

EUROPEAN LAW ON SELECTIVE DISTRIBUTION AND INTERNET SALES: AN ECONOMIC PERSPECTIVE

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Perhaps the most contentious area of European competition law over the past ten years has been vertical restraints. In contrast to U.S. antitrust law, where the trend is towards greater freedom by suppliers to enter into agreements with downstream retailers that restrict territories, distribution methods, and retail prices, EU law continues to place strong limitations on the contracts into which suppliers and distributors can enter. This article offers an economic perspective on EU law on vertical restraints in a specific area that is becoming increasingly important: distribution over the Internet.

Suppliers maintain control over the distribution of their products, including distribution over the Internet, through selective distribution agreements with distributors. Selective distribution agreements, like all agreements between firms, are governed in Europe by Article 101 of the Treaty on the Functioning of the European Union.¹ In brief, Article 101(1) prohibits agreements that have as their object or effect the restriction or prevention of competition. Article 101(3) allows for exemption of agreements or restraints that contribute to efficient production or distribution, providing that: consumers are given a fair share of the resulting benefit; the restraints imposed are indispensable to the achievement of efficiencies; and the restraints do not involve the elimination of competition for a substantial part of the products in question. The “Block Exemption” (Regulation 330/2010) provides safe harbors against the application of Article 101 for many vertical restraints. These safe harbors are trig-

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¹ Consolidated Version of the Treaty on the Functioning of the European Union art. 101, 2012 O.J. (C 326) 47 [hereinafter TFEU].

gered when the buyer and the seller in a vertical agreement hold less than an established share of their respective markets.²

“Hardcore restrictions” are vertical restraints that presumptively meet the conditions of Article 101(1). As the European Guidelines on Vertical Restraints (Vertical Restraints Guidelines) state: “Including such a hardcore restriction in an agreement gives rise to the presumption that the agreement falls within Article 101(1). It also gives rise to the presumption that the agreement is unlikely to fulfil the conditions of Article 101(3), for which reason the block exemption does not apply.”³

The Commission regards as hardcore restrictions any obligations that dissuade dealers from using the Internet to reach a wider range of customers by imposing criteria for online sales that are not approximately equivalent to the criteria imposed for the sales from brick-and-mortar shops.⁴ The Vertical Restraints Guidelines offer the following rationale for the prohibitions:

The internet is a powerful tool to reach more and different customers than will be reached when only more traditional sales methods are used and this is why certain restrictions on the use of the internet are dealt with as (re) sales restrictions. In principle, every distributor must be allowed to use the internet to sell products.⁵

The exceptions to the restraints on Internet distribution as hardcore restrictions are provided by Article 101(3), which allows as a defense of contracts the demonstration of procompetitive effects on a case-by-case basis.⁶ The exceptions are explained in depth in the Vertical Restraints Guidelines, which in practice govern the law in this area. The first exception is particularly important: This exception involves restrictions on Internet distribution in the context of firms adopting exclusive territories. Article 4(b) allows a supplier to restrict active sales by a buyer to a territory or a customer group that has been allocated exclusively to another buyer or that the supplier has reserved to itself.⁷

This protection of exclusively allocated territories or customer groups, however, is limited. The distribution agreements must permit passive sales to

² Commission Regulation (EU) No. 330/2010 of 20 April 2010 on the Application of Article 101(3) of the Treaty on the Functioning of the European Union to Categories of Vertical Agreements and Concerted Practices, 2010 O.J. (L 102) 1 [hereinafter Block Exemption Regulation]. If the market shares of the buyer and the seller are both less than 30%, the Block Exemption Regulation creates a presumption of legality. *Commission Notice—Guidelines on Vertical Restraints* ¶ 23, SEC (2010) 411 final (May 10, 2010) [hereinafter Vertical Restraints Guidelines].

³ Vertical Restraints Guidelines, *supra* note 2, ¶ 47.

⁴ *Id.* ¶ 56.

⁵ *Id.* ¶ 52.

⁶ *Id.* ¶ 47.

⁷ *Id.* ¶ 51.

such territories or customer groups.⁸ The Vertical Restraints Guidelines characterize certain kinds of Internet selling as passive sales, and other kinds as active.⁹ In general, a customer visit to a website involves passive selling, not active selling, whereas any effort to target customers by the seller on the Internet is regarded as active selling. Given the power of Internet search and the ease with which buyers can find Internet sellers, the scope for passive sales over the Internet would appear to be very broad in practice.

The European law can be described, in summary, as prohibiting agreements to impose strict limits on distribution over the Internet. A higher market share generally increases the risk that a firm imposing such limits will be found to have violated Article 101. An additional feature of the law is that the protection of image is not a valid basis for restrictions, as we discuss below in reviewing the *Pierre Fabre* case.

We conclude in this article that European law on selective distribution, and Internet distribution in particular, is in a number of dimensions in conflict with the economic foundations of competition policy.

I. AN ECONOMIC PERSPECTIVE

In the simplest of all contracts between a manufacturer and a distributor or retailer, the manufacturer would set a price, the distributor would purchase as much as it desired at that price, and the distributor would be free to sell the product to whomever it wanted, through whatever channels it wanted, and at whatever price it chose. When the good is transferred, in this hypothetical, ideal world, *all* property rights to the good would be transferred. No restrictions would be attached.

