

SECTION 3 OF THE COMPETITION ACT: SELECTIVE DISTRIBUTION AGREEMENTS AND LUXURY GOODS

Khyati Tuli, Amity Law School Delhi (Affiliated to Guru Gobind Singh Indraprastha University)

ABSTRACT

Through this Research Paper, the author aims to establish that it may be vital for luxury brands to develop an elaborate selective distribution system in order to choose its authorized sellers and distributors. This distribution system cannot be said to be a violation of Sec. 3 of the Competition act, as such a distribution system is necessary to promote its brand image as well as to preserve its aura of luxury, that it delivers or promises to deliver to its consumers.

A. I Introduction-

Section 3 of the Competition Act¹ states that an agreement between enterprises or persons at different levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade-in goods or provision of services, including—

- (a) tie-in arrangement;
- (b) exclusive supply agreement;
- (c) exclusive distribution agreement;
- (d) refusal to deal;
- (e) resale price maintenance...”

The section mentions that any of the above agreements/arrangements would amount to a contravention of Section 3 of the Act if they cause an AAEC in India.

The Act empowers the Competition Commission of India has to scrutinize any agreement that causes or may cause an “Appreciable Adverse Effect on Competition” (AAEC). The Act also lays down the framework for regulating anti-competitive agreements, which includes the concept of vertical restraints. Section 3(4) of the Act deals with vertical restraints².

Section 3 and Appreciable Adverse Effect on Competition (AAEC)

§ 3 of the Competition Act, 2002³ (hereinafter referred to as ‘Act’) prohibits any enterprise or association of enterprises or person or association of persons from entering into any agreement in respect of production, supply, distribution, storage, etc which causes or is likely to cause an appreciable adverse effect on competition (hereinafter referred to as “AAEC”).

¹ The Competition Act, 2002, § 3(4), No. 12, Acts of Parliament, 2003 (India).

² Dhruv Rajain, *Vertical Restraints In The Indian E-Commerce Sector: The New-Age Competition Issues*, SSC ONLINE (May 26th,2021, 5:09 PM), <https://www.sconline.com/blog/post/2019/08/08/vertical-restraints-in-the-indian-e-commerce-sector-the-new-age-competition-issues/>.

³ The Competition Act, 2002, § 3, No. 12, Acts of Parliament, 2003 (India).

The Act does not define AAEC however it elaborates factors which must be taken into account when determining whether an agreement is anti-competitive or not. The act also lays down certain factors such as creation of barriers to new entrants in the market, improvements in production or distribution of goods or provision of services, promotion of technical, scientific and, economic development by production or distribution of goods or provision of services, etc.⁴

It is pertinent to note that even though the Act does not explicitly mention the terms ‘horizontal’ and ‘vertical’ agreements. Agreements between enterprises at different stages of the production chain are referred to as vertical agreements.⁵ A Selective Distribution Agreement is generally an agreement that is developed in an elaborate manner and requires dealers to meet certain criteria before becoming part of the distribution network.⁶ It is submitted that Vertical Agreements are not per se void and hence the rule of reason is applied which prohibits vertical agreements only if they are proved to cause AAEC in a given relevant market.⁷

A. II The European Union and Selective Distribution Agreements

Selective Distribution Agreements are entered into between the manufacturers and the distributors wherein the former wants to maintain an exclusive brand image of its product. By entering into such agreements, the manufacturers restrict online offerings of their products to a selective chain of distributors. Even though the intention behind such agreements is to provide an overall experience which sells its brand image directly to the consumer, it entails certain potential anti-competitive risks. These include reduction in intra-brand competition, closure of certain types of distributors, reduction in the chances of discounts, etc. Since these agreements do not entirely fall within the bracket of ‘exclusive distribution agreements’ as provided under Section 3(4)(c) of the Act, it gives the manufacturers the leeway to carry out such activities, unjustly.⁸

⁴ The Competition Act, 2002, § 19(3), No. 12, Acts of Parliament, 2003 (India).

