Will the Treatment of Selective Distribution Systems Ever be the Same Again? The Turkish Competition Board's Johnson&Johnson Decision

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Introduction

Johnson&Johnson Sıhhi Malzeme Sanayi ve Ticaret Ltd. Şti. (***"Johnson&Johnson"***) applied in June 2019 to the Turkish Competition Authority ("***TCA***") and asked the Competition Board ("***Board***") to assess whether Johnson&Johnson's contemplated Warehouse Sale Agreement for Human Medicine ("***Agreement***") falls within the protective cloak of the Block Exemption Communiqué No. 2002/2 on Vertical Agreements ("***Communiqué No. 2002/2***") or, if not, satisfies the conditions for an individual exemption as per Article 5 of the Law No. 4054 on the Protection of the Competition ("***Law No. 4054***").

The Agreement sought to establish a quantitative[1] selective distribution system whereby nine pharmaceutical warehouses that satisfy certain criteria determined by Johnson&Johnson would be appointed as the authorized distributors of four pharmaceuticals (Imbruvica, Zytiga, Stelara and Darzalex) to pharmacies ("***Proposed Distribution System***"). Johnson&Johnson would not be under any obligation to appoint additional authorized distributors regardless of whether the potential applicants satisfied the relevant criteria (*i.e.*, the Proposed Distribution System did not have a qualitative[2] nature). The Agreement prevented the authorized distributors from selling the relevant pharmaceuticals to any unauthorized resellers and, if applied, it would have decreased the number of warehouses that engage in the sales of the relevant pharmaceuticals from forty to nine. Finally, the Agreement imposed direct and

[1] Quantitative selective distribution refers to a system with certain additional criteria that limit the potential number of direct sellers, such as minimum or maximum sales quantity clauses, or direct determination of the number of sellers. *See* The TCA Guidelines on Vertical Agreements, adopted by decision dated March 29, 2018 and numbered 18-09/179-RM(1). ("***Guidelines***") para. 171.

[2] In qualitative selective distribution, distributors are selected on the basis of objective criteria required by the nature of the product such as training of sales personnel, the service provided, a certain range of the products being sold, etc. (Guidelines, para. 171).

indirect export bans[3] on the authorized distributors, prohibiting them from selling those pharmaceuticals outside of Turkey.

Johnson&Johnson's market shares for each of the four pharmaceuticals under the Agreement were below the 40% threshold. Nevertheless, the Board found on September 3, 2020 that the Agreement does not satisfy the conditions of the block exemption set forth under the Communiqué No. 2002/2 and that it may not be granted an individual exemption.[4]

In this article, we will briefly explain the selective distribution systems in general and evaluate the Board's findings in the case at hand. We will also touch upon some of the concerns and uncertainties on part of the undertakings that may stem from this decision.

Selective Distribution Systems

As per Article 3 of the Communiqué No. 2002/2, in a selective distribution system, the supplier undertakes to sell its products, directly or indirectly, only to distributors selected by the supplier based on pre-defined criteria. In turn, the selected distributors undertake not to sell the products to unauthorized distributors (*i.e.*, the distributors that are outside the system). As such, the Communiqué No. 2002/2 allows the suppliers in a selective distribution system to restrict both active[5] and passive[6] sales to unauthorized distributors. If a distribution system is not deemed to be a selective distribution system as defined by Article 3 of the Communiqué No. 2002/2, the relevant agreements containing such restrictions cannot benefit from the protective cloak of the Communiqué No. 2002/2, even if all other conditions (*e.g.*, the supplier having a market share below 40%) are satisfied.