In real markets, contracts are much more complex. Suppliers often choose to constrain the prices at which retailer distributors sell their products, the customers to whom they sell, and the channels through which distributors sell. In the context of selective distribution restraints, suppliers place restrictions on the extent to which sales may be made over the Internet. Suppliers also offer inducements for retailers to sell more through brick-and-mortar retail stores rather than online.

A policy analysis of whether these laws are appropriate must focus on whether the private incentives for vertical restraints are at odds with the social value of the contracts. Has a supplier an incentive to offer distribution con-

⁸ “‘Active’ sales mean actively approaching individual customers by, for instance, direct mail, including the sending of unsolicited e-mails, or visits . . . ‘Passive’ sales mean responding to unsolicited requests from individual customers including delivery of goods or services to such customers.” *Id.* ¶ 51.

⁹ See, e.g., Vertical Restraints Guidelines, *supra* note 2, ¶¶ 51–52.

tracts that are anticompetitive? From this perspective, the rationale offered in the Vertical Restraints Guidelines for legal restrictions on selective distribution agreements—that “the internet is a powerful tool to reach more and different customers than will be reached when only more traditional sales methods are used”¹⁰—makes little sense. If the role of the Internet in reaching more and different customers were the only economic factor at play, the restrictions would not be observed. The interest of an upstream supplier, as much as downstream distributors, is to reach more and different customers. Why would an upstream supplier not want to avail its distributors of the Internet?

The answer, and the focus of any assessment of the laws on vertical restraints, must lie in whether the restraints can be used in anticompetitive ways that benefit the supplier or the parties to the agreement more generally.

A business practice is anticompetitive if it supports collusion among firms in a market or if it is designed to exclude competitors from the market. Vertical restraints of various kinds can be anticompetitive in some circumstances. Two theories of vertical restraints as facilitating collusion are well known and must be considered as potential theories of selective distribution agreements as anticompetitive. The first such theory involves upstream collusion. Resale price maintenance (RPM), for example, can serve to facilitate an upstream cartel among manufacturers. Coordinating wholesale prices would be difficult for members of an upstream cartel because these prices are not posted and may be part of more complicated contracts. Coordinating an upstream cartel via the monitoring of retail prices without vertical restraints would also be difficult because of the variation or “noise” that enters the relationship between a wholesale price and the set of retail prices charged in different locations. Retail price floors allow upstream cartel members to agree on prices and to monitor prices. Lester Telser uses this theory to explain the adoption of resale price maintenance by GE and Westinghouse in the market for large lamps.¹¹ Bruno Jullien and Patrick Rey of the Toulouse School of Economics formalize this argument.¹²

No evidence has been offered in any market that we know of to suggest that restrictions on Internet distribution are used to support cartel pricing by upstream firms.¹³ Nor does economic theory support such selective distribution

¹⁰ *Id.* ¶ 52.

¹¹ Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86, 99–104 (1960).

¹² Bruno Jullien & Patrick Rey, *Resale Price Maintenance and Collusion*, 38 RAND J. ECON. 983 (2007).

¹³ We discuss below the possibility that public law restrictions on Internet distribution reflect anticompetitive motivations on the part of retailers.

restraints as facilitating collusion. Indeed, since Internet prices are more easily observable than prices in traditional retailers and observability of prices by rivals is a necessary condition for collusion, prohibiting distribution over the Internet might have the opposite effect of making collusion more difficult.¹⁴ Nor has any suggestion been offered in the literature that restricting the extent of Internet distribution among downstream retailers is somehow designed to exclude competitive manufacturers from the market.

A second potential theory of selective distribution restraints as anticompetitive is the theory that brick-and-mortar retailers are colluding to pressure a manufacturer into restricting distribution over the Internet. Under this theory, retailers are able to protect their market position from low-cost, discount Internet retailers (retailer exclusion)—or to protect themselves against their own low-cost, Internet distribution (retailer collusion). This is not unlike historical circumstances in which traditional retail drug stores pressured suppliers to impose resale price maintenance so as to exclude discount drug stores.¹⁵

The key test of this theory is that the pressure to enter into a selective distribution agreement comes not from manufacturers, but from retailers.¹⁶ An example consistent with this test is *Deutscher Apothekerverband eV v. 0800 DocMorris NV and Jacques Waterval*, which is reviewed below.¹⁷ This case involved the compatibility of the German government's legal restrictions on the sale of pharmaceutical products over the Internet with the TFEU's obligations on Member States not to impede inappropriately the free movement of goods and services within the European Union. A reasonable interpretation of this case is that the government's actions reflected the political influence of the pharmacists who sought to limit inter-pharmacy competition.

¹⁴ RPM can also be used to support a downstream retail cartel. When retailers sell multiple products and require collectively that all manufacturers in a product market engage in RPM, then the retailer cartel can effectively implement cartel pricing across products. The U.S. Supreme Court in *Leegin* discussed a third potential anticompetitive theory of resale price maintenance: that the practice results in exclusion of products from the market. A manufacturer can use resale price maintenance to protect rents at the retail level, contingent upon agreeing to refrain from carrying the products of a new entrant. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

¹⁵ THOMAS R. OVERSTREET, JR., BUREAU OF ECON., FED. TRADE COMM'N, *RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE* 145 (1983).