⁵ B.S Chauhan, *Indian Competition Law: Global Context*, 54, JILI, 315–323(2012).

⁶ Case 26/76, Metro SB-Großmärkte v. Commission, [1977] ECR 1875.

⁷ Sodhi Transport Co. v. State of Uttar Pradesh, AIR 1980 SC 1099.

⁸ Shagun Singhal, *E-Commerce and Vertical Agreements: Is the Latter’s Scope Under the Competition Act Limited*, NUALS LAW (May 25th, 2021, 6:30 PM),

<https://nualslawjournal.com/2020/06/30/e-commerce-and-vertical-agreements-is-the-latters-scope-under-the-competition-act-limited/>.

According to the European Union Block Exemption Rules, a Selective distribution system, is generally defined as a system where the provider undertakes to sell, directly or indirectly, the goods or services only to distributors selected by it, based on designated criteria, and where such distributors undertake that they shall not sell the goods or services in question to unauthorized distributors,"⁹ Under the Indian Competition Act, selective distribution is referred to as “exclusive distribution agreement” which is defined as an agreement to limit, restrict or withhold the supply of any goods or to allocate any particular market for sale of goods¹⁰.

A. II (i) Selective Distribution Agreements and Luxury Goods

It is pertinent to note that it is common practice for luxury brands to develop an elaborate network of distribution which is usually done to maintain its exquisite brand image. The brand's division of supply and distribution of goods may seldom be accompanied by differentiation in their distribution channels. A Luxury brand usually markets its clothing line, under various brands, either through authorized retailer networks comprising exclusively of luxury retail stores or with e-commerce portals. A Selective Distribution Network is extremely flexible compared to exclusive distribution or a franchise because it allows the supplier to select distributors according to criteria it lays down as long as they do not go beyond what is necessary. Selective distribution allows consumers to differentiate between luxury products and potentially competing products. It enables brand owners to preserve the scarcity and prestige which are two of the essential characteristics of any luxury product¹¹.

A Luxury brand may also include certain conditions for its distribution networks such as Location of the store, the size of the store, the professional qualification of the staff, training, etc. It is imperative to note that an elaborate selective distribution network is frequently used for the distribution of luxury goods.¹² The Hon'ble European Commission as a general rule accepts that suppliers may require distributors to have suitable premises, adequately trained staff, and other

⁹ Art. 3 of the Block Exemption Communiqué on Vertical Agreement No. 2002/2 ("Communiqué No. 2002/2")

¹⁰ The Competition Act, 2002, § 3 (Explanation), No. 12, Acts of Parliament, 2003 (India).

¹¹ Annabelle Gauberti, *Why Selective Distribution Makes Sense For Luxury And Premium Businesses*, CREFOVI (March 20,2021, 1:45 PM), <https://crefovi.com/Selective%20distribution.pdf>.

¹² Alexandr Svetlicinii, *'Objective Justifications' of 'Restrictions by Object' in Pierre Fabre: A More Economic Approach to Article 101(1) TFEU?* 11, ELR, 348-353(2011).

service requirements in respect of the two categories of products identified above (i.e. complex consumer products and luxury products), where such requirements are necessary to preserve the quality of service around the products, to ensure their proper use or to preserve the prestigious character of luxury goods.¹³

Selective distribution systems are designed to preserve the luxury image of goods, resellers are also chosen based on objective criteria of a qualitative nature. These criteria are laid down uniformly for any or all potential resellers and are hence applied in a non-discriminatory fashion. It is pertinent to note that these criteria should not go beyond what is necessary¹⁴. All selective distribution agreements are not per se anti-competitive in nature. Selective distribution systems based upon qualitative criteria have been justified for "*high quality and technically advanced consumer durables*"¹⁵, as well as in other economic sectors given the "*special nature of those products as regards their distribution*".¹⁶

