakis

The start of 2023 marked six months since the new vertical distribution laws came into effect across the European Union (EU) and United Kingdom (UK) – see our earlier summary of the important changes here).

As brands embark on the new year looking for ways to shore up their resilience and profitability in the face of challenging economic headwinds, we take a snapshot of trends that have gained the most traction under the new rules, big opportunities up for grabs, and lessons learned on pitfalls to avoid.

In this alert we highlight:

1. How brands are optimising differential pricing for products sold online versus offline to incentivise value for consumers, reduce the risk of a “race to the bottom” on prices and quality, and achieve a level playing field for the resale of their products;
2. The expanded scope to impose inconsistent marketplace restrictions on resellers but potential risk areas to watch out for;
3. The questions brands should be asking themselves as they increasingly engage in “dual distribution”, i.e., sell directly to retailers (D2R) in competition with their wholesale distributors and directly to consumers (D2C) in competition with their retail customers;
4. The potentially enormous opportunities for optimised distribution system structuring that brands have been slower to dip their toes into so far; and
5. Good news for consumer brands about preventing sales into and out of the UK post-Brexit.

DUAL PRICING FULL-STEAM AHEAD

Perhaps the most obvious opportunity for brands in the new EU and UK rules was the legalisation of “dual pricing” for hybrid customers. Charging a hybrid reseller different wholesale prices for the products it sells in brick and mortar stores compared with those it sells online swung from being a serious (or “hardcore”) restriction of competition to being automatically exempted under the EU's Vertical Block Exemption Regulation (VBER) and the UK's Vertical Agreements Block Exemption Order (VABEO) for most brands, provided it is not aimed at restricting cross-border sales or online sales. Fast-forward six months and this is unsurprisingly the area where we have seen the most traction.

As the new rules on dual pricing are sufficiently flexible to work well across different distribution structures, brands across product categories are adopting a wide variety of dual pricing models to suit their business needs and

practicalities. These range from incorporating very specific additional discounts or rebates for particular offline investments into detailed performance pricing matrices through to blunter “offline/online” price lists and “offline discounts.” Although parties are not necessarily required to carry out complex cost calculations or share detailed cost information, the guidance published by the European Commission and the UK Competition and Markets Authority (CMA) (the Vertical Guidelines[1] and VABEO Guidance,[2] respectively) require that differential pricing should, as a general rule, be reasonably related to the different costs and investments between the channels to avoid infringing the competition laws.

We have also seen some brands taking the opportunity to harmonise their input pricing to direct partners across different European territories as they roll out new performance pricing terms (sometimes providing transitional funding to support partners facing a large wholesale price increase from one year to the next).

We expect the takeup of dual pricing to continue (and grow) as a priority area for brands in 2023. It offers producers a highly effective and legal way to disincentive a “race to the bottom” in pricing (and quality) and limits unfair free-riding by websites or stores that make lower investments.

> By contrast, taking steps to enforce “adherence” to recommended resale prices, a minimum price, or a minimum advertised price (MAP) remains blacklisted in Europe and aggressively enforced by competition authorities with large financial penalties.

The greater leeway to directly reward partners' investments in their stores and websites will also be a powerful tool as brands look for ways to reinvigorate their offline networks and explore exciting new offline and “omni-channel” brand experiences to meet evolving consumer expectations.

A DISCRIMINATORY MARKETPLACE BAN MAY BE POSSIBLE, BUT LOOK FOR HIDDEN SNARES

On their face, the EU and UK Vertical Guidelines appear to take a surprisingly relaxed stance on discriminatory or inconsistently applied marketplace bans for most brands.

A technical reading of the new guidance suggests that a company with a market share of 30% or less can, in principle, ban one reseller from selling on a particular online marketplace but not another (or itself) without any objective quality criteria and purely for commercial reasons. On a plain reading, such a marketplace restriction will not be regarded as a “hardcore restriction” of competition and should be automatically exempted under the VBER and VABEO where both parties fall under the market share thresholds, provided it does not have the object of preventing the reseller's effective use of the Internet to sell the goods to particular geographical areas/territories or customer groups.

The simplicity and convenience of this neat approach is extremely attractive for many brands, particularly if fixing online marketplace disruption is their main priority and there is an appetite for modest risk.