¹⁶ See *id.* (discussing an example of evidence supporting the retailer cartel. Pepsodent, in 1935, "upon advice of counsel, withdrew its products from resale price maintenance in California. . . . [T]he organized retail druggists of the State . . . [reacted with] an aggressive fight against the company," many of them refusing to sell Pepsodent products. Pepsodent responded by reinstating resale price maintenance and donating "\$25,000 to the National Association of Retail Druggists to be used in [sic] behalf of resale price maintenance legislation." *Id.* at 145 n.2 (quoting from the FED. TRADE COMM'N, REPORT OF THE FEDERAL TRADE COMMISSION ON RESALE PRICE MAINTENANCE (1945))).

¹⁷ Case C-322/01, 2003 E.C.R. I-14887.

Where the anticompetitive theories of collusion or exclusion do not apply, why would a manufacturer adopt selective distribution restraints?

The starting point to an answer is to recognize that retail sales of a product depend on much more than just the price set by the retailer. If price were all that mattered, a manufacturer would never restrain retail competition because doing so would only raise price and lower demand.

Demand must depend on retail decisions other than price—factors such as sales staff, retailer enthusiasm or influence; information provided at the point of sale, including simply the ability to touch and feel the product; and retailer investment in image. Saks Fifth Avenue and Tiffany's in New York City are examples of retailers that invest substantially in high-class image. These stores invest in an image as offering high-quality luxury products, whereas Walmart, for example, invests in an image of offering reasonable quality products at low prices. Suppliers are rationally willing to pay, via a high retail markup, to sell through fancy retailers.

Consider as an example luxury products such as up-market perfume, discussed in Thomas Buettner et al.¹⁸ Image is a critical component of these products, in the sense that many consumers reveal a preference for products in which suppliers have invested substantially in image. Both the suppliers and the retail distributors of these products invest to enhance product image. Suppliers of perfumes such as Dior or Chanel spend much more in creating the image of the product than they do on the physical product itself; chemicals and the development costs of new products account for a small fraction of total costs for perfume suppliers.¹⁹ Perfume suppliers invest resources on product image, rather than simply selling perfume in bulk as chemicals, because this investment enhances the demand for their product.

Investments in image take place not just at the manufacturing level but, as discussed, at the retail level. Retailers invest heavily in up-market images, and suppliers support this retailer investment through higher mark-ups at the up-market retail outlets. A consumer values both the scent of a perfume and its image, and suppliers accordingly invest resources in both of these dimensions of the product.

¹⁸ Thomas Buettner et al., *An Economic Analysis of the Use of Selective Distribution by Luxury Goods Suppliers*, 5 EUR. COMPETITION J. 201, 220 (2009) [hereinafter Buettner et al., *An Economic Analysis*]; see also Thomas Buettner et al., *Selective Distribution by Luxury Goods Suppliers: A Response to Kinsella et al.*, 5 EUR. COMPETITION J. 613, 614 (2009) [hereinafter Buettner et al., *Response to Kinsella et al.*]; Stephen Kinsella, Hanne Melin & Simon Schropp, *Comments on the CRA Paper Entitled "An Economic Analysis of the Use of Selective Distribution by Luxury Goods Suppliers,"* 5 EUR. COMPETITION J. 227 (2009).

¹⁹ Buettner et al., *Response to Kinsella et al.*, *supra* note 18, at 614.

Once we accept that demand depends not just on price and manufacturer investment in product and image, but also on retailer decisions such as investment in image as well as the provision of point-of-sale (“touch-and-feel”) information, the explanation for restricted distribution is clear. Without such restrictions, brick-and-mortar stores fail to capture the full marginal value of their investment in either image or information. Buyers can travel to a store to obtain information about the product and then purchase from an Internet retailer. Buyers are influenced in their demand by the brand image that has been built up in part by retailer investment in its own image, which is then transferred to product image. With respect to both information and image, the failure of stores to capture their full investment means that they will provide less of this investment or simply be discouraged from carrying the product at all. The product demand will suffer. This is the free-rider, or positive externality, theory of restricted distribution.²⁰

Dennis Carlton and Judith Chevalier find evidence in support of the free-rider explanation of selective distribution restraints. Manufacturers in their sample tend to prevent the sale of their products through those Internet sites offering the deepest discount prices. These sites would be the strongest source of the free-rider distortion. Manufacturers selling their products through their own websites do not tend to undercut their brick-and-mortar retail outlets, suggesting an internalization of the free-rider effect in the price-setting decision.²¹

In addition to the classic free-rider explanation of selective distribution agreements, another class of theories is based simply on the observation that consumer preferences are heterogeneous.²² Some consumers are attracted by retailer investment in information, sales effort, and image as well as price. Others are influenced primarily by price in their shopping decisions. Those influenced primarily by price include shoppers who are inclined to search for the best deals.