Landmark Judgements by European Union

In the landmark judgment of **Pierre Fabre**¹⁷ the ECJ confirmed that the organization of a selective distribution network is not prohibited under Article 101 (1) TFEU¹⁸ provided that the following criteria are satisfied:

- (i) Resellers must be chosen based on objective criteria of a qualitative nature;
- (ii) these criteria must be laid down uniformly for all potential resellers and not applied in a discriminatory manner;
- (iii) the product in question must require such a network to preserve the quality and ensure its proper use; and
- (iv) the criteria must not go beyond what is necessary to achieve the objective pursued

¹³ Case T-19/92, *Groupement d'achat Édouard Leclerc v. Commission*, [1996] ECR II-1961.

¹⁴ Thomas Buettner, *Selective Distribution by Luxury Goods Suppliers: A Response to Kinsella*, 5, ECJ, 613-621 (2009).

¹⁵ Case 26/76, *Metro SB-Großmärkte v. Commission*, [1977] ECR 1875.

¹⁶ Case 243/83, *SA Binon & Cie v SA Agence et messageries de la presse*, [1985] ECR 2015.

¹⁷ Case 439/09, *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*, [2011] ECR I-000.

¹⁸ Treaty on the Functioning of the European Union art. 101, 2012/C 326/01, March 25, 1957.

In another leading case of **Copad**¹⁹, the Court of Justice of European Union recalled that ‘*the quality of such [luxury] goods is not just the result of their material characteristics, but also of the allure and prestigious image which bestows upon them an aura of luxury*. The Court reiterated that the protection of the aura of luxury is essential as it enables consumers to distinguish luxury goods from other goods, and impairment of that aura is likely to affect the quality of the goods as well as the overall brand image of luxury that it wishes to deliver to its consumers.

Further, in the landmark case of **Coty Germany**,²⁰ the CJEU also confirmed that a carefully crafted selective distribution system, aimed at preserving the luxury image of the goods, may contribute to the reputation of those goods and their aura of luxury. The court reiterated that ‘*A selective distribution system, such as the one at issue in the present case, is therefore compatible with Article 101 TFEU – namely it does not qualify as a restriction of competition and hence is not caught by the prohibition –, provided that the above Metro²¹/Pierre Fabre²² criteria are fulfilled*’.

The court also confirmed that a specific contractual clause that pursues the same goal is also valid provided that the same criteria are also met. According to the Court, a contractual clause which requires authorized distributors to only sell through online shops and prohibits them from using different business names when selling online or using, in a discernible manner, third-party online platforms, provides a guarantee to the supplier that those luxury goods will be *exclusively associated* with the authorized distributor.

Given that one of the objectives of such a selective distribution system is precisely to ensure such an association, the Court concluded that such prohibitions imposed on retailers are coherent with the overall objective and characteristics of the entire system. It is appropriate to mention herein that the Vertical Agreements Block Exemption Regulation²³ automatically exempts from the general Article 101 prohibition, vertical agreements:

- i) between a supplier and a buyer where each has a market share of less than 30 percent;

¹⁹ Case 59/08, Copad SA v Christian Dior couture SA, Vincent Gladel and S.I.L, [2009] Bus. L.R. 1571.

²⁰ Case 230/16, Coty Germany GmbH v Parfümerie Akzente GmbH [2018] Bus. L.R. 1371.

²¹ Case 26/76, Metro SB-Großmärkte v. Commission, [1977] ECR 1875.

²² *Id.*

²³ Treaty on the Functioning of the European Union Commission Regulation (EU) No 330/2010, March 25, 1957.

ii) that do not contain any so-called "hardcore" restrictions of competition.
The 30 percent "safe harbour" applies both to the supplier and the distributor.

Conclusion

It can hence be concluded that a selective distribution crafted to preserve the luxury image, is permissible and essential as it enables consumers to distinguish luxury goods from other goods. Hence, the distribution network cannot be said to be anti-competitive and is not in contravention with § 3 of the Act.