However, our experience with this approach so far is that while it can be a useful device for some, it is not a one-size-fits-all solution. An inconsistent marketplace ban can potentially throw up some difficult legal or commercial questions in some cases, for example:

- Where market definition or market shares are hard to pin down, and there is a risk of the brand's or customer's market share exceeding 30%.
- Where the brand operates and enforces a selective distribution system in all or parts of the EU or UK and thus imposes criteria for the sale of its products across other channels, including other websites.
- Where implementing or enforcing the restriction involves data exchanges between the brand and the marketplace.
- In certain EU Member States—notably Germany—where the national authorities historically took a stricter approach than the European Commission and are yet to express alignment in this area.
- In particular product categories where marketplaces or a particular marketplace are regarded as critical routes to market.

SELLING D2R AND D2C IN COMPETITION WITH COMPETING CUSTOMERS? ASK YOURSELF THESE QUESTIONS

Some interesting questions emerged as brands moved increasingly closer to selling directly to end customers during the COVID-19 pandemic and throughout 2022:

- Many brands are still unaware of or confused about the extra layer of rules that apply when they start to sell D2C in competition with their own reseller customers (or D2R in competition with their distributor customers). Here, the competition laws prevent brands from colluding with their distribution networks to restrict intra-brand competition or from exchanging certain information. In practice, the interplay between the "horizontal" rules and the "vertical" ones can be bewildering for sales teams. So brands should be asking themselves:

"Can we Separate Our D2R Sales Team From the D2C Team?"

If feasible, this can help to limit inappropriate information flows without unnecessarily stifling the sales team's discussions with its customers on legitimate topics that are central to a healthy supply/resale relationship but that could easily stray into competitively sensitive topics (e.g., sales targets, marketing strategy, exclusivities, costs, territory strategies) or that fall short of the requirements for block exemption in the EU or UK. Equally, brands should consider whether firewalls between their personnel focused on selling to retailer accounts and the team selling to wholesalers who potentially compete for those retailers are achievable.

"Are Our Sales Teams Sufficiently Aware of Topics to Avoid in Discussions With Our Competing Customers?"

Particularly where meaningful internal separations are not possible (which we have found to be the case with some smaller brand teams, as well as where D2R selling has emerged organically in the company), training is always recommended to equip sales teams with a strong grasp of the no-go areas relevant to the brand's particular distribution system. In any event, all sales teams should know how to confidently handle potentially sensitive topics like recommended pricing and promos to be able to do their jobs well without attracting antitrust exposure.

- If a brand is terminating any partnerships as it grows D2R or D2C, have notice requirements been checked and is there any compensation risk? Are there talking points lined up to manage this transition?
- Finally, we see brands grappling with some anxiety of not wanting to alienate or harm their customers as they increasingly compete against them. In addition to exploring new distribution structures to address this concern lawfully, a useful trend we have picked up in projects over the last year has been for the brand's D2C website to be an “experiential” site designed around increasing brand awareness and engagement. This can be less confrontational for partners than a traditional transactional site aggressively focused on orders and can also serve to grow overall brand demand from which all partners benefit.

ARE BRANDS MISSING OPPORTUNITIES FOR IMPROVED SYSTEM STRUCTURES?

The new EU and UK rules introduced numerous flexibilities that can help producers to better design their European distribution systems around local market dynamics and needs, as well as afford stronger brand controls. These are starting to be looked at, but at a slower pace, perhaps because they involve a bigger long-term rethink, business adjustment, and investment.

Key changes in the EU and UK include possibilities for:

- Granting “shared” exclusivity to more than one distributor in a particular territory or geographic area (the EU specifies up to five; the UK a “limited number”).
- Obliging customers to flow down active sales restrictions to their direct customers, so that exclusive distributors can now benefit from stronger protections from active selling into their territories.
- Operating a mix of distribution structures (open, exclusive, selective, and/or franchise) across different EU Member States depending on what suits the local market best. (Brands should, however, be aware that the EU rules now prohibit a combination of exclusivity at the wholesale level and selective distribution at the retail level in the same territory unless the protections are sufficiently justified by the need to protect the exclusive partner's (or partners') investments. The UK has no such prohibition.)