Under this theory, the manufacturer would like retailers to design their sales strategies, i.e., their mix of low prices and high sales effort or contribution to image, with a focus on attracting consumers to the manufacturer’s product. A

²⁰ Dennis W. Carlton & Judith A. Chevalier, *Free Riding and Sales Strategies for the Internet*, 49 J. INDUS. ECON. 441 (2001); see also Buettner et al., *An Economic Analysis*, *supra* note 18, at 222.

²¹ The Carlton-Chevalier analysis is based on data from 2000, very early in the history of Internet retailing. Internet retailing in the United Kingdom, for example, grew from 1.8 billion GBP in 2000 to approximately 35.3 billion GBP in 2013, a factor of almost 20. *Online Retail Expenditure in the United Kingdom (UK) from 2000 to 2013 (in billion GBP)*, STATISTA, www.statista.com/statistics/283165/online-retail-expenditure-in-the-united-kingdom-uk (last visited May 24, 2016).

²² Buettner et al., *An Economic Analysis*, *supra* note 18, at 207–08.

manufacturer does not want retailers to design their sales strategy around attracting consumers away from other retailers also selling its products. Consumers attracted away from other retailers do not add to total demand for the manufacturer's products. Individual retailers, on the other hand, are interested in attracting consumers to their outlets whether the consumers are attracted away from other products, *or* whether the consumers are attracted away from other retailers. Retailers, therefore, make greater use of low-price/low-service (or low- image) channels, the Internet in particular, compared to the mix that the manufacturer would like. The manufacturer's response is to enter into selective distribution agreements that limit the extent to which the Internet channel is relied upon. Ralph Winter, one of this article's authors, develops a parallel argument for the use of resale price maintenance.²³

A number of recent articles have presented variants of these arguments. For instance, Yossi Spiegel and Yaron Yehezkel consider a situation in which a monopolist has the option to distribute its product through (exogenously) differentiated retailers, i.e., through an upscale retailer (e.g., brick-and-mortar with fancy showrooms) and/or through a no-frills discount retailer (e.g., a "pure-play" Internet player).²⁴ Consumers vary in their willingness to pay. Facing a variety of consumers, a monopolist will always want to segment consumers in a way that has low willingness-to-pay consumers paying low prices. In the Spiegel-Yehezkel model, the monopolist will profitably use both channels if buyers with a high willingness to pay are not diverted away from the upscale retailers to low-quality (online) retailers. Otherwise, selective distribution—in fact, no distribution online—is optimal.²⁵

II. POLICY IMPLICATIONS

Economics, we suggest, supports a relatively laissez-faire policy towards selective distribution restraints established by manufacturers.²⁶ These restrictions are generally designed not to aid collusion upstream or downstream but to increase non-price dimensions that influence consumer demand—dimensions such as retailer investment in image, retailer sales effort, retailer information at the point of sale, and retailers' decisions to carry the product at all. The incentives for a firm to engage in this rebalancing of price and non-price instruments may come from free riding, from consumer heterogeneity, or

²³ Ralph A. Winter, *Vertical Control and Price versus Non-Price Competition*, 108 Q.J. ECON. 61 (1993).

²⁴ Yossi Spiegel & Yaron Yehezkel, *Price and Non-Price Restraints When Retailers Are Vertically Differentiated*, 21 INT'L J. INDUS. ORG. 923 (2003).

²⁵ *Id.* at 942.

²⁶ The one exception to the laissez-faire policy should be evidence of horizontal collusion or exclusion at the downstream distribution level. The second class of anticompetitive theories, suppression of upstream competition, does not appear to be relevant for restrictions on Internet distribution.

from other sources. The underlying source of incentives is a set of retailer incentive distortions, the failure of decentralized retailers under the simplest contract (price only) to maximize collective profit for the supply chain.

When a firm uses selective distribution restraints to achieve higher sales effort at the expense of higher prices, does consumer welfare or total welfare necessarily rise? In other words, can we be sure that the restraint is not only in the private interest of the supplier but also in the social interest? The answer is no. It is easy to construct examples in which profits rise with the use of the restraint but consumer surplus or even total surplus falls. This is a specific instance of the general problem that sellers do not necessarily have incentives to provide socially optimal quality.²⁷

If we accept that intervention in markets should require a substantial likelihood of improving on the market outcome, however, the right question to ask is not whether vertical restraints *must* raise welfare. A negative answer to this question cannot justify intervention in the market choice of contracts, because this justification for intervention would be based on the mere *possibility* that intervention would raise welfare. Unfortunately, there is no practically implementable test of when prohibition of restraints raises welfare or likely raises welfare. Thus, the right policy towards vertical restraints that do not result in collusion or exclusion should be the same as policy towards the quality choices firms make—that is, a laissez-faire policy.

