## FranCast

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The European Commission has adopted revised competition rules for the distribution of goods and services.

The new vertical agreements block exemption regulation (BER) will enter into force on June 1, 2010 and replaces the 1999 BER on vertical restraints.

Under the new BER and the accompanying Guidelines on Vertical Restraints (Guidelines), the basic principle under the current block exemption remains – companies are free to decide how their products are distributed, provided their agreements do not contain certain "hardcore" vertical restraints and the parties have limited market power. However, a few notable changes to the 1999 block exemption have been made under the new BER which could affect how franchisors and manufacturers operate in Europe.

**The new BER introduces a buyer's market share threshold to accompany the existing seller's market share threshold.**

Under the current block exemption, franchisors and manufacturers with a 30 percent or greater market share are not eligible for the safe harbor of the block exemption. For many franchisors, this has not raised great concerns because they have not hit the 30 percent threshold. However, under the new BER, franchisors and manufacturers will also need to take into account the market share held by their franchisees or distributors. If the market share held by a franchisee or distributor is 30 percent or greater in the relevant product and geographic markets, the agreement with that franchisee or distributor will not be eligible for the safe harbor created under the block exemption.

In general, the revised market share threshold is likely to make it more difficult for franchisors and manufacturers to ascertain whether their agreements will fall within the safe harbor of the new BER, since they will now need to assess both their own market shares *and* the market shares of their franchisees or distributors. Franchisors and manufacturers may not be in a position to assess the market share of a franchisee or distributor readily, thus adding a level of uncertainty to the analysis.

**The new Guidelines take into account the development, in the last 10 years, of the Internet as a force for online sales and for cross-border commerce.**

As with the current block exemption, under the new BER, agreements containing hardcore restrictions of competition, such as restrictions on the buyer's ability to determine its sales price and restrictions of the territory into which, or of the customers to whom, a buyer may sell the contract goods or services, are not eligible for the safe harbor of the block exemption. According to the new Guidelines, the same rules apply to online sales. Since the Internet allows franchisees and distributors to reach different customers and different territories, the Commission generally regards restrictions of the use of the Internet by distributors as hardcore restrictions. This means in many, if not most, cases franchisors and manufacturers that want to do business in Europe will not be able to prohibit their franchisees and distributors from selling via the Internet.

As examples, the new Guidelines state that hardcore restrictions under the new BER include obligating franchisees or distributors to automatically reroute customers located outside their territories, or to terminate consumers' transactions over the Internet if their credit card data reveals an address that is not within the franchisee's or distributor's territory. Similarly, any limitation on the proportion of overall sales which a franchisee or distributor can make over the Internet is also considered a hardcore restriction, though a supplier/franchisor can insist that a distributor/franchisee does operate at least one bricks and mortar store as well as a website (if justified by the nature of the product) and, in such cases, may insist that sales from that bricks and mortar outlet must exceed a specified value or volume.

In the same vein, a requirement that a franchisee or distributor pays a higher purchase price for units sold online would also be seen as a hardcore restriction. However, the Guidelines state that a supplier (or franchisor) may pay a distributor/franchisee a fixed fee to offset the additional costs it incurs in operating the bricks and mortar outlet, as opposed to simply selling online.

While the level of detail provided on the relationship between online commerce and the new BER in the Guidelines should assist franchisors and manufacturers to assess whether online commerce restraints contained in their vertical agreements could amount to a hardcore restriction of competition, some aspects of the new rules will only become clear once they are applied in practice to individual cases.

Franchisors and manufacturers should note that, despite the Commission's general position regarding online commerce restraints, they can still establish exclusive networks, which enable them to restrict active sales by franchisees and distributors into other exclusive territories and to impose quality standards for a franchisee's and distributor's use of the Internet to sell products. In addition, in cases where a franchisor's or manufacturer's limitations on Internet sales are deemed a "hardcore restriction," as the new Guidelines point out, there may be individual circumstances where, despite the hardcore restriction, the agreement creates, or is likely to create, efficiencies that outweigh the negative effects.

For example, a supplier may prohibit distributors from making passive sales into the exclusive territory of another distributor (including, it seems, via the Internet) where the exclusive distributor concerned has made substantial startup investments to introduce a product or develop demand for it. There is no reason why this should not also apply to the franchisor/franchisee relationship, though it should be noted that any such prohibition on passive sales will only be allowed during the first two years of the appointment of the exclusive distributor or franchisee.

**The new Guidelines provide more substantial analysis and practical examples of potential efficiencies which may fall outside Article 101(1) of the Treaty on the Functioning of the European Union or may fulfill the conditions of Article 101(3) of the Treaty.**

While resale price maintenance (RPM) is still considered to constitute a hardcore restriction under the new BER, the new Guidelines provide more substantial analysis and practical examples of potential efficiencies which may fulfill the conditions laid down in Article 101(3) of the Treaty. For example, the new Guidelines suggest that RPM may be permissible in limited circumstances where a franchisor or manufacturer is introducing a new product to the market. RPM also may be permissible when implementing a coordinated short-term sales promotion campaign in a franchise system or similar distribution system, which could likely be assessed as being necessary to maintain the common identity and reputation of the franchised network.

**The new BER changes the definition of "know-how."**

Under the new BER, the requirement for know-how to be *indispensable* for the use, sale or resale of the contract goods or services no longer exists – it need only be significant and useful for those purposes. With the change to the definition, it is likely that the categories of knowledge that may be regarded as "know-how" are likely to include information currently excluded from the definition under the existing BER. Therefore, it can be expected that more manufacturers and franchisors will fall more clearly into the new BER. However, note that the block exemption does not apply to post-termination non-competition covenants in vertical agreements unless the "[covenant] is *indispensable* to protect know-how transferred by the supplier to the buyer" and so the broader definition of know-how does not change the fact that a non-competition covenant will be invalid unless it is indispensable to protect the know-how.

**The continuing influence of *Pronuptia*.**

The new BER is without prejudice to any ruling of the European Court of Justice or the European General Court. Accordingly, the long-standing Court of Justice decision in *Pronuptia de Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis* remains good law. *Pronuptia* provided that many common restrictions in franchise agreements will not infringe Article 101(1) where they are necessary either to protect the franchisor's know-how or protect the identity and reputation of the franchise, and therefore provides some comfort for franchisors seeking to enter the European market. However, this case should be treated with caution because a franchisor's standard franchise agreement may contain restrictions (*e.g.*, territorial exclusivity) that do not meet the *Pronuptia* test and also because the Court of Justice held that otherwise uncontroversial franchises might be capable of restricting competition (and hence infringing Article 101(1)) where the brand concerned was well-known or widespread.

**Recommendations.**

Many US franchisors and manufacturers with existing operations in Europe may already be operating under agreements that will allow them to continue to take advantage of the safe harbor under the new BER. These franchisors and manufacturers should be able to continue business as usual. As for franchisors and manufacturers with existing agreements that may no longer be able to benefit from the block exemption under the new BER, it is important to note that those agreements are not automatically rendered illegal. Instead, they will require individual review by franchsiors and their advisors under Article 101 of the Treaty to assess their compliance with EU competition law.

The Commission granted a one-year transitional phase-in period during which franchisors and manufacturers must determine whether existing agreements fall within the new BER safe harbor. It is recommended that franchisors and manufacturers conduct an internal review of their existing arrangements to ascertain whether they fall within the new BER before the Commission's phase-in period expires on May 31, 2011.

The EU Official Journal's version of the new Block Exemption Regulation and accompanying Guidelines **can be found here**.