An important reminder in the past six months has been that brands should embark on any strategy refreshers or revamps with the full context in mind. Each distribution model has its own nuanced and often elaborate rules, so it is critical to check that a system is workable in practice (*“Can I explain it easily to my customer?”*) and that, within the EU, a device used in one Member State would not undermine that used in another Member State.

Additionally, some national authorities (notably the German Federal Cartel Office) have indicated that they will treat the use of the new structural devices with some skepticism if these are not sufficiently objectively justified (e.g., by the need to protect investments or quality) and appear solely motivated by maintaining higher prices.

In short, there are potentially some cerebral points to navigate here; but brands stand to benefit enormously from highly optimised structures if they are prepared to do a deep dive into their market needs, realities, and the multitude of legal options now available to them.

GOOD NEWS FOR BRANDS ON EXPORT BANS TO AND FROM THE UK POST-BREXIT

Amidst the fanfare of the EU rules that were published a few months earlier, many brands missed an important clarification in the CMA's final VABEO Guidance published in July 2022 regarding the extent to which they can now restrict their distributors and resellers outside the UK from selling to customers in the UK (and their UK distribution/retail customers from exporting to customers outside the UK).

The CMA's initial draft guidance had left the door wide open for the CMA to investigate these as serious antitrust violations and the CMA's attitude had been left elusive.

However, the final text of the VABEO Guidance introduced welcome clarification. While the CMA can still find an import or export ban unlawful, it has clarified that:

> "[W]here a vertical agreement only concerns restrictions relating to exports outside the UK or imports/re-imports from outside the UK, the CMA is unlikely to regard it as having the object of restricting competition within the UK. The CMA would instead assess whether such a vertical agreement has the effect of restricting competition within the UK, taking into account the nature of the products or services, as well as the real operating conditions and the structure of the market concerned." (Own emphasis)

This is a more committed statement than many were anticipating from the CMA at this early stage of the new rules. It is good news, as the CMA (like the European authorities) typically focuses more on bringing “by object” cases, where the agreement is presumed to seriously restrict competition and the CMA does not need to adduce detailed evidence of the effect on the market. “By effect” cases in contrast usually involve much more work for the authority, and the CMA has therefore set a high bar for itself to bring a case relating to a UK-border sales restriction.[3]

While the risk will differ by product category and so it cannot be entirely excluded, this factor—combined with the political sensitivities of bringing such a case—significantly lowers the likelihood that the CMA would pursue an investigation of this kind in relation to many branded products. We should get more certainty on the position in the coming years, but the direction is useful for brands who have chosen to implement a UK distribution system that is separate from the EU.

CONCLUSION

The transition period for brands to ensure that their terms are compliant with the new vertical laws comes to an end on 1 June 2023. The next six months should be used wisely. Not only do they allow brands to ensure their terms are aligned with the current legal framework, but they present an important business opportunity for brands to look at their go-to-market strategies with a fresh pair of eyes and a new set of tools to ensure they are future-proof.

FOOTNOTES

[1] European Commission's Guidelines on Vertical Restraints (2022/C 248/01), available here.

[2] CMA Guidance on the Vertical Agreements Block Exemption Order (12 July 2022; CMA166), available here.

[3] The UK's approach to export and import bans is consistent with the EU's approach and more relaxed than that of the Swiss competition authority, which typically treats a prohibition on parallel imports to Switzerland as a by-object restriction.

KEY CONTACTS

GABRIELA DA COSTA
PARTNER

LONDON
+44.20.7360.8115
GABRIELA.DACOSTA@KLGATES.COM

JENNIFER P.M. MARSH
PARTNER

LONDON
+44.20.7360.8223
JENNIFER.MARSH@KLGATES.COM

DR. ANNETTE MUTSCHLER-SIEBERT, M. JUR. (OXON)
PARTNER

BERLIN
+49.30.220.029.355
ANNETTE.MUTSCHLER-SIEBERT@KLGATES.COM

FRANCESCO CARLONI
PARTNER

BRUSSELS, MILAN
+32.2.336.1908
FRANCESCO.CARLONI@KLGATES.COM

MICHAL KOCON
SPECIAL COUNSEL

LONDON
+44.20.7360.8240
MICHAL.KOCON@KLGATES.COM

NIKOLAOS PERISTERAKIS
PARTNER

BRUSSELS
+32.2.336.1934
NIKOLAOS.PERISTERAKIS@KLGATES.COM