III. TENSIONS BETWEEN THE EUROPEAN LAW ON SELECTIVE DISTRIBUTION RESTRAINTS AND THE ECONOMIC FOUNDATIONS OF COMPETITION POLICY

A. SELECTIVE DISTRIBUTION RESTRAINTS SHOULD NOT BE PRESUMPTIVELY ILLEGAL

Restricting distribution over the Internet is regarded by the European Commission as a hardcore restriction and therefore presumptively illegal. As we have discussed, the Commission justifies this with the argument that the “internet is a powerful tool to reach more and different customers In principle, every distributor must be allowed to use the Internet to sell products.”²⁸

This rule and its justification by the Commission might have some basis if restrictions against Internet usage were an exogenous restraint on competition, rather than the conscious choice of an upstream supplier. But these restrictions

²⁷ The potential source of distortion in a supplier's trade-off between price and quality (or image, promotion, or similar factor) is the supplier's focus on the marginal consumer instead of the average consumer. A. Michael Spence, *Monopoly, Quality and Regulation*, 6 BELL J. ECON. 417, 417–18 (1975).

²⁸ Vertical Restraints Guidelines, *supra* note 2, ¶ 52.

are the choice of upstream suppliers. Suppliers, in adopting the restraints, reveal a willingness to forgo the benefits of reaching additional buyers. A manufacturer imposing restraints on retailer competition is sacrificing the benefits of competition. It must be getting something in return: greater sales effort, greater retailer investment in product image, more investment in service, and so on. Without private benefits of some sort, we would not observe vertical restraints. We therefore cannot determine a priori that social net benefits from restraints are negative and so the law should treat them with the same deference that would apply to any choice affecting product quality. It is a fallacy to claim that because restraints limit retail competition, there ought to be suspicion about their anticompetitive nature and their consistency with the public interest.

B. VERTICAL RESTRAINTS GUIDELINES INCORRECTLY IDENTIFY A TRADE-OFF BETWEEN REDUCED INTRABRAND COMPETITION AND ENHANCED INTERBRAND COMPETITION
IN ASSESSING RESTRAINTS

The Vertical Restraints Guidelines state:

The market position of the supplier and his competitors is of central importance in assessing possible anti-competitive effects, as the loss of intra-brand competition can only be problematic if inter-brand competition is limited. *The stronger the position of the supplier, the more problematic is the loss of intra-brand competition.*²⁹

This statement reflects the idea of a trade-off, in assessing vertical restraints, between intrabrand competition and interbrand competition. A supplier's restraint on intrabrand competition may be acceptable, the argument goes, if the restraint enhances the supplier's ability to compete against other brands. Only if the benefits of the interbrand competition more than offset the loss of intrabrand competition is the restraint in the public interest. And a dominant position of a supplier renders the loss of intrabrand competition more serious.

To see the fallaciousness of this argument, consider the benchmark case of a pure monopolist, undisciplined by competition or even potential competition, selling its product through a chain of retailers. The monopolist will not do anything for the purpose of competing against other suppliers because it does not compete against other suppliers. The supplier may nonetheless find restraints profitable if the impact on demand of retailer sales efforts supported by the restraints exceeds the negative impact of reduced retailer competition in the dimensions constrained.

²⁹ *Id.* ¶ 177 (emphasis added).

If we adopted the policy suggested by the fallacy of a trade-off between the effects of a restraint on intrabrand competition and its effects on interbrand competition, then a dominant firm would not be allowed to adopt restraints at all. Yet such a legal prohibition is without foundation. We cannot simply assume that the benefits to the supplier of adopting restraints on retailer competition are of no social value whatsoever. The simple observation that vertical restraints on Internet distribution are invoked by an upstream supplier is, if collusion theories are not supported, evidence of a trade-off between lower prices and enhancement of non-price dimensions.

The observation of a restraint on Internet distribution implies that a supplier is willing to trade off the lower retail prices and convenience available on the Internet for increased distributional sales effort or some other benefit to the supplier. Do we know that this trade-off is also in consumers' interest? No. As we discussed above, however, it is impossible to identify reliably when the trade-off reduces consumer welfare or total welfare. And antitrust or regulatory intervention should require strong confidence that it will improve on the market outcome.

Indeed, the extreme case of an entrenched monopolist, unthreatened even by potential competition, is one in which vertical restraints should be presumptively legal. An entrenched monopolist has no anticompetitive motivation for imposing a vertical restraint, since it faces no competition whatsoever.

The relationship between market shares and the possibility of anticompetitive use of vertical restraints is not monotonic. Very low market shares justify a presumption that the restraints are not against the public interest. Very high market shares, and strong inherent entry barriers, also justify a presumption that intervention will not in general improve social welfare.

C. PROTECTING A PRODUCT'S IMAGE SHOULD BE A LEGITIMATE DEFENSE OF SELECTIVE DISTRIBUTION RESTRAINTS

EU law is skeptical of the role of selective distribution in promoting a prestigious brand. The European Court of Justice (ECJ), in a case discussed below, has concluded that protecting a prestigious brand image is not a legitimate aim of a vertical restraint.³⁰

The Vertical Restraints Guidelines also evince such skepticism, noting at paragraph 88, for example, that restraints are less likely to be legitimate where the product is not complex and thus high service is not justified. The Vertical Restraints Guidelines note that vertical restraints may be justified when they help to "create a brand image by imposing a certain measure of uniformity

³⁰ Case C-439/09, *Pierre Fabre Dermo-Cosmétique SAS v. President de l'Autorité de la Concurrence, Ministre de l'Économie, de l'Industrie et de l'Emploi*, 2011 E.C.R. I-09419.

and quality standardization on the distributors, therefore increasing the attractiveness of the product to the final consumer and increasing its sales.”³¹ But as we discuss below, this purpose behind a brand image (quality standardization across distributors) does not apply in the law to luxury products, such as perfume or expensive purses, where the image itself, rather than the brand assurance of quality, is the main source of value.