However, the Communiqué No. 2002/2 does not include any provision that could clarify which products may be subject to a selective distribution system. In other words, the Communiqué No. 2002/2 is not instructive in assessing whether a particular product type could or could not be subject to a selective distribution system. Therefore, the Communiqué

[3] In direct export bans, the suppliers restrict the buyer from exporting the products whereas in indirect export bans, the suppliers restrict the buyer from selling the products to other resellers that would export the products.
[4] The Board's Johnson&Johnson decision dated September 3, 2020 and numbered 20-40/553-249.
[5] Sales to individual customers from within the exclusive region or customer group of another buyer, through direct marketing methods such as letters or visits are seen as "active sales." (Guidelines, para. 23).
[6] Fulfilling demands of customers from another buyer`s region or customer group, which are not a result of active efforts by the buyer constitutes "passive sales," even when the buyer delivers the goods to the customer's address. (Guidelines, para. 24).

No. 2002/2, at least on its face, allows the undertakings to apply a selective distribution system, so long as the suppliers' market share is below 40%, regardless of the nature of the product.

That being said, according to Article 6 of the Communiqué No. 2002/2, if the Board finds that an agreement does not fulfil the requirements of individual exemption set out in Article 5 of the Law No. 4054, it may withdraw the exemptions foreseen by the Communiqué No. 2002/2. Since the effect of such withdrawal would not be retroactive, the undertakings would not be fined for adopting a distribution system that had previously benefited from the block exemption.

In light of the above, in practice, the undertakings are not expected to apply to the Board if an agreement benefits from the block exemption, which, under normal circumstances, they can assess without the involvement of the Board thanks to the straight-forward and clear-cut provisions of the Communiqué No. 2002/2.

The Board's Assessment of Johnson&Johnson's Proposed Distribution System

In its decision, the Board first calculated the market shares of the products subject to the Agreement. In line with the European Commission's ("***Commission***") practice, the Board determined the relevant product market according to the Anatomical Therapeutic Chemical classification system ("***ATC***") established by the European Pharmaceutical Marketing Association. Taking the ATC-3 classification into consideration, the Board found that there are competing products with all four pharmaceuticals, and the market shares of each of the four pharmaceuticals were below 40% (*i.e.*, the threshold set forth under the Communiqué No. 2002/2 was not exceeded for any of the pharmaceuticals concerned). The Board also did not mention any other restrictions that would prevent a selective distribution system from benefiting from the block exemption.

At this point, the Board would normally be expected to conclude its decision by stating that the Proposed Distribution System benefits from the block exemption. A more exceptional approach would be for the Board to further assess, at this stage, whether the conditions of individual exemption are also satisfied, despite the fact that the agreement already benefits

from block exemption (since this block exemption may be withdrawn in case an agreement fails to satisfy the conditions for individual exemption).

However, in this particular case, the Board took an unexpected step and stated that in order to recognise that the Proposed Distribution System constitutes a selective distribution system, it should further be analysed *whether the products under the Agreement have the characteristics that justify the establishment of a selective distribution system*. The Board emphasized that restrictions in the selective distribution systems are usually applied for the distribution of certain types of products such as automobiles, cosmetic products, or durable consumer goods, with a view to protect the brand image. Following its analysis, the Board established that the pharmaceutical products in question do not require a selective distribution system for the purposes of protecting the product quality, nor for ensuring their proper use. The Board then held that the Proposed Distribution System may not be deemed as a selective distribution system, due to the characteristics of the products. Hence, the Board stated that Johnson&Johnson's preventing its authorized dealers from selling the relevant pharmaceuticals to unauthorized resellers should be treated as a restriction on passive sales. In light of this, the Board decided that the Agreement does not benefit from a block exemption, and it was necessary to conduct an individual exemption analysis.