This narrowing that the Vertical Restraints Guidelines imposes on the image-creation justification of restraints is not appropriate from an economic perspective. If a consumer values a product characteristic, the characteristic has economic value. The Hermes Matte Crocodile Birkin purse retails for \$120,000, not because of the high quality of its materials or a convenient set of zippers, but because of the image that it conveys. And consumers reveal a willingness to spend money *because* of that image. If the imposition of Internet restrictions is designed to promote an image that consumers care about, this is an economically legitimate motivation for the restraints. Any policy decision not to allow restraints to protect the image of luxury products requires an assumption that higher prices are never worth the increased investment in image that they allow. Following this assumption to its logical conclusion, suppliers of perfume such as Chanel should be required to supply their product in bulk, perhaps at lower prices if the consumer brings her own container. Investment in image such as the original endorsement of Chanel No. 5 by Marilyn Monroe is not worth the higher prices that they require, under the Court’s argument. To the contrary, image is almost the entire source of value for this and many products.

We suggest that there is no firmer basis for paternalism when consumers spend money on product image as when they spend money on any other product dimension. The protection of product image through vertical restraints is as valid a justification for these restraints as the protection of product quality or point-of-sales information. Furthermore, we do not regulate a firm’s expenditure on resources to enhance image when this expenditure is undertaken directly. It is inconsistent to regulate this expenditure when it is undertaken via the design in distribution systems instead.

IV. CASES

A. *PIERRE FABRE*

We suggest that the facts of *Pierre Fabre* illustrate the potential efficiency role of selective distribution systems.³² Pierre Fabre, which produces non-me-

³¹ *Id.* ¶ 107(9).

³² Case C-439/09, *Pierre Fabre Dermo-Cosmétique SAS v. President de l’Autorité de la Concurrence, Ministre de l’Économie, de l’Industrie et de l’Emploi*, 2011 E.C.R. I-09419.

dicinal personal care products and cosmetics, required its distributors to sell Pierre Fabre products in a physical space with a qualified pharmacist on-site. This requirement had the effect of preventing Internet sales. The European Court of Justice considered various economic defenses of the selective distribution system, in part to determine whether it would satisfy the efficiency exception requirements of Article 101(3) of the TFEU. The ECJ directed the national court to conduct an Article 101(3) analysis (since the Court cannot adopt a final decision in cases that come from national courts). In doing so, the ECJ ruled that the national court could not consider brand-building explanations of the restraints. Pierre Fabre argued, for example, that customers should be able to see the products, but the Court replied that visual examination was unlikely to yield any useful information prior to purchase.

Pierre Fabre also maintained that the restriction on Internet sales helped it promote its brand. The Court did not necessarily reject the brand-building logic, but instead rejected the idea that brand image was worthy of protection. It held that the “aim of maintaining a prestigious image is not a legitimate aim for restricting competition and cannot therefore justify a finding that a contractual clause pursuing such an aim does not fall within Article 101(1) TFEU.”³³ The Court suggested that alternative goals for such restrictions may be worthy of consideration, stating that restricting price competition between distributors may be legitimate if it increases competition in non-price factors, such as the “maintenance of a specialist trade capable of providing specific services as regards high-quality and high-technology products.”³⁴

The facts of the *Pierre Fabre* case illustrate, contrary to the ECJ decision in the case, how restrictions on Internet sales can increase the economic effectiveness of the vertical distribution system as a whole. Downstream retailers of Pierre Fabre products are concerned not about the overall sales of Pierre Fabre products, but about their own sales. Pierre Fabre, in contrast, is concerned about the profitability of its distribution system as a whole. As we discussed in the previous section of this article, a manufacturer’s use of vertical restraints to protect a profitable product image should, as a matter of policy, justify the restraints—notwithstanding the theoretical possibility that investment in image may be excessive. Policy does not attempt to intervene in a firm’s investment in image when this investment is undertaken directly; nor should it intervene when such investment takes the form of restricting distribution over the Internet.

In competition among any cosmetic product lines, it is clear that brand image is a significant selling point. Pierre Fabre would therefore place consider-

³³ *Id.* ¶ 46.

³⁴ *Id.* ¶ 40.

able importance on promoting its brand image to consumers. Retailers are concerned much less about contributing to Pierre Fabre's brand through their own investment since each retailer captures such a small share of the benefits of this investment. Competition among retailers can lead to perverse results for the overall distribution system. Retailers, attempting to attract customers from other retailers will be too focused on low prices, for example, rather than brand image.

Indeed, the *Pierre Fabre* case leads to especially acute concerns about the divergence between downstream retailer incentives and upstream supplier incentives. First, retailer services provided by pharmacies selling Pierre Fabre products, such as a pleasant physical layout, and a physical association with pharmaceutical products, may be important not only in influencing the shopping experience for customers, but also in building the brand image of the products sold there. Brand image, however, is in some ways a public good benefiting all retail outlets selling the manufacturer's products. There is therefore an especially strong temptation for an individual retailer to free ride on the brand-building efforts of other retailers.

In the traditional theory of vertical restraints and free-riding, shoppers realize a personal benefit from point-of-sale services, such as better information about the product that they then take with them when buying from a discounting retailer that does not offer these services.

In the context of brand-building services, on the other hand, shoppers may benefit from the retailer's image-enhancing services provided by a retailer even if they never visit the store. This makes the temptation for each retailer to rely on others' services even stronger: the buyer may realize the benefits of the physical retailers' brand-building efforts without ever incurring the transaction costs of visiting the physical retailer before buying online; the buyer may therefore be especially willing to buy from the outlet with the lowest price. Because of the acute positive externality from retailer services associated with brand-building, the divergence between downstream and upstream incentives to provide such services is especially strong.

An additional aspect of the Internet version of the free-rider problem is basic: the Internet provides an excellent outlet for an excessively price-focused retailer to flourish. The physical costs of maintaining an Internet-based retail outlet (warehouse costs and shipping costs) are likely to be much smaller than those of a physical outlet. This creates especially strong incentives to shun point-of-sale services as a competitive selling point. The Internet makes the concern about an excessive focus of retailers on price competition even more acute than in traditional retail contexts.

It is interesting to observe that the Court did not reject the idea that the system that Pierre Fabre adopted was intended to promote the Pierre Fabre

brand. Instead, it decided that promoting a “prestigious image is not a legitimate aim for restricting competition.” When the Court in *Pierre Fabre* held that a prestigious image, something that consumers clearly care about, is not a desirable aim of selective distribution, as opposed to something like better technical knowledge about the product, the Court was inappropriately attempting through competition policy to fine-tune the mix of prices, image, and other features that sellers provide in their products.

B. *APOTHEKERVERBAND*

Apothekerverband concerned the compatibility of the German government’s legal restrictions on the sale of pharmaceutical products over the Internet with the TFEU’s obligations on Member States not to impede inappropriately the free movement of goods and services within the European Union.³⁵ It is not, strictly speaking, a competition case, but concerns the legitimacy of publicly imposed, rather than contractually created, restrictions on the use of Internet distribution. The source of the impetus for restrictions on Internet sales is significant in assessing their economic merit.

The defendant in *Apothekerverband* was a pharmacy located in the Netherlands that sold products by traditional dispensing, by mail order, and over the Internet. The Dutch pharmacy had a website in several languages, including German, and was selling both prescription and non-prescription medicines over the Internet. The complainant in the case was an association of German pharmacists whose explicit mission was to protect the economic and social interests of its members. The complainant objected to the Dutch pharmacy’s sales into the German market as violations of German restrictions on mail-order and Internet sales of medicinal products. The Dutch defendant argued that the German law violated the Treaty by inappropriately restricting the free flow of goods and services.

The ECJ concluded that the German restrictions were justifiable with respect to prescription medicines, given the importance of health as an objective for EU law, and the importance of the proper dispensation of such medicines in promoting health. The Court also concluded, however, that the prohibition on mail-order and Internet sales of non-prescription medicines was an unjustified trade restriction and in violation of the Treaty.

Our purpose in discussing this case is not to focus on the particulars of EU law on the free movement of goods and services, but rather to discuss the economics of this kind of restriction of Internet sales. No evidence was adduced that the restrictions on Internet distribution of prescription or non-pre-

³⁵ Case C-322/01, *Deutscher Apothekerverband eV v. 0800 DocMorris NV & Jacques Waterval*, 2003 E.C.J. I-14887.

scription medicines were initiated, or even consented to, by upstream suppliers of the relevant products. Rather, the complainant in this case represented the interests of downstream pharmacists. This aspect of *Apothekerverband* differs from the *Pierre Fabre* case, in which an upstream manufacturer both established the restrictions on Internet sales and defended the restrictions in Court. The distinction is critical. Upstream manufacturers have an incentive, for a given wholesale price, to adopt a distribution system that will sell as many downstream products as possible, and this objective generally coincides with the public good. If manufacturers impose restrictions on Internet distribution, the strategy is therefore likely to have been adopted to promote sales, which is desirable. The upstream manufacturer may wish to adopt vertical restraints to induce retailers to invest in non-price competition, including establishing physical outlets that compete in providing privately and socially valuable non-price services.

An association of pharmacies, on the other hand, has an incentive to dampen overall competition between pharmacies. Competition reduces retail prices, which is good for consumers and society, but is not necessarily good for the pharmacists. A law restricting Internet and/or mail-order distribution of medicines may play a significant role in weakening inter-retailer competition: rather than competing with any number of distant pharmacies who sell via the Internet, a restriction on Internet distribution requires local pharmacies only to compete with other local pharmacies. This case presents an example of a retailer cartel motivation for restrictions on Internet sales, and there is an economic justification for the Court's rejection of such restrictions on non-prescription medicines.