As the Board pointed out under the individual exemption assessment, Johnson&Johnson`s main contention as to why the Agreement would create net benefits was that, limiting the number of distributors that are allowed to resell these products was critical for preventing parallel exports, as closely following the activities of a large number of distributors was exceedingly difficult and parallel exports could be made regardless of the explicit bans in the Agreement. Johnson&Johnson argued that prevention of parallel exports was important to preserve the effective functioning of the Turkish market. While evaluating this argument, the Board indicated that all four pharmaceuticals were used for the treatment of serious illnesses, with Imbruvica and Darzalex prescribed for the treatment of certain rare types of cancers. As such, the Board acknowledged that these pharmaceuticals were even more expensive abroad, and thus may be subject to parallel exports. Yet, the Board stipulated that the export bans

stipulated under the Agreement (which were deemed to be lawful)[7] should be sufficient to deal with parallel exports and that limiting the number of distributors would not yield any further benefits.

Considering the foregoing, the Board decided that the Agreement could not be granted an individual exemption.

On that front, it should be noted that the Board's conclusion is in line with its previous decisions concerning the distribution of the pharmaceutical products. Indeed, the Board has consistently rejected the individual exemption requests for distribution agreements, where the suppliers intended to decrease the number of distributors that they had been working with[8] and even fined a supplier for doing so, in practice.[9] However, in those decisions, the market shares of the relevant undertakings were above the 40% threshold and it was beyond doubt that the agreements in question did not benefit from block exemption and thus the dynamics in those cases were materially different.

Why This Case Matters

The Board's conclusion that the Agreement falls out of the scope of the block exemption provided by the Communiqué No. 2002/2 may have crucial impacts on the way in which selective distribution systems are assessed in Turkish competition law. As a matter of fact, this is the first decision where the Board took into consideration the nature of the products in determining whether the relevant distribution system may be characterized as a selective distribution system in terms of the Communiqué No. 2002/2, even though the market share of the supplier was below the 40% threshold.

This deviation from the general practice is quite surprising given that the Guidelines on Vertical Agreements ("***Guidelines***") unequivocally states that the characteristics of the products shall be disregarded when determining whether a selective distribution system shall benefit from block exemption in case the 40% market share threshold is not exceeded. Indeed,

[7] The Board's Roche/Co-Re-Na decision dated September 26, 2018 and numbered 18-34/577-283; Novo Nordisk decision dated February 5, 2015 and numbered 15-06/71-29.
[8] The Board's Roche decision dated December 12, 2019 and numbered 19-44/732-312; Pfizer/Dilek decision dated August 2, 2007 and numbered 07-63/774-281.
[9] The Board's Sanofi decision dated April 20, 2009 and numbered 09-16/374-88.

paragraph 172 of the Guidelines expressly states the Communiqué No. 2002/2 grants an exemption to the selective distribution systems "*regardless of the nature of the product.*"

It should be noted that the characteristics of the products are an important factor for assessing whether a selective distribution system that does not benefit from a block exemption (*e.g.*, for exceeding the 40% market share threshold) may be granted an individual exemption. Moreover, as noted in the Guidelines, they may also be relevant in determining whether the block exemption granted under the Communiqué No. 2002/2 should be withdrawn due to the observed anti-competitive effects of a selective distribution agreement. However, rather than focusing on the nature of the products within the scope of an individual exemption analysis, which would be parallel to the methodology envisaged in the Guidelines, the Board stated that the nature of the products would also determine whether a selective distribution system within the meaning of the Communiqué No. 2002/2 may be established in the first place.

The Board's reasoning has the potential to reduce the practical benefit of the Communiqué No. 2002/2, which allows the undertakings to internally assess whether their practices fulfil the straight-forward conditions of the block exemption, since determining whether the characteristics of the relevant products are suitable for selective distribution would require a careful case-by-case assessment and occasionally, may prove to be quite difficult. This could impel those undertakings that desire to establish selective distribution systems, to make individual exemption applications to the Board for the sake of legal certainty, even if their market shares are way below the 40% threshold. This would inevitably create an additional workload for the Board and lead to inefficiencies on part of undertakings; the very outcomes that the Communiqué No. 2002/2 aims to prevent.

Time will tell as to whether this unconventional approach of the Board will become common practice or stay as an exception.

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