To summarize the contrast between the two cases, in *Pierre Fabre*, an upstream seller sought to compete better with other brands by adopting restrictions on Internet sales to promote the prestige of its products, a trait that consumers clearly view as desirable and thus one worth promoting from an economic perspective. In *Apothekerverband*, on the other hand, downstream sellers sought to limit competition from other downstream sellers by adopting restrictions on Internet sales. The restrictions were economically desirable in the first case, but not in the second.

V. CONCLUSION

Regulatory prohibition of a business agreement should require evidence that the agreement involved a substantial likelihood of harm through a lessening of competition, either as a device to enhance collusion or as a means to exclude rivals from a market. The burden of proof in concluding that a vertical agreement is problematic should be high: such restraints are common and most often explained as a means of enhancing the demand for a product or as efficient means of producing or delivering a product. These considerations

suggest that European laws on selective distribution and the Internet are too strict.

Selective distribution agreements can most often be explained by a manufacturer's decision to forgo the lowest possible retail markups in exchange for greater investment by retail distributors in product image, product information, and sales effort in general. Explanations of selective distribution agreements as devices to suppress competition or exclude efficient firms from a market are limited, we suggest, to exclusion by a cartel at the retail level. Where selective distribution agreements limiting Internet distribution cannot be explained by attempts to exclude at the retail level, the appropriate policy towards the agreements is *laissez-faire*.

The basis for this argument is not an assumption that "markets are always right." Rather, the basis is that those who would intervene in markets ought to bear the onus of justifying intervention. We do not regulate firms' choices of higher prices in exchange for greater product promotion or product image when these choices are made directly. Nor should we when the implementation of the trade-off is made indirectly, using a selective distribution agreement as an instrument.

We delineated in this article specific dimensions in which EU competition law is at odds with this perspective. Two general points are particularly troublesome. The first is the law in Europe that the enhancement of brand image does not justify the use of selective distribution. In our assessment, this is unjustified paternalism—a rejection without basis of the principle of consumer sovereignty. In the luxury goods market in particular consumers evidently value prestige and product image. Whether this is because products serve some role in signaling wealth or because the consumer simply feels good buying an expensive watch, purse, or cologne should not matter. Product image is as valid an investment as the extra horsepower in a Lamborghini or Ferrari. The investment should not be second-guessed by regulators.

The second is the rule in the Vertical Restraints Guidelines and implicit in the law generally that distributors should in principle always be free to distribute over the Internet. This principle simply pre-judges any economic trade-off, assigning zero value to retailer image, touch-and-feel information, or any of the dimensions of investment by brick-and-mortar retailers. In summary, in some important dimensions EU competition law towards selective distribution is in conflict with economic foundations.

In addition to the economic aspects that we have analyzed in this article, we recognize that EU competition law may also have non-economic objectives, such as the promotion of greater political integration between Member States. Whatever the political motivation, EU law towards selective distribution agreements and the Internet lacks a solid foundation in economic principles.

Having criticized existing EU law on vertical restraints against distribution over the Internet, we opine on the issue of optimal policy. The issue is similar in some respects to U.S. law on a related restraint, resale price maintenance. Christine Varney has discussed a structured rule of reason approach to resale price maintenance involving burden-shifting.³⁶ A plaintiff proceeding on a retailer exclusion theory of anticompetitive effects of RPM, for example, would shift the burden to the defendant with a *prima facie* demonstration of particular elements of the evidence, including evidence of retailer market power, coercion by retailers resulting in RPM covering much of the market, and a plausible exclusionary effect of RPM.

We suggest that a parallel rule of reason approach may well be appropriate for selective distribution agreements. The only significant anticompetitive theory of selective distribution involves exclusion of online retailers through coercion of manufacturers by a dominant retailer or retailers. As we have discussed, manufacturer dominance should not be an important evidentiary factor. The proposed rule of reason should, therefore, involve placing the burden of proof on the plaintiff to show dominance by a retailer or collective dominance by a set of retailers, coercion of manufacturers on the part of retailers to impose restrictions against Internet distribution, and a plausible exclusionary effect of the restraint. With these conditions met, the burden would shift to the defendant to show that selective distribution was explained not by exclusion but by an efficiency rationale.

³⁶ Christine A. Varney, *A Post-Leegin Approach to Resale Price Maintenance Using a Structured Rule of Reason*, ANTITRUST, Fall 2009, at 22. Christine Varney was at the time Assistant Attorney General in charge of the Antitrust Division of the U.S. Department of Justice. Among other cases, Varney discussed *Babies "R" Us*, a district court case from 2009 that involved an allegedly dominant retailer accused of coercing producers of high-end baby merchandise to institute and actively police RPM agreements to prevent discounting by Internet retailers. *McDonough v. Toys "R" Us, Inc.*, 638 F. Supp. 2d (2009); Varney, *supra*, at 36. Levenstein and Suslow, and MacKay and Smith, offer evidence that vertical restraints have been used to support cartels. Margaret C. Levenstein & Valerie Y. Suslow, *How Do Cartels Use Vertical Restraints: Reflections on Bork's The Antitrust Paradox*, 57 J.L. & ECON. S33 (2014); Alexander MacKay & David Aaron Smith, *The Empirical Effects of Minimum Resale Price Maintenance* (Chicago Booth Working Paper, 2014), home.uchicago.edu/~mackay/research.